Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

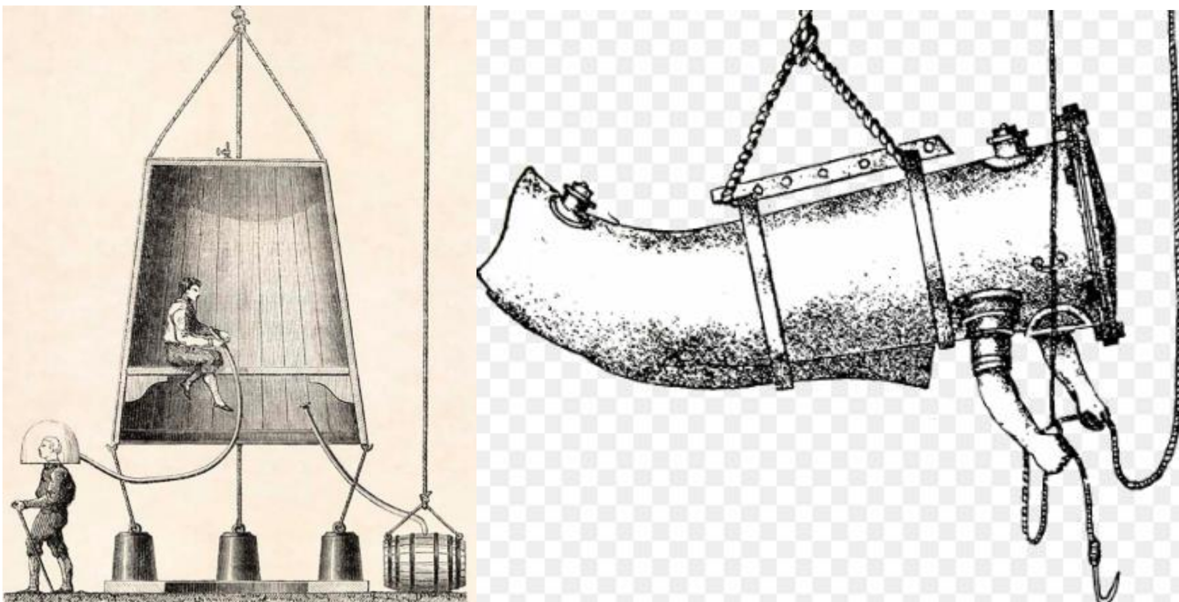
Investing in Acquirors

18 May 2020

There are moments when we can doubt the wisdom of bothering with small cap investing. The 5 largest stocks quoted in the US, Alphabet, Amazon, Apple, Facebook, and Microsoft, have strong business models and their share prices have beaten most other asset classes even during lockdown. The governments printing of money suggests that going forward the laws of supply and demand will maintain or increase valuations, while earnings are also set to keep growing strongly too. And following these leaders there are, as ever, many imitators.

Warren Buffett gave an interview (2008) explaining "the three I's" progression. "First come the *innovators*, who see opportunities that others don't. Then come the *imitators*, who copy what the innovators have done. And then come the *idiots*, whose avarice undoes the very innovations they are trying to use to get rich."

A good example of this can be found as far back as the 1690's in the treasure hunting mania. Sir William Phipps obtained finance from the Duke of Albemarle to locate the shipwreck of the Concepcion. This ship was said to have sunk with "unimaginable" treasure in the Caribbean and the funding was to locate and claim this "unimaginable" booty. After a number of years, the treasure was eventually located in 1687 and it took 2 months to haul the 32 tons of treasure to the surface. The Duke of Albemarle received a 10,000% return on his investment, which spurred on many imitators. A boom in speculation around treasure hunting ensued. 17 patents were filed for diving engines in the two years 1691-1693 with some intriguing designs.



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Few of these imitators prospered, though a lot of canons were recovered. Eventually the treasure hunting idiots turned up with ever more inventive schemes including "catching fish with lights" and "sea crab apparatus".

Today's Bubble

The Unicorn bubble we are undergoing now is an ideal time for imitators. And there are plenty of imitators at the moment in the software and hardware space. I haven't yet found the idiots turning up which may imply there is longer to go in the cycle. The idiots are generally quite amusing. I recall in 2000 Panmure Gordon trying to float a company that had a website where you could build a picture of a house online. When I asked what the business model was the broker suggested I shouldn't worry about it. My recollection was of walking down Cheapside back to the office in a haze of wonder. How could I do my job if the investors wanted concepts without a business model. Either I had lost the plot, or they had.

As we would expect following the success of the large US technology companies the best performing FTSE 350 sector over the last 10 years has been Technology Hardware, while Software is also up among the best performing sectors. But some of these companies could well be imitators.

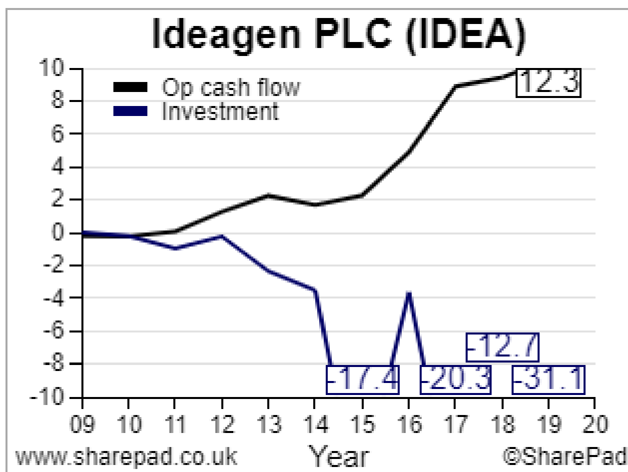
A screen of AIM for all software companies over £100m market cap reveals 13 companies that trade on reassuringly high PE valuations while on average they lose money. Anecdotally this is evidence of – to use Daniel Defoe's words of 1697 – "shares……blown up by the air of great words, and the name of some man of credit".

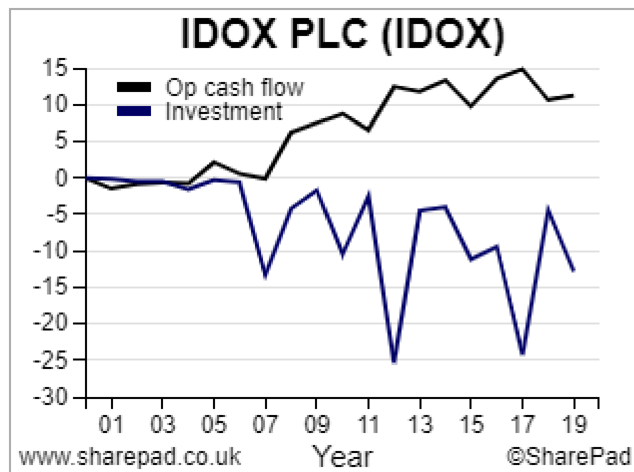
Company	Price (p)	Mkt Cap (£m)	PE X	Revenue (£m)	Op Profit (£m)
Blancco	188	142	54.3	30.5	0.06
Blue Prism	1296	142		101	-80.7
Eckoh	58	146	41.1	28.7	1.2
Ideagen	162	368	30	46.7	3.3
Idox	39	173	18	65.5	1.7
IMI Mobile	307	253	19.8	142.7	2.1
Learning tech.	132	886	30.7	130.1	20.1
Oxford Metrics	107	133	31.7	35.4	4.7
Quartix	303	145	26.9	25.6	6.4
Sumo	194	294	30.4	49	8
Tracsis	575	167	20.8	49.2	9.9
Tribal	56	112	15.1	78.2	8.4
Wandisco	547	264		17	-22.1
Average			**29**	**62**	**-3**

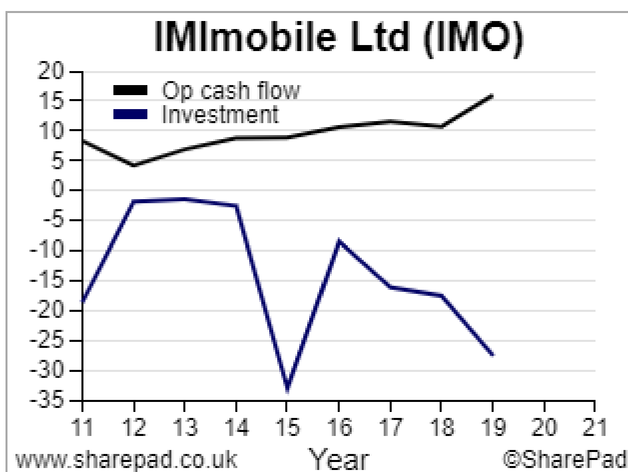
Source: SharePad

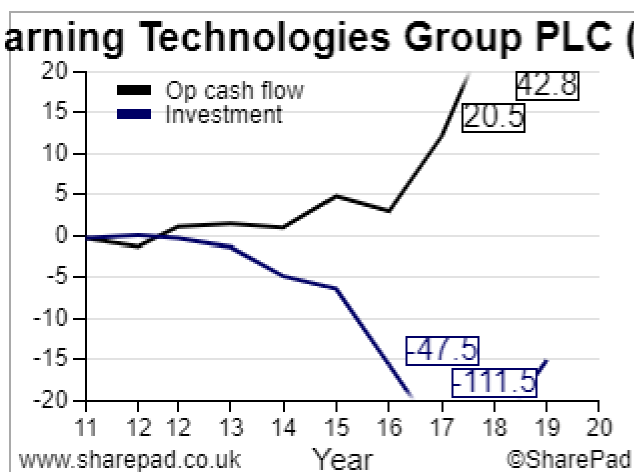
Many of these companies have consistently raised equity in the markets in order to invest in the spectacular opportunities available. SharePad has a useful "Financial charts" tool (click here for guide) which if I set it to plot "Net cash from investing" and "Operating cash flow" we can quickly filter to the

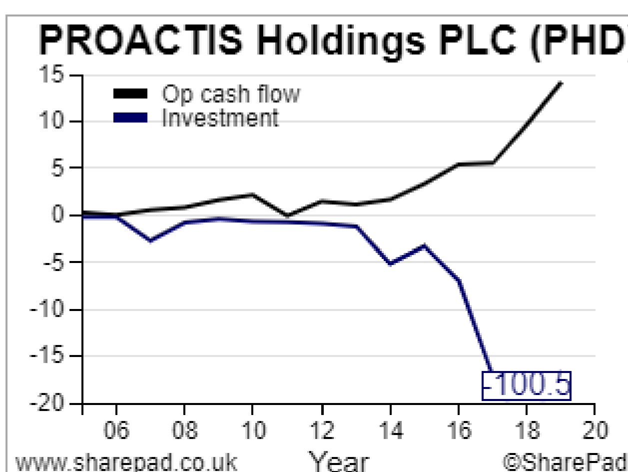
companies where they have been investing for growth. Six stocks show clear charts marking them out as "investors".

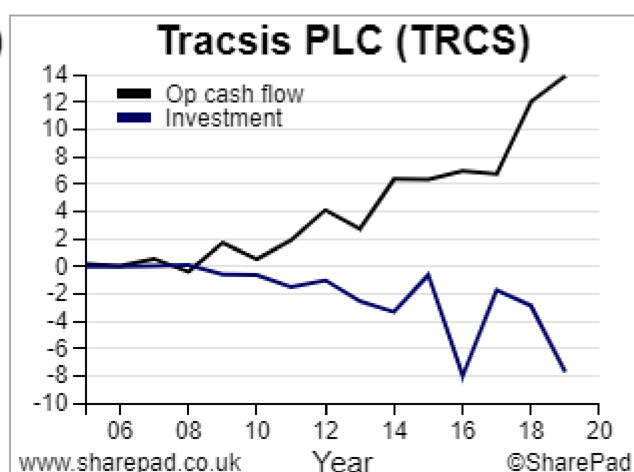












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Effective Investing?

One of the more commonly used tests of whether a company is investing its capital effectively is the ROE. This is the adjusted post tax profit divided by the balance sheet equity which for this collection of stocks produces the very healthy-looking table below.

Company	Adjusted ROE
Ideagen	17.2%
IDOX	11.8%
IMImobile	18.9%
Learning Technologies	19.0%
Proactis Holdings	7.7%
Tracsis	17.9%

Source: SharePad

Investors can be enticed by these attractive returns as the holy grail of investing is a company that invests money at attractive returns and can continue to invest more at attractive returns thereby growing fast at the same time. By this method investors can benefit from the magic of compounding at high rates of return. If we invest £1,000 over a 30-year investment horizon, which perhaps may equate to an investing career, at 10% compound return we end up with £17,450, which is a pleasing sum from our £1,000 investment. However, if we manage to achieve a 15% return by allocating our investments to companies that achieve better returns, that £17,450 would in fact turn out to be £66,210. These ROE figures are important for our allocation of investments.

Companies have realised this and so are naturally keen to present a strong ROE figure. There are two ways of doing this, either by increasing the profit number or reducing the equity number.

The most commonly used way to do both of these in one stroke is to strip out the amortisation figure from the profit but still deduct it from the equity, which increases the profit while reducing the equity. This is a dishonest presentation of the return that investors receive and has now become standard practise. It is misleading because we are comparing a profit number with an amount of capital that is less than the amount that has actually been spent. If we are to strip out the amortisation from the profit it would make sense to add the amortisation back into the balance sheet assets, and yet companies depart from the rules of double entry accounting at this point by reversing the income statement entry and not the balance sheet entry.

Another technique used to flatter ROE is to strip out as much as possible from profits through adjustments. In the case of these six companies all of them strip out share based payment charges, restructuring costs and amortisation. There are endless arguments over what should or shouldn't be stripped out of profits. In the case of share-based payments there is a genuine cost to shareholders so arguably should be left in as a charge to profits. But accountants have made the charge both complex and volatile by using sophisticated techniques to derive the quantum of the charge. They use a "Monte Carlo simulation" to derive a charge

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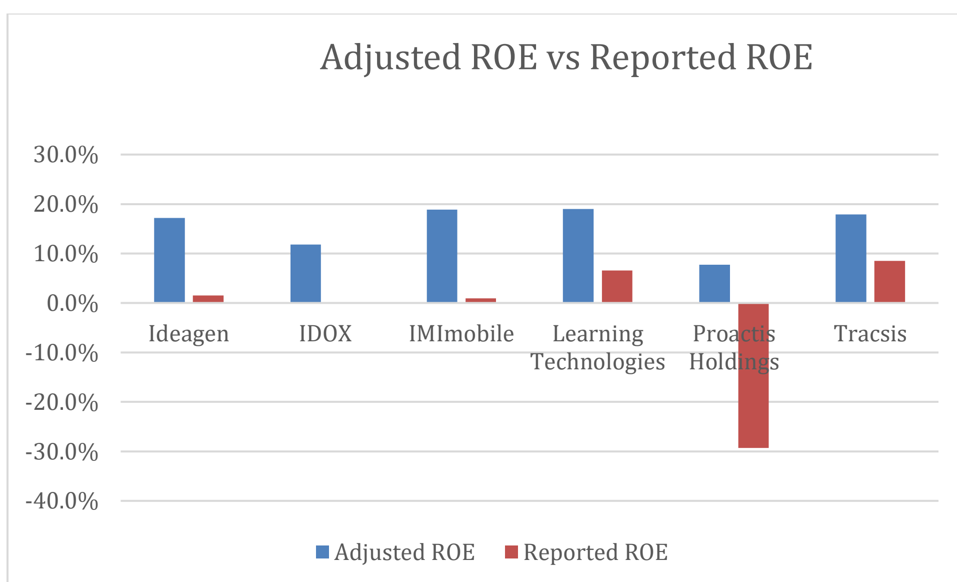
which is dependent on past volatility of a share. And consequently, the share-based payment charge can depend on the share price, which may not be a useful metric for an investor attempting to derive a share price target.

Accountants ROE vs Companies ROE

Accountants and companies differ in how they wish to present their ROE. One has to wonder why? For these six companies the difference can be summarised in the chart below where I have used a tax rate of 20% across the board.



Source: Author, SharePad

With accountants taking a dim view of ROE across the board relative to companies' presentation of adjusted ROE it becomes difficult for investors to work out where to allocate their equity. The highest reported ROE in the chart above is Tracsis at 8.5% while the negative ROE of Proactis is impacted by a goodwill write down, which clearly is hoped not to be a recurring event, implying that sometimes the adjustments to profits can be fully justified. The goodwill write down should in this case however be added back to the balance sheet capital if it is to be stripped out of profits.

If we give companies the benefit of the doubt in their adjusted profit numbers (in order to avoid endless debate) while reinstating the intangible amortisation number into the balance sheet capital we may get a more realistic view of return on equity. This was a method used by Terry Smith when he developed a database called "QUEST" in the 1990's. By doing this we have a return in "invested" equity rather than a return on "balance sheet" equity which may give a better guide for investors wishing to allocate their capital.

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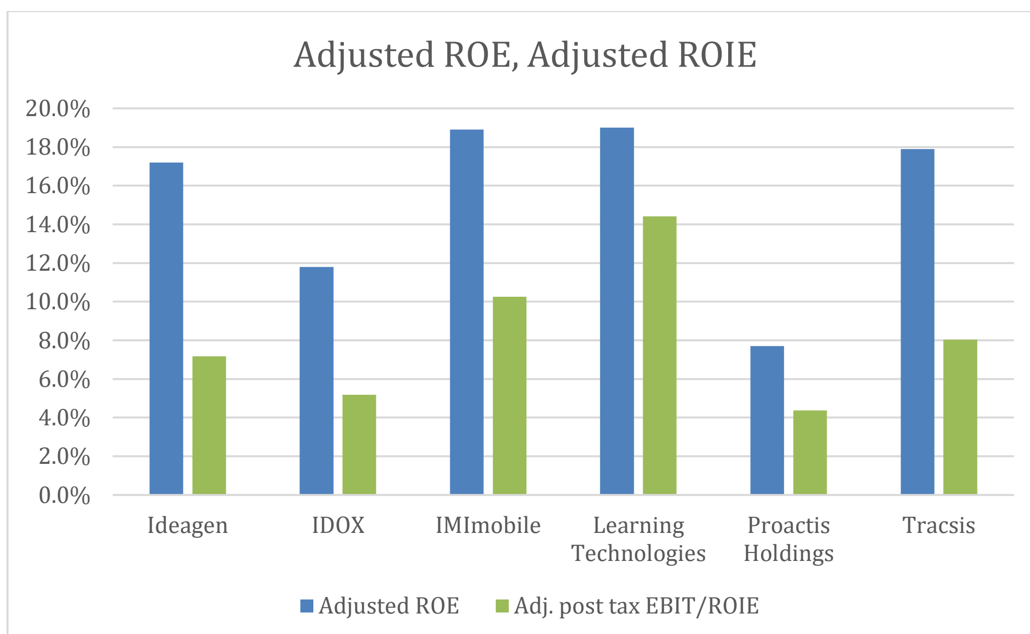


Source: SharePad, Author

Learning Technologies appears to make a strong ROIE of 14.4% and IMImobile gets above 10% on this basis, but none of the others achieves a competitive return on invested equity based on these numbers which are the last reported full year results.

EBITDA

Coincidentally Learning Technologies is also the only company of the six that doesn't highlight its adjusted EBITDA number in its accounts. Could it be coincidence that this company exhibits the highest return on invested equity I find myself wondering? It has now become commonplace for companies to highlight EBITDA numbers which wasn't the case in my early investing years. The use of EBITDA was learned from private equity who are masters of stripping cash and assets out of companies, while presenting a growth narrative to maximise the equity value. A company that discusses EBITDA extensively is always a warning indicator for me personally. The justification is generally as it is a proxy for cash generation from the underlying business, but it would seem more sensible in that case to use cash generated from operations, in my view.

Certainly, it seems to be the case for four of these companies that the returns reported on the invested equity are disappointingly low. The companies may argue that the returns are yet to come in the future given they have been investing extensively. Analysts generally forecast on a 3-year time horizon so it may be instructive to take the furthest time horizon that is forecast and take a look at the ROIE at that point in time. Of course over that time the company will retain some profit which will grow the equity value and therefore depress the ROIE, but to give the most optimistic view of ROIE we can simply divide the 2-3 year forecast profit by today's equity to derive the ROIE.

Company	Year	Yr end	Post Tax profit	Invested Equity today	Projected ROIE
			(£m)	(£m)	(%)
Ideagen	2022	April	16	154	10.4%
IDOX	2022	October	13.3	209	6.4%
Proactis Holdings	2021	July	2.5	265	0.9%
Tracsis	2021	July	10.8	96	11.2%

Curiously, it seems that neither IDOX of Proactis are forecast to achieve an acceptable return on the forecast horizon.

Proactis

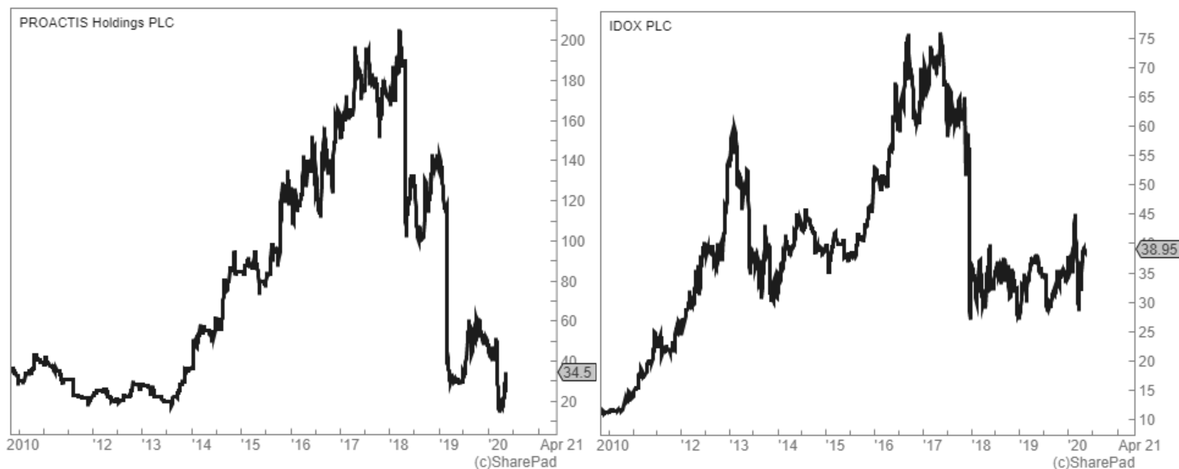
A review of Proactis' results on 29 April this year highlights the perilous position the company is in. The company has experienced "customer churn", which sound more like customer losses, while a sale process resulted in no acceptable or firm offers being presented to the board. The CEO tries a positive spin by saying the group has returned to organic growth in annualised recurring revenue. Which leaves me confused as to why the shares trade as high as 16.6X forecast EPS while the company has net bank debt of £35.6m.

IDOX

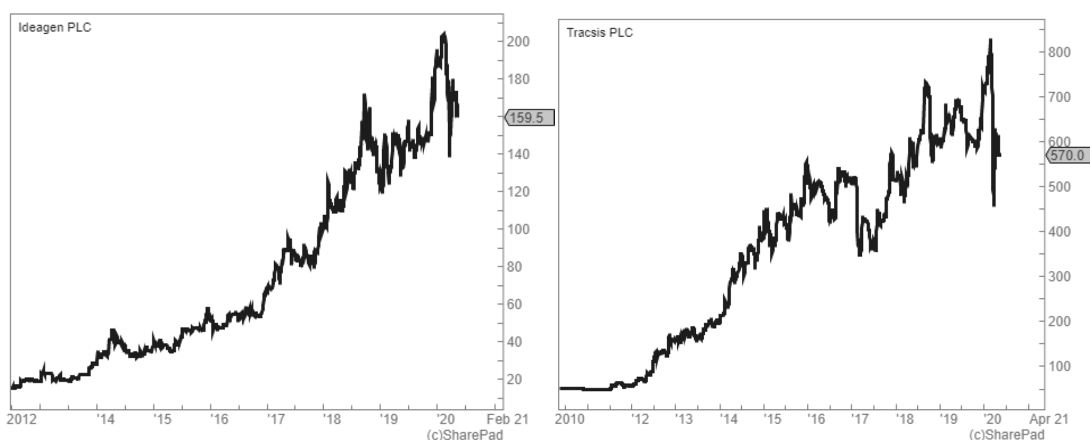
Results on 14 April stated "this has been a turnaround year for IDOX" as it reported a loss. The company reported it had disposed of loss-making businesses and acquired a "cloud-native" solutions supplier, had a new board, senior management and finance team and settled "legacy" issues. Again, I am confused as to why the shares trade as high as 18.2X forecast profits.

Conclusion

Both Proactis and IDOX are good examples of what happens when a sector is in fashion. High valuations lead to liberal share issuance to make risky acquisitions. Returns on acquisitions are flattered through some one-sided adjustments ensuring the continued supply of equity until eventually the poor returns can't be disguised any longer. "Legacy" businesses are then typically sold by a new management team with new ambitions and the cycle starts again. The 10-year share price charts tell the story.



What I find most worrying is what happens to Tracsis and Ideagen next whose 10-year charts look like this:



In the case of Proactis the first profit warning was said to be a deterioration in the pipeline in early 2018. Idox reported customer disruption in H2 2017 on the back of the June general election while simultaneously saying acquisition integration was proceeding well. In fact, the underlying issue was poor returns on acquisitions.

In Tracsis' interim results released on 20 April this year the highlights include several large tenders in the final stages of negotiation across the Rail Technology division. Let us hope that they are not delayed by the impact of COVID 19.

Ideagen reported on 7 April this year that COVID 19 was impacting customer investment decisions and deployments but due to lower operating expenditure EBITDA would be broadly in line with consensus expectations. This could mean that the returns on investment reduce which means the ready supply of equity from the stock market vaporises and then the stripping out of amortisation from the returns starts to have less impact over time leaving the poor returns rather clear to investors. As Warren Buffett puts it "only when the tide goes out do we find out who has been swimming naked".

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Summary

With an ongoing technology bubble driven by Amazon, Alphabet, Microsoft, Apple, Facebook etc the result has been highly valued equity for the software and technology sector. Companies are issuing expensive equity to invest in inferior businesses which inevitably ends in pain. Tracsis has made 6 acquisition in a little over two years while Ideagen has made 5 acquisitions in the same period. Getting paid handsomely for the equity issuance the brokers encourage this activity and hire M&A teams to milk the fees. But looks to me like there is reason for investors to steer clear as the tide goes out.

Forthcoming Events

	Date	Event
Idox	28-May-20	AGM
Learning Technology	5 June-20	AGM
IMImobile	2 July 20	FY Update
Ideagen	17 July-20	FY Update
Tracsis	13 Nov-20	FY Update
Proactis	9 Dec-20	FY Results

Source: SharePad estimates

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