The Best Defense Is A Good Offense

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Readers will be forgiven for groaning over the title of this piece and assuming that what follows is another tired and hackneyed “business is sports” cliché. In fact, the notion that the best defense is a good offense originates not in sport, but rather has been attributed to George Washington, who in 1799 wrote, “…make them believe, that offensive operations, often times, is the surest, if not the only (in some cases) means of defense”. Similarly, Sun Tzu, the Chinese military general, writer and philosopher centuries earlier in The Art of War wrote that “Attack is the secret of defense; defense is the planning of an attack”. With that said, we turn our focus to how this notion applies to investing.

In the wake of the deepest recession of our lifetimes, scores of companies have been severely harmed or even bankrupted. This is an unfortunate but entirely natural fallout from the downturn phase of an economic cycle. Fortunately, the weight of economic downturns doesn’t fall evenly on all companies – many operate in recession proof or recession resilient businesses like utilities, telecommunications, e-commerce, health care, grocery, etc. Still others take deliberate and strategic steps to turn recession to their advantage – growing, expanding and further entrenched their competitive position and industry leadership while rivals stumble and fall around them – playing offense while everyone else plays defense. Specifically, we refer here to companies that skillfully deploy shareholder capital countercyclically to grow via mergers or acquisitions.

By way of preamble, the holy grail of equity investing is earnings per share (EPS) growth. EPS growth comes in different forms and is valued hierarchically by investors, with organic growth most valuable, cost-cutting strategies least valuable and financial engineering and inorganic growth occupying the middle ground.

**Organic growth:**

- stems from existing assets, products, services, go-to-market strategies, research & development and new investment
- companies that innovate, create, define, and come to dominate a new or emerging product or service category
- in prior eras, companies like Coca-Cola, Microsoft, Xerox and Kodak exemplified this type of growth
- today, companies like Apple, Netflix, Facebook, Google, Amazon, Tesla and Shopify, several of which we own in our U.S. portfolios, are among the world’s most recognizable and valuable companies
- these pioneers can become so ubiquitous and synonymous with the category that their name becomes a common noun or a verb in everyday usage ("Make a xerox of that letter", “Pass me a kleenex”, “google that topic”)
- originates from proprietary assets or intellectual property and has a long runway of opportunity, making it the most valuable form of growth
network and scale effects often apply such that growth further entrenches the company’s competitive positioning

• growth may require limited new capital, so profitability metrics like return on invested capital and return on equity are very high

Cost cutting:

• Investors are least apt to reward this type of earnings growth with high stock market valuations

• fundamentally constrained – at the extreme limit, costs can only be cut to zero, and obviously in most cases by much less, whereas revenues for rapid organic growers can in theory grow without limit

• boosts short term profits but risks cutting “muscle” (i.e. important but costly research & development, key personnel layoffs that erode important institutional know-how or jeopardize important client relationships, facilities closures that lengthen supply chains or alienate clients) as opposed to “fat”, which destroys long term shareholder value

Financial engineering:

• mathematically grows earnings \textit{per share} while net income stagnates or grows slowly by substituting currently very inexpensive bond or bank financing for equity capital by buying back shares in the open market

• this type of growth is also finite - eventually the company runs out of free cash flow and borrowing capacity to fuel the strategy – and accordingly investors downplay it

Inorganic growth:

• growth via mergers and acquisitions

• investors systematically and severely underestimate and undervalue these companies

• we capitalize by owning these stocks, especially in Canadian portfolios, given the relative dearth of bona fide organic growth in Canada.

Some Canadian companies we own that have excelled “on offense” this past year, successfully and profitably growing via acquisition include: Intact Financial, TFI International, Alimentation Couche-Tard, Open Text and Curaleaf Holdings. For context, analysts forecast overall earnings per share for S&P TSX Composite index constituents fell 34% in 2020 compared with 2019. By contrast, each of these companies, most of whom are accomplished serial acquirors, earned record profits (or in the case of Curaleaf, which has a short operating history, record low losses) in 2020.

Intact Financial:

• acquired Guarantee Company of North America and Frank Cowan Co. in a $1B deal, as well as On Side Restoration in a smaller transaction of undisclosed size

• announced a $12B deal to acquire RSA International, putting them on them map in the U.K. and Denmark and taking their already leading share of the Canadian property and casualty insurance market from 17% to 22%

• if analysts’ forecasts for their 4th quarter prove accurate will have grown EPS by 47% in 2020

TFI International:

• completed 8 small-to-mid-sized acquisitions during the first nine months of 2020, including several bargain-basement purchases of operating divisions and assets of bankrupt or distressed rivals

• acquired for $225m DLS Worldwide Logistics from printing company R.R. Donnelly & Sons during Q4, expanding their parcel & logistics capabilities whilst e-commerce drives rapid growth in this segment of the trucking industry

• Grew EPS by 5% in 2020 if analysts’ forecasts for Q4 prove correct - in a business that is cyclical and capital intensive
- Very recently announced the $800m purchase of the “less than truckload” division of U.S. shipping giant UPS in a deal described by their CEO as their “most strategic ever” in a long string of 90 transactions over the last 12 years

**Alimentation Couche-Tard:**
- for $479m acquired Convenience Retail Asia BVI Ltd., a Hong Kong based licensor of their Circle K banner, planting a flag on Asian soil and opening the door to a repeat of their success consolidating the fragmented North American convenience store market with the backdrop of a fast growing, urban & high density, less auto-dependent geography
- increased their stake to 59% in Fire & Flower Holdings, a leading & rapidly growing cannabis dispensary chain
- a knockout bid of $28B from rival 7/11 thwarted their attempt to acquire Speedway from Marathon Petroleum
- walked away from a $6B bid for Caltex in Australia as pandemic travel restrictions frustrated their due diligence efforts and as business conditions deteriorated rapidly for Caltex
- very recently blocked in their $25B bid for French grocery giant Carrefour by the French government
- grew EPS by 6% over the latest twelve months despite a clearly unsatiated appetite for transformative acquisitions

**Open Text:**
- late in 2019 for $1B acquired Carbonite, a cloud-based subscription data protection, backup, disaster recovery and endpoint security business, extending their reach beyond large global enterprises into small and mid-sized businesses
- in September, acquired Solutions Xmedius, another cloud computing business for $75m
- Earnings per share grew by 22% over the latest twelve months

**Curaleaf Holdings:**
- acquired Grassroots for $895m, expanding their dispensary footprint into the U.S. Midwest with a leading market share position
- acquired Select for $728m, and with it a nationally scalable, well-recognized brand in various cannabis formulations
- achieved operating profit (EBITDA) growth of 357% in 2020, if analysts’ forecasts for the fourth quarter prove correct

As a group, these companies last year generated total shareholder returns (dividends plus share price appreciation) that were universally positive, ranging from 3% to 86%, with an average of 32%, as compared with a return of 6% for the S&P TSX Composite index, leaving little doubt that the best defense for these companies was indeed a good offense. Longer term, the advantage of their strategies is clearer still, with total returns over three years ranging from 34% to 106% and averaging 60% (excluding Curaleaf which lacks a three year history) as compared to the S&P TSX Composite index three year return of 17%. Over ten years, the advantages and compounding benefits of this outwardly focussed, consolidation and growth strategy are staggering, with total returns for Alimentation Couche-Tard, Open Text, TFI International and Intact Financial of 1066%, 455%, 667% and 325% respectively versus a total return of 88% for the S&P TSX Index Composite index. Moreover, the strong returns over the full 2010-20 decade demonstrate that growth by acquisition strategies are both sunshine and rain success stories, working as well during economic expansions as during downturns.

At this point, academics and readers of financial white papers might reasonably object to the conclusions above, citing reams of empirical research over decades finding that the majority of corporate acquisitions primarily enrich shareholders of the target companies, who benefit from a takeover premium offered for their shares while destroying value for the acquiror’s shareholders. This is indeed true, but the two findings are not contradictory. Rather, it is simply the case that there are success criterion and markers that can help growth-minded investors identify capable acquirors, just as there are success criterion and markers useful to income investors evaluating whether a company’s dividend is sustainable, as we wrote about in our e-article entitled [How Safe is that Dividend?](#). It’s also true that most active investment managers underperform their benchmarks over time, but as active managers ourselves endeavouring to outperform a benchmark, we’re not interested in the statistical “many”, but rather the select “few” companies that
can execute this growth by acquisition strategy to the benefit of their shareholders, and lay out below our principles for identifying them.

1. **Management shareholder alignment**: the best way to ensure this is to invest in founder managed companies, but failing this, one of the best signs of good management shareholder/alignment is skin in the game – management and directors owning meaningful stakes in the company, preferably via direct ownership of shares, or alternatively via restricted share units or stock options. Nothing focusses the mind quite so well as monetary incentive, ideally through equity ownership supplemented by measurable and transparent incentive compensation metrics that appropriately reward profitable and sustainable growth as opposed to just growth for growth’s sake - which can lead to unwieldy and unprofitable empire building and vanity projects.

2. **Acquisitions that are strategically in scope**: good acquisitions are complementary and synergistic to a company’s existing business, and often involve either horizontal mergers where a company acquires a rival to expand it’s market share, or vertical integration where a company acquires a supplier or a customer to capture more of the value chain in it’s marketplace. Other sensible acquisition rationales include geographic expansion, extension of capabilities/intellectual property and acquiring footholds or platforms for entry into logically adjacent product or service categories. The antithesis of a strategically sound acquisition, to illustrate with several absurd examples would be Facebook acquiring General Electric, or Suncor acquiring Blackberry, for instance, where there are no logical rationales for the transactions. Real life examples of hare-brained deals predicated solely on the flimsy thesis that bigger is always better would be the flurry of mergers and acquisitions in the junior cannabis industry from 2015-19.

3. **Synergies**: synergistic deals are those where 1+1 = 3. Good acquisitions present opportunities for synergies, often in the form of operating cost reductions, capital cost reductions or cost-of-capital advantages. Most common are operating cost reductions, typically via personnel redundancies, facilities redundancies, greater procurement clout with suppliers or leveraging shared services (HR, legal, accounting, IT, etc.) Capital cost reductions occur when companies combine and can grow more efficiently by building, for example, one large factory, distribution centre or store as opposed to two mid-sized and less efficient sites, at perhaps 20-30% lower overall cost. Cost-of-capital advantages arise when companies combine to form a financially stronger and thus less risky entity that can accordingly borrow at lower rates or issue shares at higher valuations. Lastly, some mergers bring about revenue synergies, facilitating cross-selling of company A’s products & services to company B’s clients, or vice versa.

4. **Financial accretion**: good acquisitions increase earnings per share, ideally immediately, but at a minimum over the medium term (3 years) as the companies are integrated and synergies realized. Beyond this, good acquisitions should not degrade a company’s overall profitability as measured by ratios like return on equity or return on invested capital.

5. **Sensibly financed**: good acquisitions don’t expose the acquirors shareholders to undue financial risk, by burdening the balance sheet with excessive debt, risking credit rating downgrades and financial distress in a downturn.

6. **Industry structure**: fragmented industries are a target rich environment for acquisitive firms as many small, sub-scale players exist. Many of these may be privately owned with motivated sellers who wish or need to monetize the business for personal reasons. Larger consolidators can typically operate these businesses more efficiently than smaller rivals, and accordingly the acquired assets hold higher value in their hands. A corollary to this is opportunities that arise from “de-conglomeration” when for instance, as noted above a printing company like R.R. Donnelly decides that trucking products to customers is not a core activity for them, creating acquisition opportunities for a trucking specialist like TFI International, or alternatively, big oil integrated companies divesting gas stations and convenience stores, creating acquisition opportunities for a company like Alimentation Couche-Tard.

7. **Price discipline**: good acquirors are dispassionate allocators of capital, just as good investors are, and are accordingly price sensitive, willing to walk away from the bargaining table if the price for a target exceeds their assessment of its value. Price discipline was evident last year when in the scenario described above, Alimentation Couche-Tard walked away from the bidding table for Marathon Petroleum’s Speedway division.

8. **Global players**: the best acquirors cast their nets far and wide. Just as the Canadian Olympic hockey team is likelier to win a gold medal when the best players are chosen from across the country vs. solely from Corner Brook, NL, the likelihood of an acquisition ticking all of the above boxes rises when the opportunity set is global. Good acquirors identify, complete, integrate and operate acquired businesses globally. This requires leadership depth and an understanding of foreign market regulations, antitrust laws, supply chain nuances, competitive dynamics within the industry, as well as cultural/linguistic and labour market norms, among other things.
9. **Track record:** notwithstanding the above, which any investor relations rep can spill out eloquently on a PowerPoint slide, successful acquirors tend to be dominant operators within their industries. Given the adage, “walk before you run”, where a company struggles to manage its existing business, one would hardly expect resounding success should they expand it. Accomplished acquirors have experience, ideally spanning a full business cycle of sourcing, integrating and operating acquired assets successfully and profitably, demonstrating that they can “walk the walk”.

Investors quite rightly view acquisitive companies with a healthy dose of skepticism, given the plethora of research showing that most mergers and acquisitions destroy shareholder value for the acquiror. However, a robust research process using these criteria can de-risk inorganic growth focussed portfolios as these highlighted companies demonstrate. Moreover, growth strategies need not be of the “either/or” variety. While many of the companies cited above compete in low organic growth industries (trucking, convenience stores, property & casualty insurance), still others compete in moderate growth industries (enterprise software) or even rapidly growing, emerging new industries (cannabis). Finally, the real opportunity for investors lies in the pervasive discount these types of companies trade at in the marketplace, with the four profitable companies cited above (excluding Curaleaf which has not yet scaled up to profitability) trading at price/earnings ratios between 14-16x, with an average of 15x, versus a price/earnings ratio for the overall S&P TSX Composite index of 17.5x, despite significantly better historical and prospective EPS growth prospects for the acquisitive companies. Simply stated, the current investor fascination and infatuation with the dynamic organic growth leaders of today has bid up their share prices to very high valuations in many cases, while leaving this other category of outwardly focussed growth stocks overlooked and undervalued – an opportunity our research process poises us to capitalize upon.