Mr Bearbull October 2 2019

Practice makes perfect

Mr Bearbull

When Dave Packard was asked to explain the success of **Hewlett-Packard** (US:HPQ), the one-time technology titan he founded with Bill Hewlett, he said: “We try a lot and keep what works.” If this is a generic formula for corporate success, we might tweak it to another: “Buy a lot and keep what works.”

True, it is not supposed to be like that. Conventional wisdom says companies that buy a lot – ie, rely on acquisitions for their growth – don’t prosper in the long run. It is almost axiomatic that transformative deals transform, but not in a good way. The archetype is the infamous $160bn merger of Time Warner and AOL in 2000, which soon after was dubbed “the biggest mistake in corporate history” by Time Warner’s boss.

Lots of small deals are supposed to sap value, too. In the short term, they buy earnings growth, which offers the appearance of success. Longer term, however, they land a hyperactive acquirer with too much dross, too little identity and too many management hours devoted to fire fighting.

If the image of the transformative deal remains accurate – think of bosses suffering a combination of delusion and hubris – the picture of what we might label the ‘accretive deal’ – a little and often – may need revision. At least, management consultant McKinsey reckons that lots of small deals can add up to lots of value added because practice makes perfect, or it can do.

McKinsey uses findings from data for the developed world's 1,000 biggest quoted companies by market value to show that, in the overlapping periods 1999 to 2010 and then 2007 to 2017, those that made lots of small acquisitions – "placing multiple bets and being nimble with capital" – produced better shareholder returns than both the average and those that pursued other growth strategies. The worst-performing group in 2007-17 were those companies that did just a few big deals, yet even those companies that relied on 'organic' growth – ie, capital spending on their own operations – did worse than the 'little-but-often' group.

Two further findings stood out. First, excess shareholder returns rose in line with the number of bolt-on deals. So, those companies that averaged two to five deals a year between 2007 and 2017 generated annual returns of 0.5 per cent above the average. Those that made over five deals averaged 0.7 per cent in excess returns.

Linked to that, these 'programmatic acquirers' were much more likely than average to be among those who remained in the elite 1,000 between 2007 and 2017. Of the 178 companies relegated from the Global 1,000 over that period, just 8 per cent were programmatic acquirers. Similarly, these acquirers were over-represented among both the 250 and 100 biggest companies at the end of 2007 that remained in those sections at the end of 2017. They accounted for 48 per cent of the 157 survivors from the top 250 and 60 per cent of the 65 survivors from the top 100.

As to why serial acquirers make better acquisitions than rival companies, according to McKinsey it is because each will have an effective M&A blueprint, which embraces all aspects of the process from defining a business plan, to finding likely targets, doing due diligence and integrating new subsidiaries. Its effectiveness means such companies will understand the forces shaping their markets, how their sectors are likely to evolve, what competitive advantages they have, what capabilities they are seeking and whether companies offering them are overpriced.

This enables serial acquirers to burrow into acquisitions quickly and effectively. Quite likely, they will plan the details of integrating a new subsidiary well before the deal has closed. Simultaneously, they will pay close attention to the corporate culture of their targets. So much so that, in the case of one technology company mentioned by McKinsey, when teams were integrated after a deal, selections were tilted towards candidates from the new subsidiary on the logic that a built-in bias towards employees from the acquirer would favour home-grown employees and needed to be countered.

If this sounds too good to be true, it could be. After all, it is easy to recall the fate of serial acquirers among UK companies that eventually fell apart – textbook cases from the 1980s, such as Hanson and BTR; or more recently, and still going, **Rentokil Initial** (RTO). Meanwhile, current takeover-crazy companies, such as **Capita** (CPI), **Dignity** (DTY) and **Mitie** (MTO), are diminished versions of their former selves.

Yet it is also easy to forget that for many years those companies made serious money for their shareholders. Besides, they may be unrepresentative of serial acquirers. In contrast – although probably also unrepresentative – take three still on the acquisition trail: **Dechra Pharmaceuticals** (DPH), **Intertek** (ITRK) and **Bunzl** (BNZL).

In the past 10 years Dechra has made 15 deals with an average size of £55m, Intertek has done 36 at £42m on average and Bunzl has maxed out at 95 deals (no data for average size). Granted, their share price performance over that period has been in inverse relationship to deal-making. Dechra's shares are the top performer (up 550 per cent), followed by Intertek (up 329 per cent) and Bunzl (up 228 per cent). But all three have skinned the FTSE All-Share index (up just 53 per cent).

The moral is that, at the very least, the built-in investment bias against serial acquirers needs to be countered. The assumption that, in the long run, they destroy value might be too lazy. It could be, as McKinsey suggests, that practice makes perfect.