# Why we favor profitable growth

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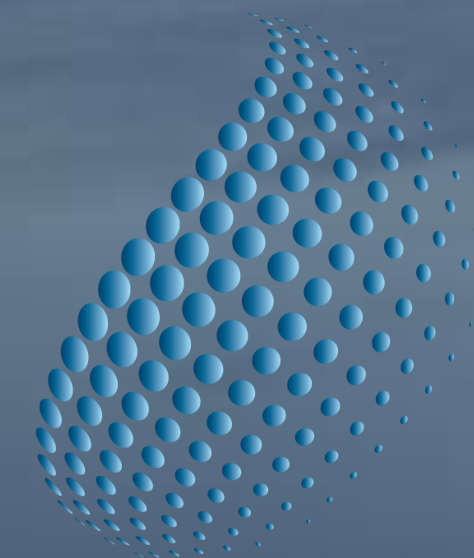


REQ CAPITAL

INVESTING WITH INSIGHT

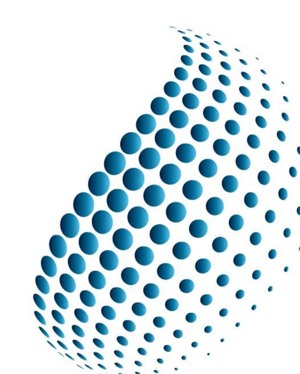
## Why we favor profitable growth

Growth stocks have been out of fashion lately, triggered by fears of rising inflation and higher interest rates. This follows years of massive outperformance in these stocks. Most of this outperformance has come from companies operating in industries that are predicted to grow significantly over the next decades, such as sectors like technology and renewable energy. As interest rates have risen, the discount rate for these future cash flows has increased, resulting in lower company valuations. But do higher interest rates and poor market sentiment mean you should steer clear of investing in growth?

At REQ Capital, we invest in companies that grow profitably over time through programmatic mergers and acquisitions (M&A), known as serial compounders. This type of M&A activity comes in addition to underlying organic growth, providing these companies with dual engines for growth.

Programmatic M&A is high-paced acquisition activity of small private companies, that often generate no more than 1% of the parent company's total revenues (USD 1-10m). Acquisitions are made at significant discounts to market multiples due to the size of the target companies (acquisition targets are often too small to attract interest from private equity) and liquidity (private owners selling). The sellers of these companies often prefer to sell their companies to serial acquirers because they are perpetual owners, maintaining a decentralized organizational structure, and do not want to restructure or change the company in any way.

The companies in which we are invested have shown impressive growth rates over the past decade, and most of that growth has been achieved through programmatic M&A. We invest in companies that we expect will continue to grow profitably in the future. Growth will be achieved step by step through small acquisitions and is not dependent on positive macro cycles or large megatrends in the distant future.



Growth itself does not always create value. Growth requires investments, and for growth to be valuable those investments must generate a return on capital that exceeds the cost of capital. If a company grows with returns below its cost of capital, the growth is value destructive. We value profitable growth and invest in companies that can deploy a lot of capital at high returns over long periods of time. Therefore, two criteria must be fulfilled: profitable reinvestment opportunities (high incremental ROCE) and long runways of growth. We capture both criteria through our investment philosophy.

## Profitable reinvestment opportunities

Serial acquirers are characterized by their systematic approach to M&A, and strict return requirements. They rarely acquire companies presented to them by M&A brokers, but rather source deals themselves. Dialogues with potential acquisition targets often lasts for years. They rarely pay more than 5-8x EV/EBITA, which equates to 13-20% return, with no improvement in cash flow generation. Despite rising asset prices and multiples in the public markets in recent years, we have not witnessed the same multiple expansion in the private markets. We are often asked how it is possible for these serial acquirers to buy companies at these valuations. The answer is that most acquisition targets are too small to attract interest from other buyers, and that sellers care about non-financial factors, such as keeping employees employed, and continuing the business without restructuring it or liquidating assets. Purchase considerations often include earn-out mechanisms, with a portion of the consideration often consisting of stock in the parent company, and management of the acquired company continuing to run the business.

Successful serial acquirers achieve high returns by deploying their capital to purchase well-managed companies that generate a high return on invested capital on their own. However, the prudent pricing discipline of these companies also leads to a public-private arbitrage, as most of these serial acquirers buy private companies at significantly lower valuation multiples than their own valuations.

## Runways for future growth through acquisitions

In the EU, there are over 22.5million SMEs (small- and medium-sized enterprises), representing 99.8% of all businesses. In the US there are over 32million SMEs, comprising over 99% of all businesses. SMEs are defined as companies with fewer than 249 employees and revenues of less than USD 100million. This showcases that the global economy is largely made up of smaller businesses, and that the number of potential acquisition targets for serial acquirers is large. There may be regional, industrial, or regulatory limitations on the market size within certain areas of the market, but overall the pipeline of growth is endless.

We are often asked about the future growth prospects of these serial acquirers, and how we analyze them. There are two types of serial acquirers: generalists, who acquire companies in all industries if they meet certain return and profitability requirements, and specialists, who focus on a niche market or industry. It is easier to analyze the growth prospects for a specialist serial acquirer than for a generalist, because the market is limited to one product or industry, but nevertheless the number of potential acquisition targets gives a good indication of future growth for all serial acquirers.

## Conclusion

We invest in growth companies, but only in companies that have profitable growth and good long-term growth prospects. The valuation of these serial acquirers is usually higher than the market. These companies are systematically and consistently growing their earnings, and current earnings estimates rarely reflect acquired growth. Because it is difficult to predict the pace and timing of acquisitions that have not yet been announced, consensus estimates often do not reflect this growth before the transactions are fully reflected in earnings.

This means that while the valuation of these serial acquirers remains at a premium to the market average, the growth rate of our portfolio holdings is high, and the return on capital over time is also well above the market. We are willing to pay a premium for exceptional companies, because we believe the market is underestimating their growth prospects. Growth stocks are not bad, if it is the right type of growth.