Bids—Who Isn't Next?

August 2007

Earlier this year we enjoyed one of those short-lived but welcome "hot" streaks, when our portfolios benefited from a succession of takeover approaches, both in London and Tokyo. That heady week in May, when two big Lindsell Train holdings, Dow Jones and Reuters, were bid for, prompted a call from one of our longstanding shareholders who asked "Are you fellows good, just lucky or…..working on inside information?"

He was alluding not only to those two media transactions, but also our live situations in Cadbury, Sansei Foods, a Japanese confectioner, ironically bid for by Cadbury itself and Impact 21, the Japanese licensee for Polo Ralph Lauren, recently in receipt of an offer. Further back, as this shareholder well remembered, bids for major LT positions, such as Glenmorangie, LSE, Pixar and Toyko Individualised Education, had made important contributions to our returns.

It was a friendly question, inviting and receiving a flippant answer – we put our success down to divine inspiration. But as 2007 has unfolded and, in particular, as our hot streak has cooled, I've been thinking hard about the incidence of takeovers, both for LT stocks and the markets in general.

There's a Lot of it About

First, far from feeling good or lucky, it is not obvious that we have done a better job than anyone else in contriving exposure to bid targets. Put another way, there have been just so many deals that one would feel quite the fool not to have had a fair leavening of them in any portfolio. After all, so far in 2007, there has been a record $1.3 trillion of European M&A action, already in excess of the total for 2006 and $1.6 trillion in the US capital markets, a run rate nearly 50.0% higher than last year's.

There are various drivers of this great wave, one of which we return to in more detail below. But a key consideration is the post tax cost of corporate debt. This is low by historic standards, despite the tick up in August. At, say, 150 bps above the US Treasury 10 year yield of 4.75%, the gross cost of corporate borrowing is 6.25%. With tax at 33.0%, the post tax cost is running at 4.1% (6.25%x0.66=4.1%). This 4.1% cost is the hurdle at which a deal begins to make sense and equates to a P/E of 24.0x (100/4.1=24.4x). In other words, any earnings generating asset that can be purchased on lower than a P/E of 24.0x is enhancing to a corporation that can borrow at 6.25%. With major equity markets around the world trading on average P/Es in the mid-teens it is not so surprising, therefore, that deal volumes and share buybacks are exploding. During the recent setback, which has made equity even cheaper on this measure, FTSE 100 constituents' share buybacks were 40.0% higher than the previous few months, illustrating not only the confidence that major UK companies clearly feel about their business prospects, but also the compelling math of equity retirement at current borrowing costs.

Rather than congratulating ourselves, then, on our acumen in getting lucky with a few bid stories, perhaps we should be wondering why we haven't owned more. Two big bids of the last year gall us. BAA and Boots. Both companies qualified for admission to Lindsell Train's universe of "great British franchises" and both, therefore, we could - and in hindsight, should have owned. Errors of commission are more visible than errors of omission. It is incumbent on a professional investor to give an adequate account for the stock purchased which plummeted, but less so for the stock missed that soared. But errors of omission can be just as demoralising. We simply failed to comprehend how valuable BAA and Boots might be to Ferrovial and Pessina. In particular we failed to understand how the use of cheap debt could carry the warranted worth of those companies far beyond the limits of conventional equity market valuation tools.

The crucial point is that equity market investors put themselves at a disadvantage to corporations and investment bankers when they persist in utilising P/Es and, in particular, historic P/E ranges when attributing value to earnings-generating assets. Instead, we should all take what is the relatively modest step of inverting the P/E and arriving at an earnings yield. For equity investors a P/E of 20.0x is "high" and "risky", being above the average and above the long-run average. But a P/E of 20.0x equates to an earnings yield of 5.0%. And an earnings yield of 5.0% which has the potential to be enhanced by real earnings growth in the long run and, in the case of a takeover, to be enhanced by cost savings looks very acceptable compared to

prevailing government bond yields, and, of course to the issuer of tax-favoured corporate debt. "The P/E of 20.0x scares you, but the earnings yield of 5.0% doesn't." That fear creates a capital market anomaly that corporations and Private Equity have been delighted to exploit – P/E-bound investors sell equity assets too cheaply.

Unintended but Welcome Consequences

The "P/E"quote above comes from a book I read over the Summer, Ken Fisher's new investment manual – "The Only Three Questions That Count". Fisher is a successful practitioner and son of feted investment pioneer, Philip ("Put all of your eggs in one basket, then watch that basket very, very closely."). I suppose I recommend his book, although there's a deal of, doubtless justified, self-congratulation to negotiate.

Anyway, Fisher has a chapter where he offers his rules for identifying stocks likely to receive takeover bids (thereby returning us to the subject of this note). He says – "Good buy-out targets are likely to have some or all of the following characteristics:

- Low valuations
- High free cash flow
- Strong balance sheets
- Quality brand names
- Regional strength
- High relative market share
- Smaller in size
- Strong distribution networks
- No concentrated controlling shareholders…

Seek those kinds of stocks to capitalise on cash-merger mania.

Our reaction to this advice represents our most serious answer to the question our shareholder put to us. And the reaction is to say – Surely the characteristics that Fisher lists as likely to attract takeover interest are also the very same characteristics that are likely to make those companies good long term investments, whether they are bid for or not?

It seems to us that Fisher is effectively advising his readers to "Invest for the Bid" – but this is a risky policy that almost always ends up driven by gossip and compromises with asset calibre.

By contrast, a counter proposal to Fisher gets close to LT's investment approach – Don't invest for the bid, instead, invest for the quality of the franchise and, in the end, good things will happen to you (including, but not inevitably, takeovers).

LT has owned stock in bid targets, but also "one-off" franchises, such as Fontaine, a Japanese wig maker (don't laugh, this was an important business for an image-conscious and ageing population like Japan), Instinet (the electronic market place bought by NASDAQ), Manchester United ("One Man Utd, there's only one Man Utd"– where that singularity was an important investment consideration) and Marston's (where thankfully, given the subsequent trebling of the shares, the 2001 bid failed).

But the important point is that we didn't own any of them because we thought they were going to be taken over. We owned them because we thought they were great business franchises that were undervalued. From our point of view, the bid was the unintended consequence of the strength of the franchise. Sometimes the offer was welcome, but in many cases we were positively disappointed to lose our equity and felt the purchasers were getting a good deal.

We worry today about the portfolio assets we could lose after an indiscriminate market shakeout. For instance, Bradford & Bingley, Cadbury, Clarins, eBay, Euromoney, Lloyds, Pearson or Sage. All exhibiting some of Fisher's characteristics, all of strategic value to larger industry participants, all undervalued compared to where recent transactions for similar properties have been effected.

You Ain't Seen Nothin' Yet

In July there was another takeover deal we missed out on, French company Steria's bid for fallen UK tech-star Xansa (not that we would ever have owned Xansa). We are interested in this transaction for three reasons. First, it confirms our strategic view that UK investors currently undervalue technology companies, still reacting against the wrenching unwinding of the overvaluation extreme of 2000. Steria offered a 70.0% premium to win the approval of Xansa's board. This is obviously a substantial value gap, akin to the premium to market price that Murdoch had to pay to acquire Dow Jones, another company situated in the pariah sectors of Technology and Media. Next, a specific issue for our portfolios, the deal demonstrates what we regard as the anomalously low valuation accorded to Sage, a much better business than Xansa. The takeout P/E is 32.0x historic, or 40.0x Xansa's average earnings of the last three years. A similar rating for Sage delivers a share price of close to £4.00, again 70.0% above the market quote. Sage trades on a historic P/E of 19.0x, or earnings yield of over 5.0%. Borrowing Ken Fisher's terminology, this does not look scary.

Finally, the Steria/Xansa deal, though tiny, is representative of the takeover ferment that, to perpetrate a cliché, is Changing the World.

It is worth taking a moment to think through its implications. Xansa delivers to the French company both UK clients and an Indian employee base, with over 60.0% of the latter's staff in the Sub-Continent. Steria's CEO says – "We're going to use Xansa's Indian platform for clients in other European countries. In the UK they're a step ahead in outsourcing and off-shoring back-office for public services". In addition, the combined group will vault to become Europe's fourth-largest information technology provider, still behind Cap Gemini (which bought Kanby International in February 2007 to access its own workforce in India), Atos and LogicaCMG (another recent combination). So, we can assume, Steria badly needed Xansa just to sustain its competitive position in a rapidly globalising business world. A new world where French corporations serve British local authorities by employing Emerging Market labour. A world unguessed of as recently as, say, 1990. Steria's pre-deal strategic bind will be ruefully familiar today to many companies in many industries in many geographies. Either we bulk up by acquisition, particularly cross-border acquisition, or get left behind, or, even more unacceptable to incumbent management, we become takeover fodder ourselves. Here is the primary impetus behind the Great Takeover Wave of the early 21st Century.

After Summer 2007's jitters, it is critical that investors distinguish between two types of takeover activity. Private Equity represents just one class of deal. As a generalisation these are asset-stripping exercises, involving a lot of debt and a more or less urgent requirement to justify the trade by disposal or early relisting of the acquired company. The other type of deal, like Steria/Xansa, is between corporations, designed to deliver permanent improvement in the strategic positioning of either or both entities.

We agree that the events of this Summer have somewhat dimmed the prospects for Private Equity transactions (although it is extraordinary how quickly conditions and sentiment can improve, once the key players return from their holidays). However, it appears to us that the impetus for strategic consolidation between corporations is as strong as ever. In fact, we submit that the last few weeks have seen unusually high takeover activity for the time of year, rather than its complete cessation, as the swoon in the markets suggests. Akzo is buying ICI. The Dubai bourse has outbid NASDAQ for the OMX Exchange. News Corp has secured Dow Jones. Rivergroup is building a global education franchise, by consolidating Houghton Mifflin and Reed's Harcourt Education. Kraft has purchased Danone's European biscuit division and Danone, flush with Kraft's cash, has bid for Numico, in a $14.0bn deal. Meanwhile, Barclays and RBS duke it out for ABN-AMRO, while HSBC is playing catch-up in Korea, trying to acquire the Korean Exchange Bank.

It is apparent that globalisation means that corporations all over the world feel an imperative to consolidate and attain economies of scale, in order to position themselves for the new millennium. We think that "merger mania" has barely got going and that we are moving from a decades-long period when deals were primarily domestic, to one likely to see the emergence of global champions across many industries. Banks will almost certainly be at the forefront of this, because the opportunity is great, both to take out costs and to acquire earnings streams lowly valued by portfolio investors. It is the cross-border nature of Barclay's move on ABN-AMRO that is so incendiary in this context. This deal could light the touch paper for consolidation amongst global banks and will reverberate long after the dreary macro-economics currently afflicting it have

been forgotten.

Cynical investors observe that often such deals, particularly ambitious global ones, prove value-destroying, that takeover premiums turn out unjustified. This may be so, but this arithmetic does not necessarily invalidate the transaction from the perspective of the acquirer. It is important to recognise that in an imperfect world sometimes the alternative - of not doing even a value-destroying deal - is worse. Because inaction leads to even more rapid loss of competitiveness, to rivals with greater global scale and results in permanent value-destruction.

The inelegant title of this note – "Bids - Who Isn't Next" means therefore, that few UK-listed companies are too big or too perfectly formed not to be vulnerable to or amenable to consolidation. Both our portfolios and yours will be boosted by many more takeovers before this decade is out - willy-nilly, whether we are "good or just lucky".

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