QV UPDATE
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Darren Dansereau, CFA

QV Investors Inc.

M&A: Friend or Foe?

There is a continuous debate as to whether mergers and acquisitions (M&A) add shareholder value over time. We can find many examples of resounding success. For instance, in documents filed in a 2016 Oracle court case, Google was estimated to have earned a cumulative US$22 billion in profit on its US$50 million purchase of the Android mobile operating system in 2005. Since then, the profits have continued to grow unabated.

On the flip side, consider Microsoft's purchase of mobile hardware manufacturer Nokia in 2014. Within 18 months, Microsoft wrote off US$7.6 billion (96%) of its purchase price excluding the cash on Nokia's balance sheet.

One of the key items we need to focus on in any acquisition is the price paid. Even if the strategic fit is ideal, a price too high will usually result in a poor rate of return on the capital outlay. Another area for study is the rationale for the acquisition. Is the motivation to enter a new geography, or acquire expertise in an area that might take too long or cost too much to build internally? For each rationale, we can show you examples of success and failure. The ultimate question is how do we try and determine which M&A transactions will create value?

According to McKinsey Consulting, "acquirers in the most successful deals have specific, well-articulated value creation ideas going in." We believe companies that have maintained the same acquisition strategy over many years and have executed on it over time are more likely to be successful. We have many examples of effective acquirers within our portfolios.

One example in the QV Canadian large cap and balanced strategies is Saputo Inc. Saputo produces high quality dairy products in Canada, the US, Australia, and Argentina. With a strong capital allocation strategy, its focus has been to expand out of its Canadian base into new markets where it can bring its operational expertise. It has employed this approach successfully with over 30 acquisitions totalling C$6.9 billion since its IPO in 1997. Its return on capital record places it in the top 10% of companies in Canada on that measure.

One interesting difference between Saputo and many other companies is its conservative approach to testing markets before a large entry. This is exemplified by its small entry into the United States in 1988 to get a solid understanding of the market dynamics. Nine years later, Saputo tripled the size of the company by acquiring Stella Foods, a leading natural cheese producer in the US. Could the fact that the Saputo family owns 33% of the shares outstanding contribute to this measured approach? We think so.

This is not to say Saputo has not made any mistakes. Saputo entered the German and UK markets in 2006 and 2007, respectively. In 2013, Saputo announced it would close those plants and exit Europe because it lacked strong brands and size, factors it believed were critical to profitable operations in this mature market. Lino Saputo Jr., the current CEO, stated in the 2013 Annual Report that they would not rule out an eventual return to Europe, but would concentrate on other areas for now.

Fast forward six years: Saputo is now attempting to re-enter the European market by offering to buy Dairy Crest Group plc, a leading UK based dairy producer, for C$2.0 billion. Dairy Crest has the #1 UK cheese, dairy spread and oil brand in the country, which provides a much better market position than Saputo's previous European assets. The price offered is in-line with the metrics of other acquisitions they have made. Saputo has fully financed the deal with a line of credit, so there is no requirement to issue equity or sell any assets.

While the level of debt is at the higher end of its historical range, Saputo has shown discipline in using excess cash generated to swiftly right size its balance sheet after previous acquisitions. In regard to Brexit, the potential effect should be minimal since 97% of Dairy Crest's products are sold in the UK and its 7 plants and 330 farmers are also within the country.

The strategy of entering Europe has been on the table for over 13 years. From what we see today, this meets the criteria of being a "well-articulated value creation strategy." As with all acquisitions, we can't be positive this one will be successful, but we think Saputo has tried to mitigate the risk through its long-term focus and conservative positioning. These factors increase the odds it will be a friendly deal to us as investors.