AORIS INVESTMENT MANAGEMENT

Beware the acquirer’s curse

Aoris Investment Management

Aoris is a *specialist* international equity manager founded in 2017.

We are a *focused* business and manage a single international equity portfolio.

Our investment approach is *conservative*, fundamental and evidence-based.

The Aoris International Fund

Our portfolio is long-only and highly *selective*.

We own a maximum of 15 stocks, each of which has considerable breadth or *internal diversification*.

We aim to generate returns of 8–12% p.a. over a market cycle.

Our Quarterly Reports

We are *business owners*, not economists. As such, our reports focus on the performance of our investee companies.

We report on portfolio performance and changes with candour and transparency.

Each quarter, we include a thought piece or feature article on a topic area with direct relevance to our investment approach.

About the cover image: The Colosseum amphitheatre was completed in 80 AD, at the height of the Roman Empire. A key reason for the Empire's fall was overexpansion, making it difficult to effectively control all regions.

This feature article was written by Delian Entchev, our Senior Equity Analyst

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INTRODUCTION

In our September 2020 feature article, ‘Staying clear of the equity market disaster zone’, we identified some characteristics of companies that are more likely to end up in the bottom 20% of the equity market in a given year. For a long-term investor, the positive impact on wealth from avoiding the bottom 20% is massive.

Two of the metrics most often associated with ending up in the bottom 20% were growth in a company’s total assets, and in their share count. Companies with the highest growth in total assets/ share count were 38%/32% respectively more likely than the average company to end up in the bottom 20% of the market.

Rapid growth in these measures usually goes hand-in-hand with large acquisitions, with major deals often funded by issuing equity. Mergers and acquisitions (M&A) tend to be pitched with flashy PowerPoints and lofty promises of growth and cost efficiencies, but there’s a lot that can go wrong.

In this quarter’s feature article we put M&A to the test. We aim to deconstruct the main causes of failure with acquisitions and consider how to stay on the right side of M&A as an investor.

HOW BEST TO MEASURE THE SUCCESS OF M&A?

Most academic research on M&A has been focused on studies of short-term price performance around the announcement of a deal. This may provide an indication of the market’s general (dis) approval of a particular deal, but is not an appropriate measure of long-term success and value creation.

Systematically measuring the success of M&A is anything but straightforward; every deal is different. Metrics like relative share price performance, growth in sales and earnings, and Return On Invested Capital (ROIC) will be affected by various other internal and external factors, and it would be nearly impossible to isolate the impacts of one particular acquisition, especially for companies that have made multiple acquisitions. There may also be strategic reasons for a deal that aren’t immediately obvious in the financials. Finally, M&A can take years to fully integrate and even longer for its fruits to be borne in the financials, so over what time frame should it be assessed?

Instead, we study a combination of the quantitative and qualitative aspects of each individual deal, and make a subjective judgement as to whether it has been Successful, Unsuccessful or Inconclusive. The Inconclusive deals are then excluded from our study. Some of the factors we consider are:

Successful	Unsuccessful	Inconclusive
- Positive feedback on the deal from competitors. - If the acquirer later sells the same business for significantly more than they paid for it. - In the absence of other M&A, if the acquisition marks a clear positive inflection in the financials of the acquirer. - Clear and validated media coverage, e.g. that the acquisition is resulting in market share gains or improved growth/margins for the acquirer.	- There has been meaningful write-down of the acquired business. - The debt burden from the acquisition has necessitated the acquirer to raise equity or sell assets. - If the acquirer later sells the same business for less than they paid for it, or at a poor rate of return over the time they owned it. - If a key product from the acquired business has been decommissioned (e.g. if an acquired drug isn't approved). - If there is evidence of fraud or other serious governance concerns arising from the acquisition.	- The deal is too recent (usually within the last five years) to clearly assess its success. - In general, if there are simply insufficient proofpoints to assess a deal's success.

Our study looks at the largest 1000 M&A deals by transaction value over the last 50 years, ranging in size from US$5 billion to US$150 billion. We only include deals where there is a single, publicly listed acquirer, which provides us with clearer information to assess the success of its acquisitions. We exclude acquisitions by private firms, groups/consortia of companies, joint ventures and private equity firms. All financial data is sourced from FactSet.

SUMMARY OF FINDINGS

The failure rate of M&A in our study was 59%.

An initial observation as we started to comb through the data was that the scale of M&A is mind-boggling. Over the last five years, there have been an average of 50,000 acquisitions completed per year around the world – that's one deal every 10 minutes!

We also noticed that five industries were notably over-represented relative to their weighting in global share markets, comprising 71% of the total deal values in our study: Banking & Insurance, Pharma & Biotech, Materials & Energy, Telecoms, and Utilities. We exclude all five of these industries from our investment process because their internal growth is too dependent on external factors like economic cycles and regulation, and so it's no surprise that they turn to M&A for growth.

The failure rate of M&A across our study was 59%. Two main characteristics were found to affect the probability of failure, which we will explore in the rest of this feature article: the size of the deal, and how far the acquirer is straying from their core business.

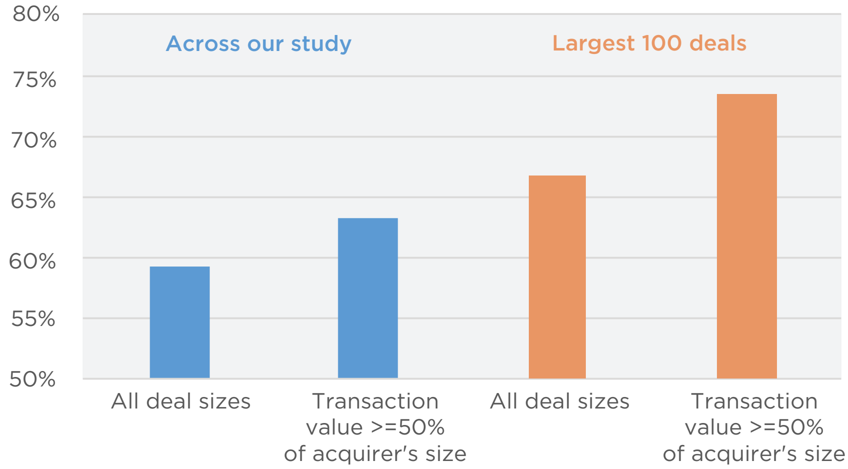
BIGGER ISN'T ALWAYS BETTER

At Aoris we have a natural aversion to firms that have made meaningful acquisitions relative to their size. Acquisitions are difficult undertakings on any day of the week. There are often significant complexities and challenges in integrating cultures, accounting and IT systems, and organisational structures. The larger the deal, the more there is that can go wrong. In the meantime, the integration effort is a distraction that can compromise the performance of the acquirer's core business.

We would expect this to be reflected in a higher failure rate for larger acquisitions, which is what our study found. The failure rate for the largest 100 deals in our study (67%) was higher than the average deal (59%). In both instances, the failure rate was higher again when the acquirer was buying a business at least 50% as large as itself.

Acquisitions are more likely to fail when they are meaningful relative to the acquirer's size.

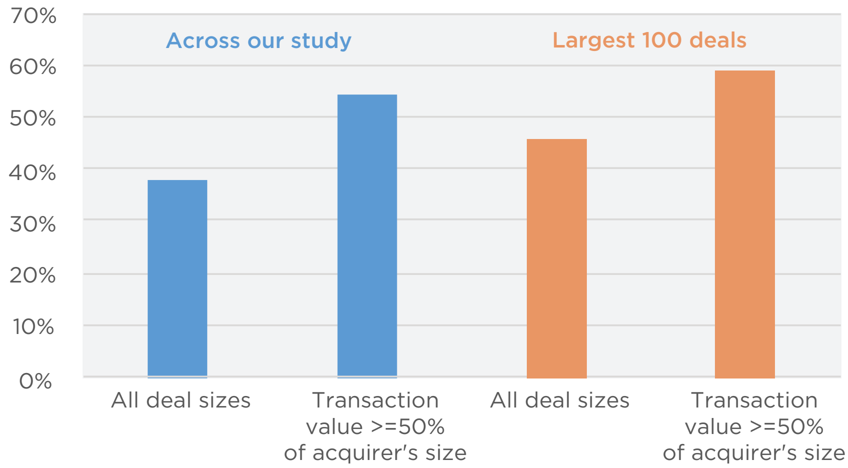
Failure rate of acquisitions



Source: Aoris research, FactSet

For the deals that did fail, we found that in 38% of cases the acquirer became overly indebted as a direct consequence of an acquisition, which necessitated an equity raising, asset sales, and in some cases resulted in bankruptcy. The percentage of failed deals where the acquirer ended up overly indebted was higher for the larger deals, and even more so when the deal size was at least 50% of the acquirer's size.

% of failed deals resulting in financial distress for the acquirer



Source: Aoris research, FactSet

Unfortunately for shareholders, numerous studies have shown that the variable most highly correlated with a CEO's pay is the size of the firm they run, much more so than its operational or even share price performance. In fact, a 2011 Cornell research paper found that for every 10% increase in a company's size, the CEO's pay increases by an average of 3%. The median deal in our study had a transaction value that was 32% the size of the acquirer, so hefty rewards are at stake.

STRAYING TOO FAR

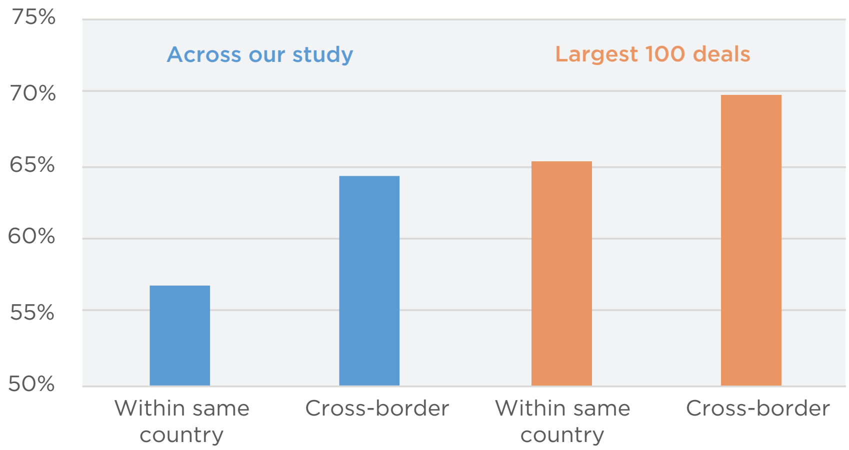
M&A that takes the acquirer beyond their core line of business is much more likely to fail.

Although M&A is often assessed through a financial lens, cultural and strategic fit are also crucial to the success of any deal. As always, there are exceptions, but in general we are cautious when we see businesses straying beyond their core into unrelated areas. Our process favours companies with a clear purpose and a strong core business, where there is a clear line of sight to durable growth.

Meanwhile, firms that are finding it challenging to grow in their existing lines of business might be more tempted to venture overseas or into other industries.

In our study, cross-border M&A had a much higher likelihood of failure than those within the same country. The risks associated with cross-border deals were also magnified for larger deals, as represented by higher failure rates in the top 100.

Failure rate of acquisitions based on geography



Source: Aoris research, FactSet

Why might this be?

- Some business models are simply not as relevant in different parts of the world.
- For some business models, local leadership also matters more than being global – for instance, Nike is a very successful global brand that can leverage its strengths in product innovation and marketing globally; whereas Westpac's Australian banking business wouldn't become any stronger if it acquired a Canadian bank.
- When entering a new market it can take time for a business to understand and adapt its products to the local culture, regulations and customer needs.
- Finally, there may be cultural differences or clashes that affect the ability to integrate the businesses successfully.

Our research also suggests challenges with expanding into a new industry through acquisition. A whopping 75% of deals failed when the acquiring firm was buying a business in a different industry, which was consistent across all deal sizes.

Failure rate of acquisitions by industry

Source: Aoris research, FactSet

The difficulties that acquirers can encounter with cross-industry M&A are similar:

- The competitive strengths of the acquirer may not be relevant to the new industry.
- The acquirer may take time to develop their understanding of the new industry's customer needs, regulations and other nuances, which are learned through experience. Rio Tinto is a successful iron ore miner, but management underappreciated the different characteristics of the aluminium industry with its disastrous Alcan acquisition.
- There may be cultural differences between industries that lead to integration issues. For instance, a key contributor to the failure of AOL's infamous acquisition of Time Warner was the cultural clash between AOL's 3000 new economy pioneers and Time Warner's 80,000 old media mavericks.
- Management and the business's resources can become spread too thinly and lose focus on the core business.

OUR EXPERIENCE WITH S&P GLOBAL

In December 2020 S&P Global announced the US$44 billion acquisition of IHS Markit, bringing an early end to our investment in the business, which we sold the day after the deal was announced. Both aforementioned deal characteristics – size, and straying from the core – were considerations in our decision.

This is a large deal that will increase the size of the business by 50%. The dreaded word 'transformational' was used in the analysts' call to announce the deal. The purchase will be paid for entirely by the issuance of new shares, and our ownership would have been diluted to 67% of the enlarged entity. Such a large combination has introduced substantial risks of distraction and integration.

Furthermore, one of the initial attractions of S&P Global was that it had over the course of many years undergone a corporate Atkins diet, selling off lower-quality businesses like education publishing to refocus on its truly special financial data businesses, including the S&P credit rating agency, S&P Indices and the Platts commodity pricing benchmark. By contrast, IHS Markit is a provider of data across disparate markets, from credit to energy, to automotive to engineering, and in our view, none of its businesses are as good as those of S&P Global.

BREAKING THE CURSE

Smaller bolt-on acquisitions are more likely to succeed than large, transformative deals.

What if we take a look at the flipside – is there a repeatable model for M&A success?

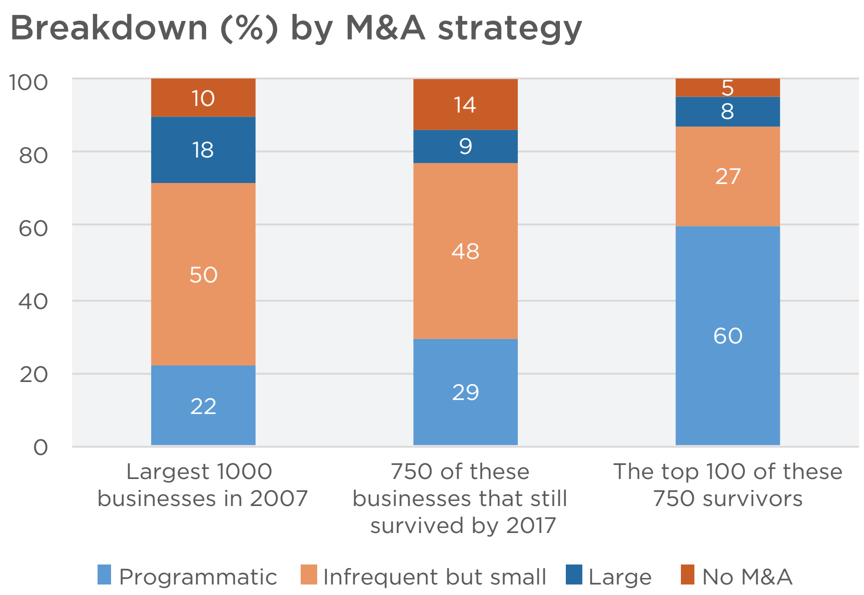
Multiple academic studies, including by Harvard and McKinsey, have shown there is a much higher likelihood of M&A success for businesses with a deliberate strategy of making many regular but small bolt-on acquisitions that are related to their core business. A larger number of these small acquisitions gradually evolve the business over time, rather than betting the house on episodic and transformative 'big bang' transactions.

McKinsey's researchers separated the largest 1000 businesses in 2007 into four buckets based on their M&A strategy:

- 22% of these companies were 'programmatic' acquirers as described above, where a regular pace of small bolt-on acquisitions is a core part of the company's strategy
- 50% made acquisitions irregularly and of an insignificant size
- 18% made only large acquisitions
- 10% hadn't made any acquisitions at all through their history

They then analysed how these businesses looked 10 years later, in 2017. A quarter of them had dropped out of the top 1000, either because they had been acquired themselves, had lost relevance, or had gone out of business altogether.. A much greater proportion of the businesses that survived were programmatic acquirers compared to in 2007, suggesting that these businesses are more durable and resilient. The drop-out rate was highest for the serial large acquirers, with half of them no longer being in the top 1000.

Even more tellingly, of the companies that survived, the top 100 companies were disproportionately represented by programmatic acquirers. So, companies applying this strategy consistently are more likely to become or remain market leaders.



Source: McKinsey Global 1000 Corporate Performance Analytics

McKinsey later surveyed the companies' management and found that programmatic acquirers tend to have a clear playbook for making deals, make better-informed and more considered decisions around whether to proceed with a deal, and have fewer integration issues with these smaller-sized deals.

There are two great examples of this programmatic M&A strategy in the Aoris portfolio:

Amphenol is a world-leading producer of electronic connectors and sensors. It operates in a very fragmented industry, and a key element of the company's strategy has been to acquire leading connector businesses operating in particular niches, often purchased from the founding family. These bolt-on acquisitions have been consistently successful over many years in creating value for Amphenol shareholders. Their success is supported by Amphenol's decentralised structure, which is in fact a collection of 120 businesses run by general managers that are fully empowered and accountable to their decisions.

Accenture is the world's largest IT consulting and outsourcing company. It helps its clients deal with change and complexity, and has done an admirable job of remaining relevant and continuing to grow market share amid rapid technological change. One way it does this is through a regular program of small bolt-on acquisitions, on average one per week, adding talent to build on the range of problems it can solve for clients. They have achieved an exceptionally high success rate, and typically the businesses rapidly integrate into Accenture. An example of this strategy in practice is that it built the world's largest digital advertising agency, Accenture Interactive, through a series of small acquisitions over the course of just a few years.

CONCLUSIONS

Our research found that on average, M&A is more likely to fail than succeed. Moreover, the chances of failure are especially high for acquisitions with these two characteristics:

- With larger deal sizes, especially relative to the size of the acquirer.
- When the acquirer is buying a business in a different country or industry.

At Aoris we want to own businesses that are already market leaders, with strong core businesses that can grow for a long time. In cases where a company is expanding into a new business area, we prefer to see a more considered approach rather than bet-the-house transformative acquisition. Our investment process favours businesses whose acquisitions are the bolt-on, easily integrated type.

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Get in touch

T +61 2 8098 1503
E info@aoris.com.au

www.aoris.com.au

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