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## Five Signs of a Good Acquisition

While many acquisitions are accompanied by management bravado and a flashy slide presentation, most don't live up to expectations. The motivation for management to make acquisitions is clear. Management bonuses are linked to earnings growth and share price appreciation. What better way to fast track growth than by making an acquisition?

However, while management incentives are clear, the likelihood of success is murky. So how do we sort the wheat from the chaff? Here are five signs that lead to a successful acquisition.

### Made in distressed times with a motivated seller

The Global Financial Crisis resulted in a number of motivated sellers looking to offload assets. In this environment, companies with strong balance sheets were well positioned to make opportunistic acquisitions.

In 2010 **McMillan Shakespeare** (ASX:MMS) acquired the Interleasing Group from GMAC Australia, the auto financing arm of General Motors. With General Motors in financial distress following the Global Financial Crisis, they were a motivated seller of this business. The acquisition was made at an 11% discount to Interleasing's net asset value and resulted in a 45% uplift to McMillan Shakespeare's earnings per share.

It took the market a long time to recognise the merits of the acquisition. Not only was it opportunistic but it mitigated the risk of McMillan Shakespeare's salary packaging business, which has been under constant political scrutiny. While the share price increased 13% on the day of the announcement, it was up fivefold three years later.

### Consolidates an industry

The best acquirers are those that were so successful that they consolidated an entire industry - to the point where no one thinks of them as aggregators any more. While critics of aggregators cite the examples of roll-ups such as ABC Learning or more recently **Slater & Gordon** (ASX:SGH), few think of the banks or supermarkets as aggregators.

Following deregulation of the banking sector in the late 1980s, today's big four banks consolidated the industry to the point where few regional banks remain and building societies and credit unions are practically relics.

Similarly, the two supermarket giants, **Woolworths** (ASX:WOW) and **Wesfarmers** (ASX:WES) owned Coles acquired many of the discount supermarket chains such as BI-LO and Safeway. They have consolidated the industry over the past two decades and their combined market share is 70%.

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## Synergies and beyond

Most acquisitions are touted to have synergies. Put together two similar businesses and one can cut costs by saving on duplication. For example, the merged company only needs one management team, one accounting department and one set of insurance policies. Two legal advisers can be reduced to one, two head offices can be merged to save rent and there are many other potential savings.

However, when synergies extend beyond simple cost savings, a truly cracking acquisition can result. For instance, an acquisition can materially increase the size of a company, enabling it to get a better deal from suppliers. Or perhaps an acquisition comes with a great product but needs the acquirer's distribution capabilities to rapidly grow sales (this seems to be the premise for at least half of the contestants on Channel Ten's *Shark Tank*).

When **Super Retail** (ASX:SUL) acquired Rebel in 2011, Rebel's business model was transformed. Historically Rebel focused on selling branded sporting goods. While it still does, the focal point of its business is now on apparel, particularly active wear. There were two main benefits to this strategy. Firstly, selling apparel captures a wider audience, with active wear holding broad appeal among female shoppers. Secondly and perhaps more importantly, by placing less emphasis on brands, Super Retail was able to do what it does best – source product cheaply offshore to offer customers compelling value.

## Bolt-ons work better than diversification

iiNet used to be a run-of-the-mill telco. Did it offer consumers the lowest prices in the industry? No, that distinction belonged to its eventual acquirer, **TPG** (ASX:TPM). Did it have the most differentiated offering? No, that would be **Telstra** (ASX:TLS), with best mobile network in Australia and exclusivity to bundle Foxtel into its packages. So how did iiNet transform from a \$300 million company in mid 2011 to being taken over for \$1.56 billion four years later?

The simple explanation is that management made easily digestible acquisitions during this period. Most were privately owned telcos whose customers could be easily shifted across to iiNet's network. These are commonly referred to as bolt on acquisitions, which are small complementary businesses that are easily integrated into a larger organisation.

This is in stark contrast to companies that make acquisitions to diversify earnings. Often such acquisitions are made offshore. For instance, Telstra acquired CSL to enter the highly competitive Hong Kong mobile space in 2001. Unlike the Australian mobile market, Telstra had few competitive advantages in Hong Kong and 12 years later exited the Hong Kong market with its tail between its legs.

## Cheap

Sometimes an acquisition can be a cracker simply because it was acquired for a ridiculously cheap price.

One of our holdings, **GR Engineering** (ASX:GNG) acquired oil and gas services business, Upstream Production Solutions, two years ago for \$6 million. In 2016 alone this business has been awarded two important contracts that are expected to generate revenue of \$47 million and

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pre-tax profit margins similar to the broader group, around 6–8%. It appears that the \$6 million GR Engineering paid for this business was quite the bargain.

### **All of the above**

**Amtcor's** (ASX:AMC) acquisition of Alcan's packaging asset from **Rio Tinto** (ASX:RIO) in 2009 was a game changer. For the previous 16 years, its share price had gone nowhere as the business suffered from operating in a competitive industry where large customers held all the bargaining power.

The Alcan acquisition displayed all five of the above signs of a good acquisition. Rio Tinto was a motivated seller as packaging assets were not a core part of its business. The acquisition targeted \$200-250 million of synergies. It merged the top two companies in both European food packaging and global tobacco packaging. It was complementary to Amtcor's existing business. And it was well priced, at around five times earnings before interest and tax.

The benefits of the acquisition were clear, with earnings per share and the share price increasing more than threefold since 2010.

While the above list is not exhaustive it does provide a useful set of factors to consider when assessing the merits of an acquisition. Without at least one of these factors being met, shareholders would do well to question the logic of an acquisition.