Evenlode Investment View

June 2014 – Not All Growth Is Equal

EVENLODE
INVESTMENTS FOR LIFE

The market has trundled along over the last month, with sentiment still generally positive amongst investors and volatility low. Company news flow has been thin on the ground, but what there has been has reassured. Elsewhere, although Mark Carney has been talking up interest rate expectations in the UK somewhat, central bank policy still remains extremely accommodative overall, as demonstrated by recent statements from the European Central Bank, the Federal Reserve and the Bank of Japan.

A Deal Maker's Paradise

With this benign backdrop, investment bankers are starting to enjoy themselves! The flood of initial public offerings (IPOs) onto the market continues at a pace, with IPO activity now approaching levels last seen at the peak of the last cycle in 2007. These IPOs could by no means be uniformly described as 'great businesses at reasonable prices'! In several cases unproven business models have been floated at much higher valuations than established market leaders in the same sector (with multi-year histories of profitable growth).

Another boon for deal makers has been the surge in merger and acquisition (M & A) activity this year. You can sense management teams are feeling the pressure to do deals – financing is available and everyone else is at it (just look at recent activity in the medical devices sector for an example of this herding behaviour). Moreover, revenue growth remains hard to find in a deleveraging world, so the idea of buying growth has a certain short-term appeal.

Not All Growth Is Equal

The historical record suggests that this strategy of 'buying' growth does not have a particularly high success rate. In fact, somewhat depressingly, *less than a third of all acquisitions have been shown to create genuine long-term value for shareholders*.*

Why is this? Acquisitions tend to be made at a time when valuations are quite high but money is cheap, and money is certainly cheap today. So a management team in the mood for empire building can justify pretty much any debt-financed acquisition at any valuation in the current environment. But it's a bit like the owners of Manchester City suggesting recent success is to do with a great youth training system. If you chuck enough money at it, you can buy whatever (or whoever) you want.

The Right Kind of Growth

What is much harder to achieve (in any environment, including this one) is sustainable growth without reinvesting much incremental capital. This attribute is the cornerstone of long-term dividend growth but it's by no means found in every business model. In their 2012 book *Repeatability* Chris Zook and James Allen found that less than 10% of companies are genuine long-term 'value creators'**. That's a remarkable statistic, given that profitable growth is something pretty much 100% of companies aim for! For me, this is a reminder of how rare it is to find companies with excellent micro-economics. As investors we cherish these characteristics when we find them.

Zook and Allen point out that for almost all of these value creators the source of their success has come from a combination of good leadership economics (customer loyalty, strong differentiation etc.) and measured expansion that has largely been organic and incremental. I have talked before of 'hidden champions'*** that occupy a strong position in a niche industry, remaining focused on this specialism long-term (this is an area we don't have much exposure to at the moment for valuation reasons, but we do expect these stocks to play a more meaningful role in the future). They fit the above description of sustainable value creation very well. Examples from our investable universe include Rotork, Renishaw, Spirax-Sarco and Domino Printing. These companies implicitly understand the concept of 'the right kind of growth'. The mantra is *this is what we're good at, this is what we should stay focused on*. They tend to sit out waves of M & A (like the current one) that come and go over the years and their approach to investing for growth is largely incremental - expanding steadily into closely related adjacencies and new geographies. To return to the football analogy these companies really *do* have a great youth training system.

The results from such disciplined focus can be fabulous for long-term results. Rotork and Renishaw have both produced average dividend growth of +10% over the last 15 years, Spirax-Sarco +11% and Domino +15%.

Shrinking To Grow

An important take-away from these hidden champions is that *it's just as important for company management, as well as investors, to appreciate and nurture the excellent micro-economics of a core business*. There are plenty of examples of great companies that have severely damaged their original franchise by failing to pursue a strategy of measured expansion. Think, for instance, of Guinness plc's diversification after the Second World War. Its starting point was a great core business but, by the early 1980s, it had become a sprawling conglomerate of more than 270 businesses ranging from baby bibs to car polish. Or Gillette's expansion in the 1960s and 1970s into oil and gas production and other fairly tenuous strategic moves (e.g. they bought a wig business in the late 1960s!). Both of these companies eventually managed to retrace their way back to their core businesses, but they would have been better off staying focused all along.

In golf you can hit the ball further by slowing down your swing. In gardening, you prune back plants to produce healthier growth. And in business you can often grow more quickly and profitably if you *shrink*.

Conventional management strategy is to focus on turning round underperforming areas in order to revitalise growth. But corporate history suggest that de-emphasising these areas and prioritising the performance of business units with the *best* leadership economics tends to be more effective. Strong businesses, when carefully nurtured, tend to grow stronger over time. Which leads to a paradox that I find very interesting and important: *the better performing business units in a company are actually likely to be those operating the furthest below their full potential*.

There are several case studies in Evenlode's universe that demonstrate this principal of shrinking to grow over recent years. Compass Group, for instance, has exited forty difficult and sub-scale businesses to great effect. The company is now much more focused on markets in which it enjoys scale and leadership economics, and you can see it in the numbers. Elsewhere, recent disposals from Sage and Reed Elsevier reflect companies that have improved their understanding of where their economic strengths lie. Other Evenlode businesses have, in my view, the potential to benefit from increased focus. Take, for instance, the somewhat lethargic conglomerate Smiths Group (a new holding for Evenlode this year). Smiths Group has several core businesses with excellent leadership economics, particularly its specialist engineering business John Crane. But the current conglomerate structure and a series of shorter-term issues are masking their attractions. Glaxosmithkline's recent announcement of plans to dipose of some of its weaker business units (oncology, parts of its legacy asset portfolio etc.) will leave the group more focused on four key market-leading franchises, as discussed last month. Elsewhere, Reckitt's proposal to spin-off its pharmaceutical business will give the group a more tightly defined focus on consumer branded goods.

It is worth noting that other companies in our universe are in the process of expanding by merger or acquisition. Weir Group and Amec, for instance, two engineering franchises that have benefited from increased focus over the last decade have recently proposed expansion through acquisition (though Weir's proposal has now fallen through). We tend to view these steps with some scepticism and do careful work on the strategic, operational and financial implications of big deals.

Three Key Characteristics

Clearly, there is no such thing as a perfect business model. However, to sum up, we think that the following three key characteristics play a big part in producing long-term value creation and sustainable dividend growth:

1) Great micro-economics (brands, reputation, customer loyalty, entrenched distribution network, control of a key element of a wider economic system etc.)

2)Steady, incremental expansion into adjacent markets and geographies that share similar economics with the existing business.

3) A management culture that understands these benefits, nutures them, and returns cash to shareholders when the business doesn't need it (instead of going off and buying a wig business!).

This model is the investment equivalent of jumping over lots of one-foot hurdles rather than trying to set high jump records all the time. Not exciting perhaps, but the risks are lower and this incremental progress can often produce remarkable results over the years.

Hugh Yarrow
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Please note, these views represent the personal opinions of Hugh Yarrow as at 20th June 2014 and do not constitute investment advice.

*e.g. *Mastering The Merger* (Harvard Business School Press, 2004) - Daniel Harding and Sam Rovit found that the average success rates of deals (as defined by creating economic value reflected in the share price) was c30%.
****Repeatability** (Harvard Business Review Press, 2012) - Chris Zook and James Allen found that 9% of companies in the world were able to achieve profitable growth of more than 5.5% in real terms from 2000-2010, while earning their cost of capital - their definition for sustained value creators. 13% of all companies fell into this category for the decade 1990/2000.
*** *Hidden Champions* - Evenlode Investment View July 2011

Footnote: When *Do* Acquisitions Create Value?

While more than two thirds of acquisitions *don't* create value for the acquirer, there are clearly some businesses that *do* make successful acquisitions. So what are the key features of these acquisitions? It would be naive to assume there was one clear recipe, but Zook and Allen suggest successful acquisitions tend to be in or very close to the company's core market. Companies that approach acquisitions systematically also tend to be most successful. This fits with our experience of successful, serial acquirers. Take Halma, Diploma and AB Inbev, for instance, all of which have made multiple acquisitions over the years to supplement their organic growth, which have worked well for shareholders. These companies share the following characteristics - acquisitions tend to be in-market or in closely related adjacencies, the companies have a very clear operational methodology for integrating acquisitions, and they focus on return on capital as a key criteria for running their business. On the subject of AB Inbev, I have recently read *The Big Dream* by Cristiane Correa, which is worth a read. This is the story of the Brazilian triumvirate behind 3G Capital (which recently purchased Heinz in partnership with Warren Buffett). They were central to the transformation of the Brazilian brewer Brahma (acquired in 1989) into AB Inbev, now the world's largest beer company, through progressively larger acquisitions. Though acquisitive, AB Inbev is a company that understands the excellent economics in its industry and the importance of 'focusing on the core'. It has been a remarkably successful operating model and dividend growth has averaged +23% over the last 15 years.