Jeremy Grime's Weekly Commentary

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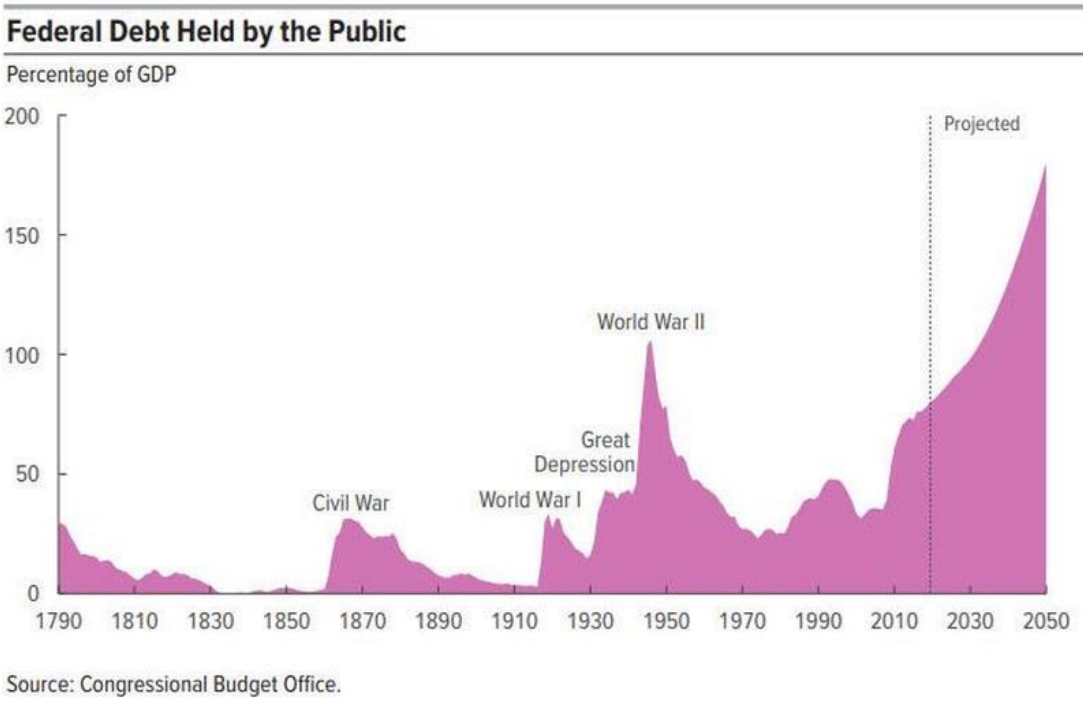
Acquirers in a low interest world

Milton Friedman first coined the phrase "helicopter money" in 1969 in his economic parable. The basic principle was that dropping money from a helicopter would encourage people to spend the money increasing economic activity and pushing inflation back up towards the target level. I found myself wondering how many helicopters exist in the US. There are apparently 9,393 commercial helicopters which may all be needed in the years ahead as all the newly printed money needs distributing if this chart is to be believed.



For individuals that can't repay their debt there is the prospect of bankruptcy, but this option doesn't exist for governments. Their only option is to inflate the assets, so the debt starts to look smaller in proportion to the debt. It seems impossible with projected debt heading towards double the level of WW2 not to have direct cash transfers from the government to inflate assets. The results of quantitative easing started to show with the unicorn valuations, but it looks almost certain to continue. So far, the effect of cheap money has been to inflate investment valuations but in order to enjoy the multiplier effect and stimulate the consumer governments will have to get the money spent rather than invested on the back of cheap debt.

When the government choppers come to drop money on us however, it is very possible that we will save the money rather than spend it. It doesn't really matter to an investor. If the money is saved market valuations increase and if it is spent company profits increase. All we can be sure of is that this is not a time to hold cash. That is the only certain way to lose.

Investment Style

The unicorns have long bolted the valuation stable, encouraging many pretenders, and the quality large stocks have had a re-rating evidenced by the outstanding performance of Lindsell Train, Fundsmith. Yet over the last 12 months Lindell Train Global Equity fund performance is ranked 225 out of 323 and 332 out of 332 over 3 months. Fundsmith performance is also fourth quartile over the past 6 months as value investing has enjoyed a long overdue renaissance. The problem is however that value investing requires undervalued stocks to be sold when the reason for investing changes (i.e.: the valuation improves) and so doesn't work for "buy and hold" investing. And if we are investing because we don't want to hold cash, we are taking a longer-term view than a value investor.

Consequently, we need to find the quality stocks rather than the value stocks as over time the bulk of the return will come from the performance of the company rather than the change in valuation. Judges Scientific and Scientific Digital Imaging are two stocks that are widely acknowledged as quality, who have carried out "buy and build" strategies to shareholders benefit. The share prices of these stocks are up 223% and 901% respectively over the last 5 years. The ROE's are 40% and 21% respectively. In a fragmented industry where capital use is light companies with good reputations can be acquired for reasonable value to the benefit of shareholders. It may be that this is where the smarter investor can outperform the large quality investors such as Fundsmith and Lindsell Train. But we need to check that these companies are able to add value through acquisitions. There are frequently "pretenders" in the space.

Buy and Build

Companies that have been pursuing a buy and build strategy have generally performed well. On average the buy and build companies below have produced 479% share price increases over the last 5 years. The average ROE is 34% and the average PE of 26 is a premium valuation.

Name	Price	fc PE	Yield	Mkt Cap.	ROE	EV / turnover	EV / EBITDA	Price/NAV	Price/NTAV	%chg 1y	%chg 5y
	(p)	X	%	£m	%	X	X	X	X	%	%
AFH Financial	390	11.8	2.5	167	14.6	2.3	10	2.1	-6.5	13	159
Ideagen	201	34.1	0.1	455	17.2	9.8	32	6	-25.9	42.6	412
Judges Scientific	5310	25.1	0.9	332	41.8	4.3	22.1	10.8	31.2	104	226
Keywords Studios	1311.5	33.1	0.1	856	17.4	4.2	24.2	5.2	81.3	21.4	795
Learning Technol.	151.7	33	0.5	1,014	17.2	10.9	36.1	6	-13.8	95	640
Next Fifteen	517	14	1.7	448	29.7	1.7	10.9	3.8	-31.5	7.15	220
S4 Capital	194.5	35.5		913	115.8	16.7	195.1			44.6	
SDI Group	89.8	25		87	15.2	5.1	23.3	5.1	-809.1	153	898
Average		**26**	**1**		**34**	**7**	**44**	**6**	**-111**	**60**	**479**

Source: SharePad

The outstanding performance of these companies is down to effective capital allocation which in my view is the single most important thing for investors. Most investors spend more time discussing valuation or growth when these are far smaller determinants of the investment return than capital allocation.

Risks

Acquisitive companies are risky because integrating acquisitions carries risk by definition. There are plenty of examples of deals destroying companies and sometimes companies make acquisitions because the existing business has become ex growth. But a carefully planned and well executed M&A strategy can be hugely accretive in a fragmented industry. But only if the acquisitions are of reputable businesses. I don't ever recall a company announcing it has made a bad acquisition. The signs of a bad acquisition need to be spotted in the report and accounts, or anecdotally in the behaviour such as stopping acquisitions, as AFH Financial have recently announced. When companies stop acquiring the organic growth often disappears for two reasons:

- **Firstly,** there is no standard reporting of how organic growth is calculated. Because acquisitive companies need a high share price with which to issue shares they will include as much as they can in organic growth. Mattioli Woods, for example, includes acquisitions as non-organic for two years and then in the third year drops the acquired business into organic growth making the year 3 organic growth rather high. And cross selling new services to an acquired customer base is usually counted as organic growth.

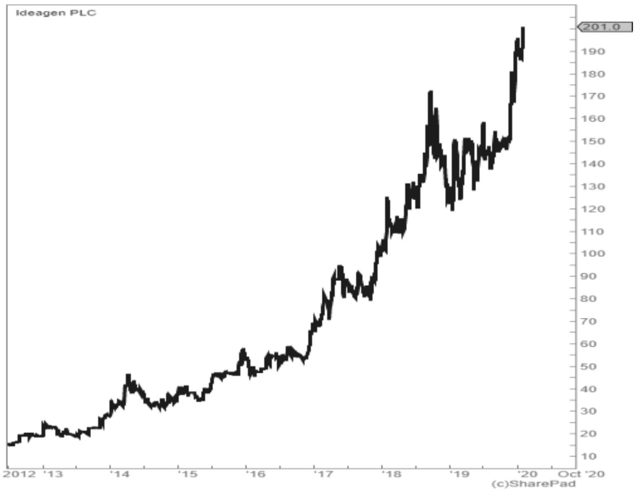
- **Secondly** the culture of a business can change when acquisitions cease. Acquiring can be an invigorating process and once the adrenalin goes heads sink lower at desks and the sales push weakens.

Then there has been a long history of acquisitive companies using dubious accounting practices to flatter their results which ultimately becomes unsustainable resulting in shareholder pain.

A reader requested I take a look at Ideagen, which is one of the buy and build companies which has performed well over the years for investors evidenced by the share price chart below. A check of the report and accounts may throw some light on whether the past performance is likely to continue.

Ideagen

Share Price 201p
Mkt Cap £455m



Source: SharePad

Deferred consideration At April 2019, the date of the last report and accounts, the company had £769k contingent consideration expected to be paid on the acquisition of InspectionXpert Corp. A check back to the original acquisition terms shows a $1m earn out subject to performance conditions. That suggests the business is performing well and the majority of the earn out is likely to be achieved. At the interims last month contingent consideration of £500k is accrued for the acquisition of Redland in June 2109 which is the maximum amount of performance related consideration indicating the acquisition is performing well.

Revenue recognition Software sold as a service is invoiced in advance and revenue deferred over the period of the customisation work. With revenue from this being £13,727k and £18,579k last year this suggests the work is either accelerating or it is expected to be carried out over more than 1 year. Both of those are positive implying either visibility or growth of revenue.

Incentives The executive chairman breaks corporate governance codes having moved from CEO to Chairman but is not overpaid with a base salary of £185k. He earned a £120k bonus last year. Sadly, the company issues 1p share options in the LTIP scheme instead of market priced options with vesting conditions of a 196p share price and a 259p share price. At the end of April 2019, the shares were c.150p so the issue of the 2.7m options amounts to a gift of £4m from investors to management which is not captured in the EPS calculation. It is this mis statement of EPS that suggests a look at the long-term value accretion of the acquisition strategy may help.

ROE last year was 17.2% and this is forecast to grow to 18.3% in the current year. This is based on the "company adjusted profit after tax" which last year was £10.7m divided by the average balance sheet equity which was £62.1m. The problem is that companies tend to adjust out any costs that aren't representative, which is understandable, to give an idea of the underlying profits as accounting rules increasingly amortise capital items through the income statement. By stripping them out of the income statement they magically get lost in thin air and it would be more representative to include them on the capital side of the balance sheet. In Ideagen's case there were a number of these:

1. **Amortisation** This is effectively goodwill in that client relationship acquired are amortised through the income statement each year. These are stripped out of the profit number by the company but represent cash paid for an acquisition. As the balance sheet is reduced by this amount each year, they should be restated on the balance sheet if we are to obtain a like for like return on capital spent. This amounts to £28.6m since 2012

	Amortisation/Impairment £'000
2019	8,928
2018	6,802
2017	5,006
2016	4,121
2015	93
2014	83
2013	3,146
2012	426
	28,605

Source: Report and accounts

2. **Option Exercise** The fair value of an option awarded to management is transferred from the reserves when exercised. This over time may correspond to the share-based payment charge in the income statement which is stripped out of the company adjusted profit, but the extra shares should be added back to the capital. The transfer of the option value from reserves represents the transfer of value from shareholders to management. This amounts to £3.6m since 2012

	Exercised option value £'000
2019	722
2018	1,337
2017	1,379
2016	92
2015	85
2014	2
2013	2
2012	2
	3,621

Source: Report and accounts

3. **Acquisition Costs** These are advisers and other costs incurred on making an acquisition which are stripped out of company adjusted profit but in reality, are part of the acquisition cost of a business that shareholders have to pay. They may be more appropriately included in the capital cost of acquiring the company. This is £3.4m since 2012

	Acquisition costs £'000
2019	1,268
2018	426
2017	609
2016	0
2015	450
2014	246
2013	87
2012	358
	3,444

Source: Report and accounts

4. **Restructuring Costs** Over recent years Ideagen has started to strip out restructuring costs separately from acquisition costs. There is an argument that these shouldn't be stripped out of the profits as the improved efficiency that they bring is not stripped out of the income statement. The increase over the last 3 years is cause for concern. It seems very strange that no acquisitions prior to 2017 required restructuring, or perhaps the company has simply found a new way of declaring a profit. In the last 3 years these have amounted to £734k.

	Restructuring Costs £'000
2019	479
2018	151
2017	104
2016	0
2015	0
2014	0
2013	0
2012	0
	734

Source: Report and accounts

5. **Share Issue Costs** When new shares are issued in a placing the costs of issuing the shares such as broker commission is deducted from the capital raised rather than expensed in the income statement. This should be added back to the capital in order to get a meaningful representation of capital for ROE as it is a cash expense incurred by the shareholders. This amounts to £1.77m since 2012.

	Share Issue costs
2019	625
2018	0
2017	335
2016	0
2015	584
2014	0
2013	228
2012	0
	1,772

Source: Report and accounts

Result: If we take the company's adjusted profit number and add back all the adjustments to capital the balance sheet asset equity actually spent would increase from £73.7m to £111.9m.

	2019	2018
B.Sheet Equity	73,682	50,484
Amortisation	28,605	19,677
Incentive shares	3,621	2,899
Acquisition Costs	3,444	2,176
Restructuring costs	734	255
Share Issue costs	1772	1,147
Capital Invested	**111,858**	**76,638**

On this basis the ROE declines from the 17.2% shown to 11.3% which is acceptable but unexciting.

Conclusion

The incentive scheme suggested something was amiss. The issuing of nil priced options based on share price only incentivises management to get the share price up. With modest basic pay this is where management make the big money. It is no surprise to see the company start classifying costs as restructuring costs so they can be adjusted out of profits. The increasing rewards to management are coinciding with increasing profit adjustments and that is enough to suggest to me that this company may run out of adjustment road at some point and be obliged to start reporting declining ROE. Which won't be good for the share price. Which with management incentivised on share price may result in a disincentivised management team and it could all unravel.

Summary

In a world of cheap money which looks set to remain cheap for some time the importance of capital allocation by companies has never been more important. The rewards for efficient capital allocation at high levels of return are large valuations. There are a number of small acquisitive companies that are now highly valued. With company adjusted profits now very normal it is important to scrutinise incentive schemes to determine whether the incentive to adjust profits exists. In many cases, such as Ideagen, the returns may not be as strong as claimed.

Forthcoming Events

Company	Date	Event
AFH Financial	Feb-20	Q1 update
Judges Scientific	18-Mar-20	FY Results
S4 Capital	18-Mar-20	FY Results
Learning Technologies	24-Mar-20	FY Results
Keywords Studios	Apr-20	FY Results
Next Fifteen	Apr-20	FY Results
Ideagen	Jul-20	FY Results
SDI Group	Jul-20	FY Results

Source: SharePad, RNS