High Conviction EAFE

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Last summer we ruminated on the potentially fertile conditions for increased share buybacks among Japanese firms. The increased propensity to repurchase shares being exhibited by a number of historically hidebound and high-profile corporations continues to bode well for shareholders longer-term. Nevertheless, it is worth reiterating that, particularly for the caliber of companies we invest in, the more strategically significant aspects of balance sheet management are M&A. However, both academic research and market experience show that surprisingly few management teams are consistently able to exercise financial discipline and demonstrate success in operational integration. There is no universal recipe for success, and companies that exhibit both skill-sets are a relatively scarce and valuably-compounding commodity.

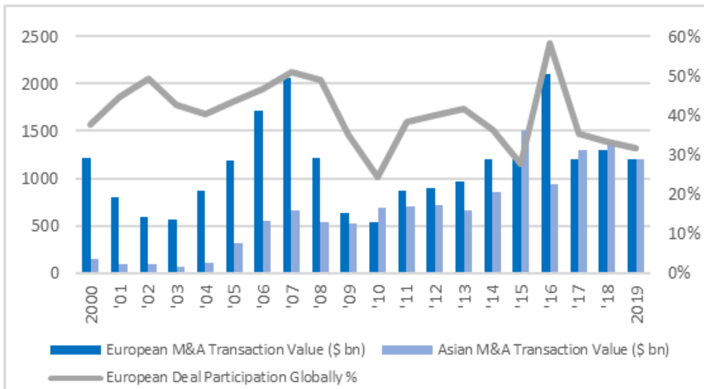
European M&A as a percentage of global deal-value participation has been relatively muted in recent years. A hard-nosed EU Commissioner for Competition, German economic softness, and Brexit uncertainty have all played a part. It is noteworthy that in dollar terms, annualized activity levels in Asia have been on par with Europe since 2017, just north of $1 trillion in aggregate.

However, there is reason to believe that European deal activity may pick up, and two recent transactions illustrate the different types of deals that exist. First, the plan to combine auto manufacturers Peugeot and Fiat-Chrysler, quick on the heels of the failed Renault/Italian group merger, acknowledges an urgent need within the industry to address costs and build platform scale in the face of daunting transformational investments. The challenges of this merger are complex enough for us to maintain a watching brief, but the risks are likely to prove less severe than those of defying necessary industry consolidation. Second, and more relevant to our portfolio, is French luxury goods conglomerates LVMH's bid to acquire iconic jeweler Tiffany. Despite the sumptuous business category and price tag of $16.9bn (17x trailing EBITDA), this is far from being a "trophy asset" deal. Rather, it bears the hallmarks of LVMH's fundamental strengths as a well-managed group with ample scope to diversify its world-leading portfolio of brands and augment an existing roster of growth generators via earnings accretive deals.

M&A expertise, an elusive mix of financial and operational prowess in timing and integrating deals, is often a feature of our individual company investment theses. The specific cadence and significance of strategic deal-making is determined by industry dynamics and concentration levels. Chemical distribution specialist Brenntag is an example of a frequent, but piecemeal, consolidator of a globally fragmented industry where secular and digital trends should reward economies of scale. Conversely, freight forwarder DSV has accrued considerable investor goodwill over the years for its unblemished track record of acquiring more sizable but underperforming competitors and over-delivering in terms of the scale and timing of operational synergies.

To underscore the fact that buying rather than building cross-border growth can be fraught with risks, we should humbly acknowledge where M&A has not lived up to our expectations. There is little doubt that one German chemical company is experiencing "Bayer's remorse" in the wake of its big-ticket acquisition of Monsanto. However, we believe that the company's market cap destruction due to glyphosate litigation risks likely exceeds the ultimate financial impact, and we remain holders.

Exhibit 1: Global M&A Activity



Source: Bloomberg

Finally, it is worth considering cases where targeted acquisitions were successfully rebuffed. Pharmaceutical company Astrazeneca spurned U.S. rival Pfizer in 2014, and has since successfully navigated a "patent cliff" of expiring blockbuster drugs and reinvigorated the pipeline of next generation therapeutics. We bought the company in 2Q of 2018, and it remains a key holding having gained a further 30% in 2019. On the other hand, Unilever was able to escape the combined clutches of Kraft Heinz, 3G, and Warren Buffett in 2017. However, this required management to undertake some of the activist, cost-eliminating practices of its predators, including zero-based budgeting techniques and more frugal marketing spend within SG&A. The resultant margin uplift helped to buoy shares but the ongoing de-emphasis in brand investment ultimately led to slower revenue growth. In anticipation of these sales headwinds persisting, we sold our Unilever position in 1Q of last year. The shares subsequently endured a steady de-rating in the second half of 2019, culminating in a downgrade to financial guidance in December.

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DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

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