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Investment Management

In search of the next big elephant

- elements of great serial acquirer -

EUROPEAN Investing Summit 2016

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Overview

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1. What does a great business look like?
2. Research and Elements of a great “serial acquirer”
3. The idea - Judges Scientific

1. What does a great business look like?

Media and mainstream love “quality-stocks”

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But what is a quality-stock?

- Large Cap, high liquidity?
- Well-known brand?
- Strong balance sheet, growing free cash flows?
- High-dividend yield (*New label: “Bond- proxy”*)?
- Continuously increasing dividend over time?
  (*New label: “Dividend Aristocrats”*)
- No mentioning of price vs. value

Nestlé

Everybody’s darling

… sounds like the Nifty Fifty in the 70ties!

How we define a “great business”

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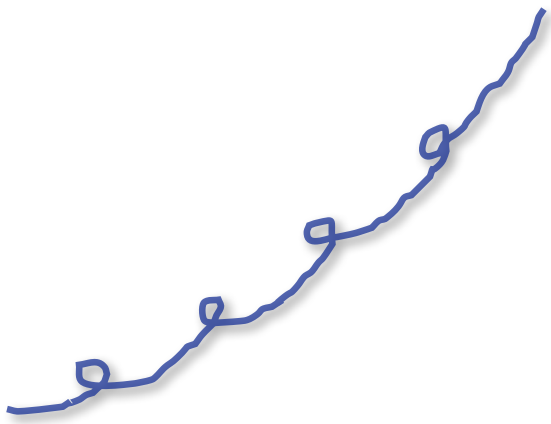
A “great business” has a number of elements (characteristics)

that result in…



… an ability to reinvest free CFs at

high returns on incremental capital.

Example 1 – Reinvestment in own growth

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Wal-Mart in the 80ties – the benchmark.

In $Mio	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
NOPAT	67	91	134	175	250	318	404	549	772	1064
Reinvestment	107	146	332	209	244	564	485	752	1107	1012
Free Cash Flow	-40	-55	-199	-34	6	-246	-81	-204	-335	52
Reinvestment Rate	161%	161%	249%	119%	98%	178%	120%	137%	143%	95%

Learning 1:
A really great business reinvests even more than FCFs (!)

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
ROC (NOPAT/Avrg. Capital)	20%	20%	19%	18%	21%	20%	19%	20%	21%	23%
Cost of Capital (Estimate)	12%	12%	12%	12%	12%	12%	12%	12%	12%	12%
Spread	8%	8%	7%	6%	9%	8%	7%	8%	9%	11%
x Capital (in $Mio)	329	455	694	965	1191	1595	2120	2738	3668	4727
"= Economic Value Add"	27	36	50	59	107	126	150	220	332	497

Learning 2:
Essential requirement is that Return on incremental capital > WACC

Source: Polleit & Riechert Research and Stern Stewart & Co, “The quest for value”, G. Bennett Stewart, 1991

Example 1 – Reinvestment in own growth

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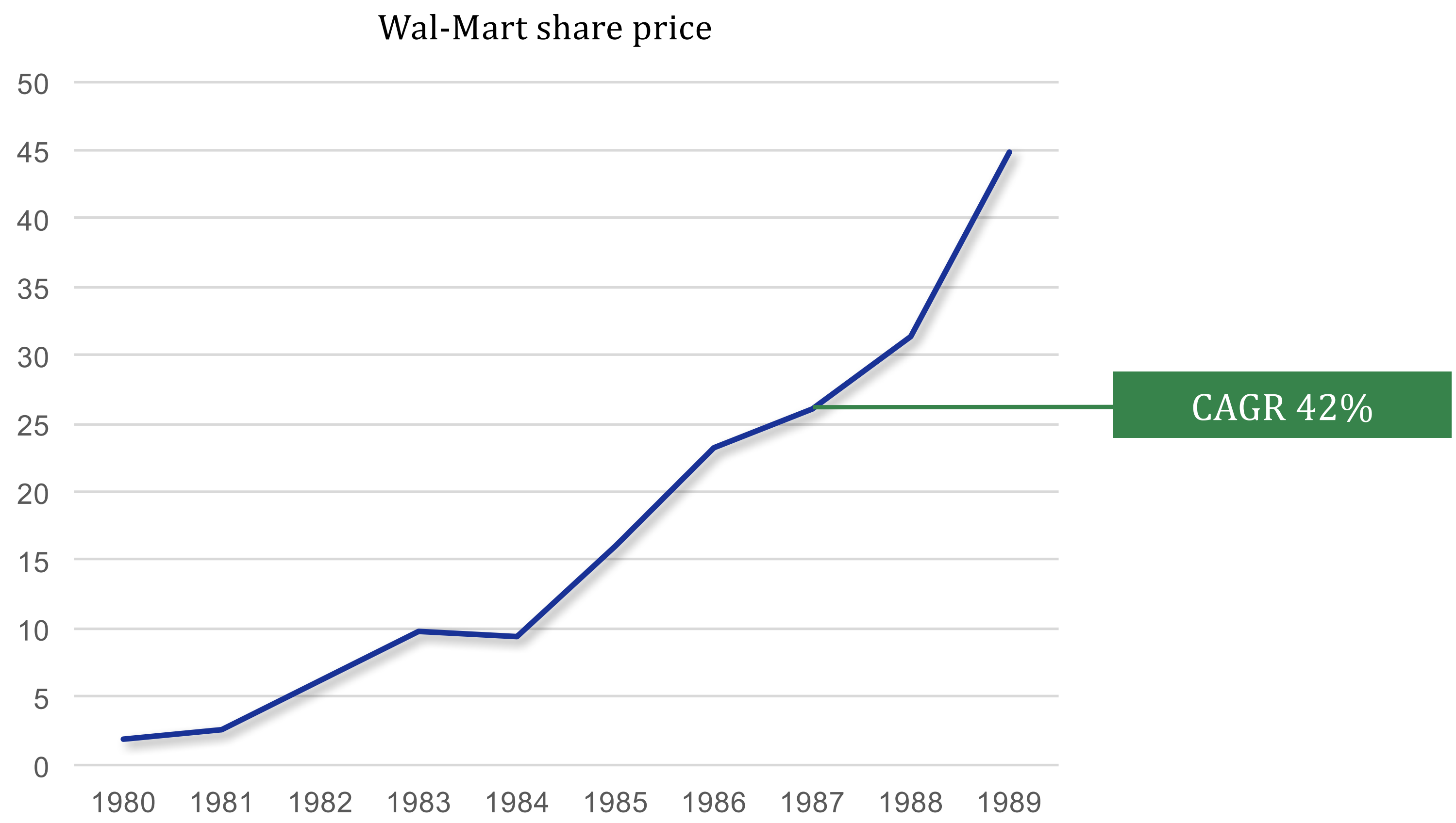
The stock price follows the operating result.



Example 2 – Reinvestment in acquisitions

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Constellation Software during the last decade - deploys free cash flows into M&A.

In $Mio	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
NOPAT (assumes 30% tax)	24	31	48	64	86	124	125	164	244	312
Acquisitions	19	56	71	42	83	46	138	523	122	249
Free Cash Flow (after acq.)	4	-25	-23	22	3	78	-14	-359	122	63
Reinvestment rate	82%	182%	149%	66%	97%	37%	111%	320%	50%	80%

In total 1.1x NOPAT deployed in acquisitions

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
ROC (NOPAT / Avrg. Capital)	24%	22%	23%	25%	27%	34%	27%	21%	23%	27%
Cost of Capital (Estimate)	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%
Spread	14%	12%	13%	15%	17%	24%	17%	11%	13%	17%
x Capital ($Mio)	100	139	204	260	314	362	465	785	1050	1165
"= Economic Value Add"	14	17	27	38	55	87	78	85	139	195

Extremely high ROC leading to increasing EVA

Source: Company and Polleit & Riechert Research

Example 2 – Reinvestment in acquisitions

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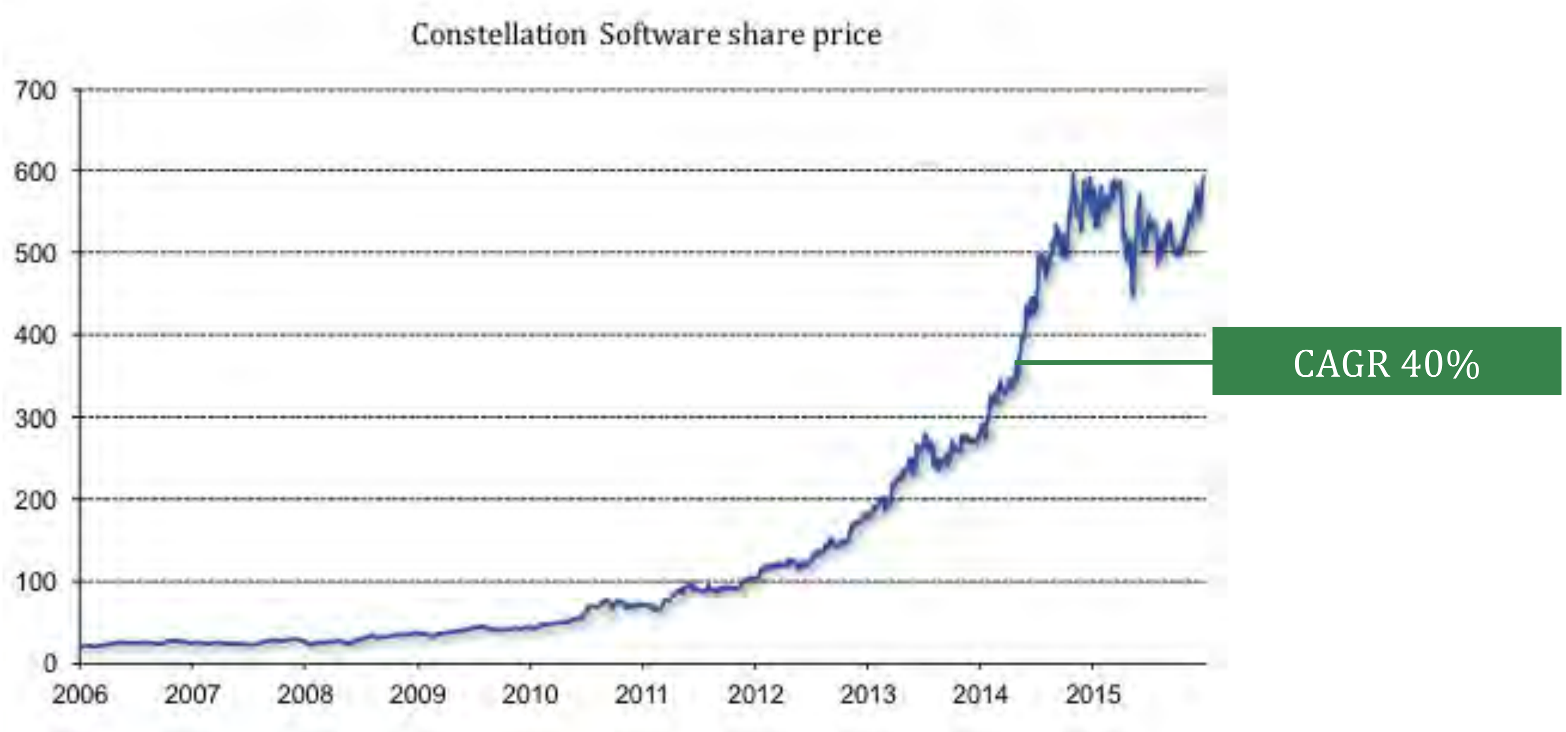
… producing a similar phenomenal result.



Unfortunately only in hindsight are results clear.

How can we find a great business (a “young elephant”)
early enough to enjoy a long runway of growth
but mature enough to allow for a confident assessment?

2. Research and Elements of a great "serial acquirer"

Learning from books and other investors…

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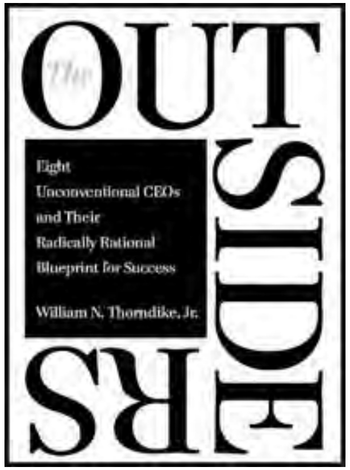
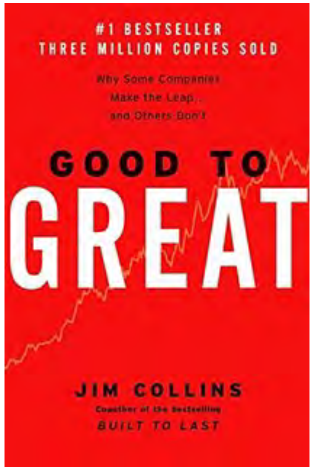
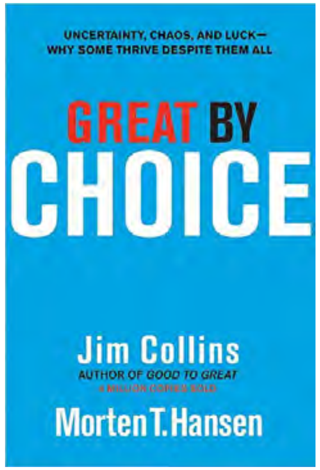
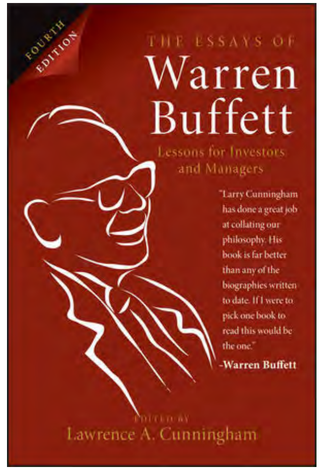
We set out to study all the elements that successful platform businesses have in common (and those that unsuccessful examples have in common).









Presentations:

Pershing Square Capital Management, L.P.: 45x (May 2015)

JHL CAPITAL GROUP LLC: Conglomerate Boom 2.0 (October 2015)

Elements of a great business

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Research framework to find a great business.

PRODUCT

What is all the evidence that…

… the product has a value proposition to all constituencies (customers, employees, vendors, shareholders)?

… the product offering provides stable recurring revenues basis?

… there is a definable competitive advantage?

SALES & MARKETING

What is all the evidence that…

… the firm has an above average sales & marketing organisation?

FINANCIAL ANALYSIS

What do the financials tell us, are there meaningful trends?

Does is produce EVA?

What are owner's earnings?

What are the unit economics?

Is the financial disclosure complete and easy to understand?

FINANCIAL OUTLOOK

What is all the evidence that…

… there is a high probability of either increasing margins or, at worst, maintaining them through a variety of potential business environments?

… the firm has good cost controls and cost analysis?

... the firm has the financial characteristic of a potentially great business?

CULTURE & MANAGEMENT

What is all the evidence that

… top management has a clear vision of what the company can be best in the world at?

… they are intensely focussed on it?

… the company has depth to its management?

… the management has the right orientation?

Elements of a great business

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Further important questions for serial acquirer

What is all the evidence that

- management understands that the financial purpose of a public company is to build EVA (or something that is the equivalent of EVA) in *per share* terms?
- they are (or are not) a management team that demonstrably thinks and acts like owners?
- they have (or do not have) a thoughtful, shareholder oriented compensation structure throughout the company?
- they are a management team with unquestionable integrity and business ethics? Do they avoid self-dealings and any improper behaviour?

Elements of a great business

"… much of what distinguished Singleton from his peers lay in his mastery of the critical but somewhat mysterious field of *capital allocation*—the process of deciding how to deploy the firm's resources to earn the best possible return for shareholders."

W. Thorndike

What is the Capital Allocation decision process?

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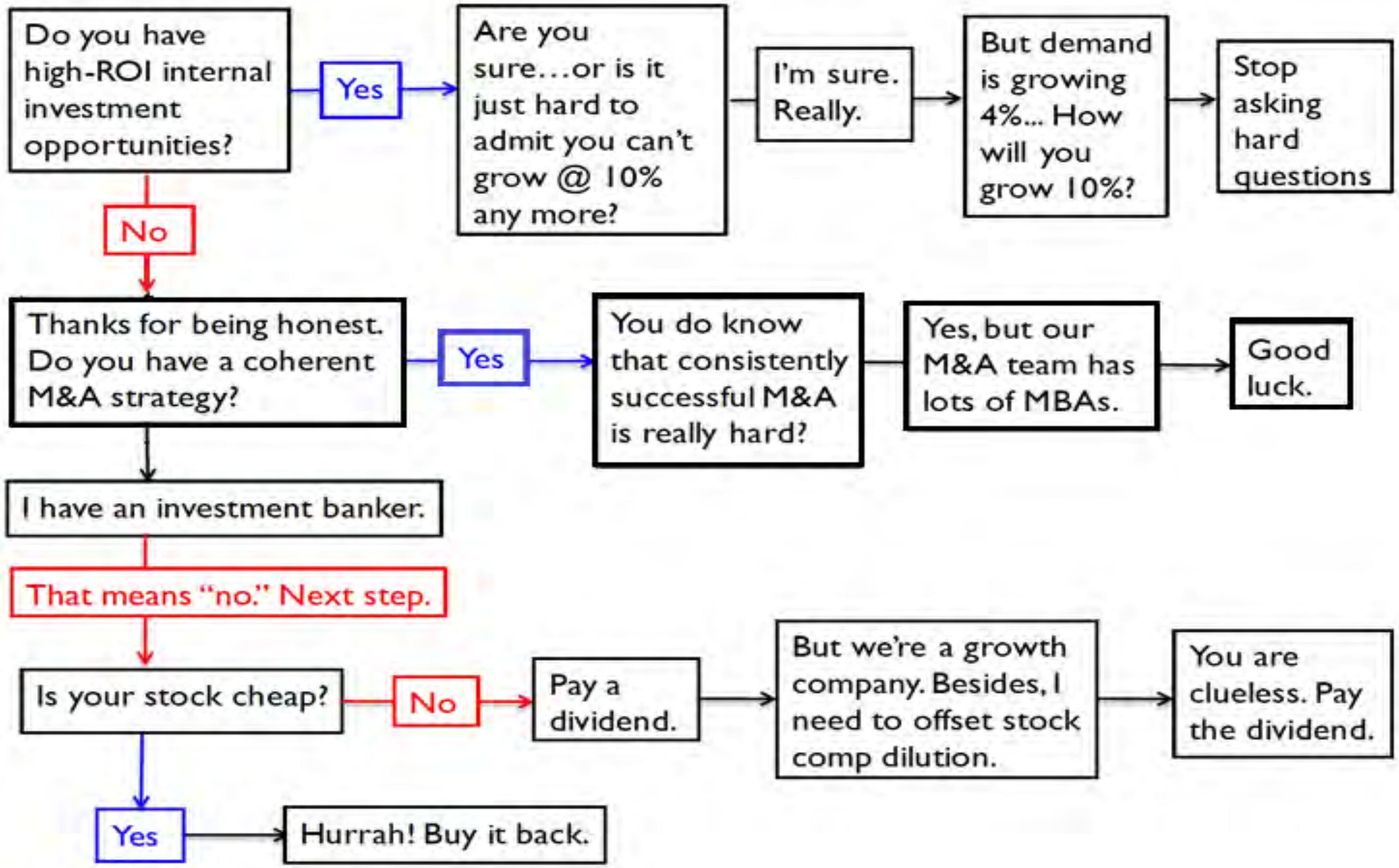

Source: Slide taken, with permission, from Pat Dorsey

3. The idea - Judges Scientific

Summary – Judges Scientific

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Judges Scientific plc (AIM:JDG) is a UK based serial acquirer with focus on the scientific instrument sector. Since 2005 Judges has acquired 14 small niche companies at low multiples. 82% of sales are outside the UK.

Name	Judges Scientific (JDG)
Stock price on 3.10.2016	£12.00
Mcap	£77 Mio.
+net Debt	£10 Mio.
=TEV	£87 Mio.
P/E (LTM, adjusted)	12x
TEV/EBIT (LTM)	10x
P/Owner's Earnings (2016E)	**14x**

CEO David Cicurel owns ~15% of the outstanding shares.

Stock chart

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Since the peak in March 2014, the stock is down ~50%.

Source: Capital IQ.

How do they make money?

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60% of customers are Universities, 10% are testing firms and the rest are a diverse group of researchers from pharma, biotech, commercial and industrial backgrounds.

Examples:

- instruments to test flammability
- fibre optics testing instruments
- Educational instruments
- R&D instruments for food and drinks
- instruments to test the mechanical properties of soil and rocks
- Ultra high vacuum manipulation
- systems for neuroscience research

Source: Company presentation

Do the individual businesses have barriers-to-entry?

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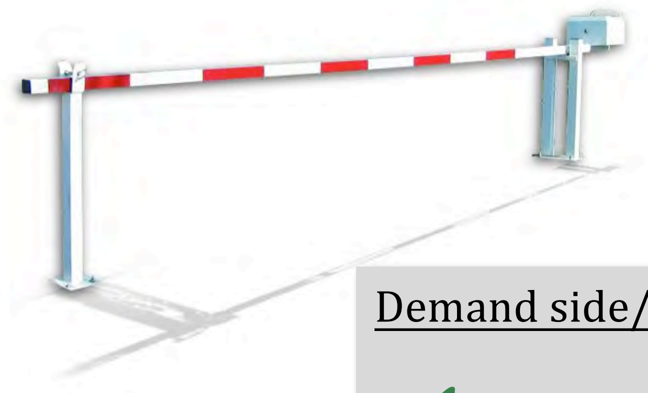
"Greenwaldian" methodology of competitive advantage analysis.



Barriers-to-entry checklist

<u>Demand side/Consumer</u>

✔ Search costs

Reputation; researcher use "high standard" equipment as other researcher; detailed scientific knowledge (example Scientifica)

<u>Supply side / producer</u>

✔ Protected technology
✔ Learning curve

Businesses are typically market leader; small markets protect incumbents; firms always own IP

Professor Bruce Greenwald, Columbia Business School „Media Mogules", „Competition demystified"

Strategy & Communication

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The annual report and presentations do a good job in explaining what they do. However, they do not clearly convey their vision of what they can be best in the world at and what their financial focus is.

1. Vocabulary: "long-term sustainable profits", "cash flows", "long-term strength".

2. Deeply passionate about: Not clear. "Acquiring a diverse portfolio with sustainable returns and strong dividends"

3. Best in the world at? Not clear

4. Focus: "Target companies need to meet exacting performance criteria that supports sustainable sales, profits and cash generation"

>>> Does not show signs of a great business

Management and capital allocation

… however, after meetings with CEO (and business managers) we found many elements of a great "serial acquirer".

- Understands EVA? … Yes, CEO understands drivers of shareholder value creation
- Think and act like owners? … 19% ownership
- Shareholder oriented compensation structure? … CEO base salary 160k + 40k bonus
- Integrity and business ethics? … very trustworthy, humble
- CEO character: … mathematician, very analytical, "value investor"
- BUT: … Pays a dividend

>>> CEO is trustworthy, thinks and acts like an owner.

Small is good – long runway

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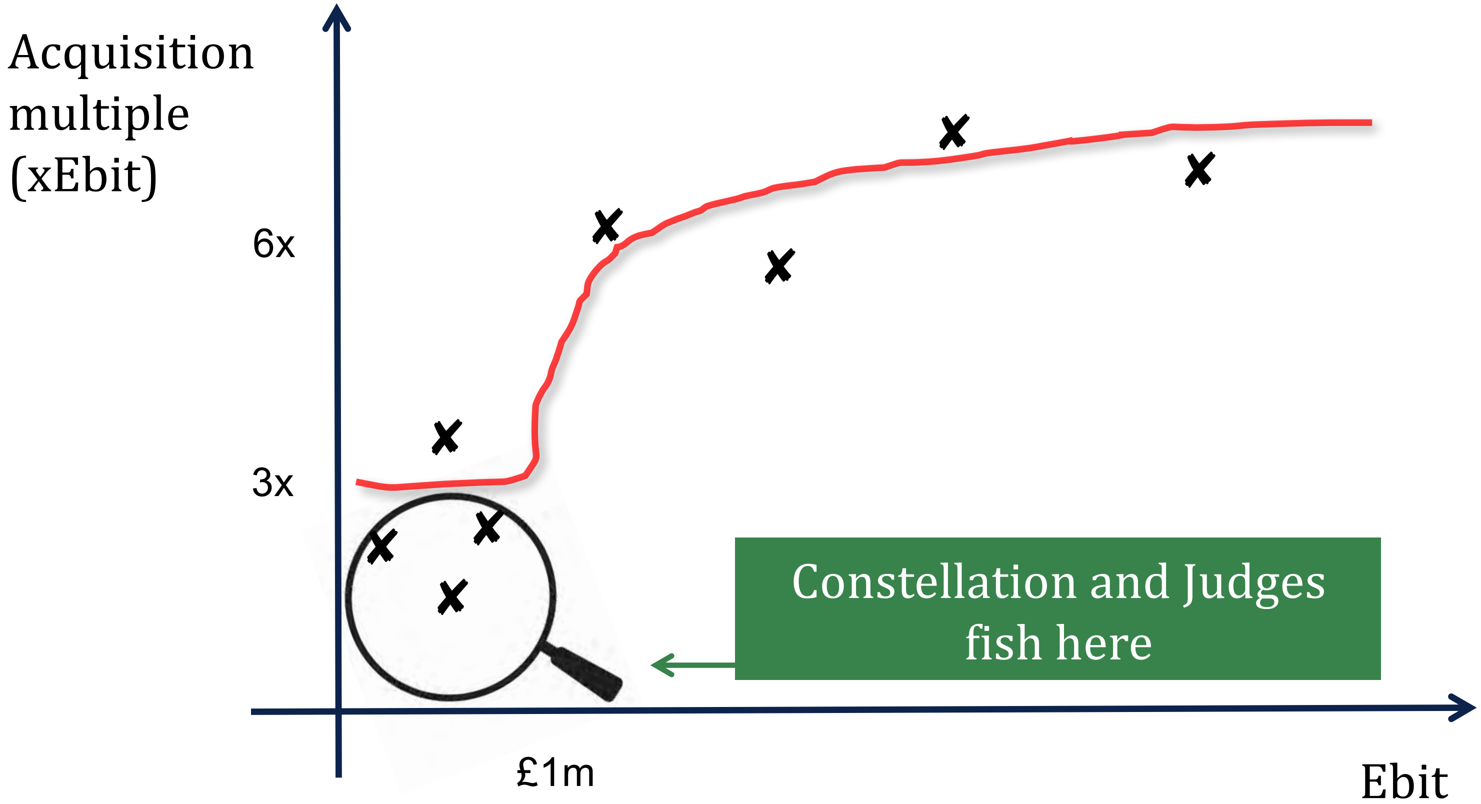
Fragmented: There are c. 2000 private companies in the sector with little competition for small companies with Ebit <1m.



Value creation – portfolio of businesses

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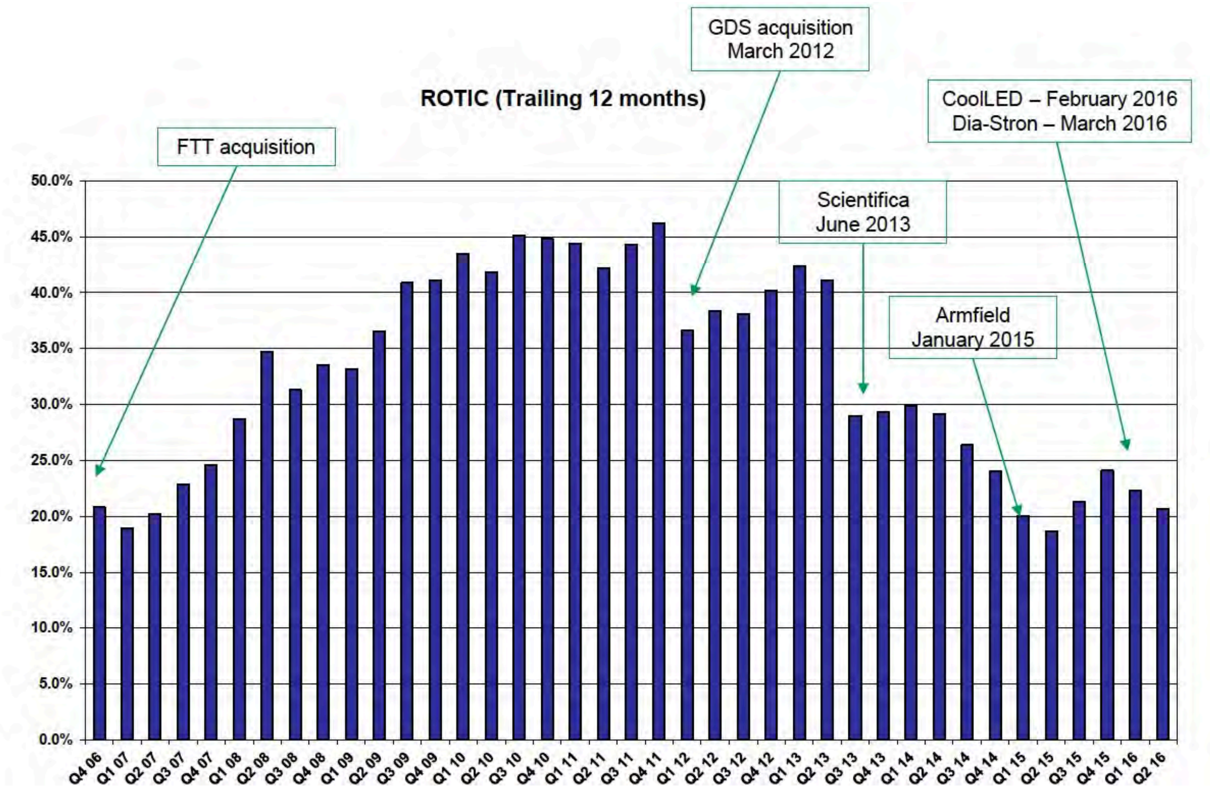
ROTIC shows the operating efficiency of the company portfolio.



Source: Company presentation

>>> Acquisitions have produced high returns on capital.

Value creation – shareholders

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Return on total equity, calculated on a per-share-basis, shows the true picture from a shareholder's perspective.

(in £Mio)	2008	2009	2010	2011	2012	2013	2014	2015
FCF (before Acquis.)	0.8	1.4	1.2	2.8	3.8	1.6	5.5	6.0
Acquisitions (net)	0.0	1.0	0.8	3.0	6.6	11.6	0.5	7.5
Dividends	0.1	0.1	0.3	0.4	0.6	0.9	1.2	1.4
Reinvestment Rate (Acqu./FCF)	0%	75%	68%	104%	177%	731%	9%	124%

In total 1.3x FCF deployed in acquisitions

(in £/share)	2008	2009	2010	2011	2012	2013	2014	2015
A: NI (adj.)	0.2	0.3	0.4	0.6	0.8	1.0	0.8	1.1
B: Average total equity	1.9	1.9	2.0	2.3	3.1	4.5	5.4	6.6
Return (A/B)	12%	15%	22%	25%	26%	21%	15%	16%

Source: CapitalIQ, Polleit & Riechert Research

>>> Decent returns on shareholder level. Will improve with more acquisitions.

Valuation

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This year has been a mixed bag with slow demand for some businesses and production issues. Margins will be depressed but demand has picked up recently.

End of 2016	
Our estimate of adjusted EPS (£)	0.85
Stock price	12
P/E	14x

Growth	
Organic	3%-4% (9% CAGR in last 8 yrs)
Acquisitions	11%-15%
Total	14% to 19%

On the back of the envelope valuation:
On sales of ~58m Judges should make ~20% in EBITA margin (=11.5m). Minus head office cost (1.5m), Interest (0.5m) and tax of 20% Net income comes to ~6m (or 1.25 per share).

With adj. EPS growth of 14% over the next 5 years the company should trade at ~18x 2016E adj. EPS = £15.20. (With growth of 19% at ~22x = £18.80).

Assumptions: Reinvestment rate 75% of FCF in M&A, acquis. multiple 3-4x Ebit (25% to 33% ROC), financing with 2-3x Ebitda.

Risks

With M&A many things can go wrong…

- No stable recurring revenues (instruments last long)
- Public spending / Austerity impacts demand for science and research
- People risk: David Cicurel is important

That's all. Thank you.

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