Podcast: Aktiesnack #70 Adnan Hadziefendic – REQ Capital

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Peter: Please tell us a little bit about yourself and your background and also what you do at REQ Capital.

Adnan: First of all, thank you for welcoming me here to talk about what I like and if you can have a passion for something in investing, it really for me is these types of companies. Portfolio Manager at REQ since last autumn. We have a strategy of investing in acquisition-driven companies. We have two funds, one on a Global basis and one on a Nordic basis, and I am responsible for the one that is in the Nordics.

Peter: Are they exchange-traded funds?

Adnan: It's just listed shares in our funds.
Just before this, I came from Swedbank where I was working full-time with serial acquirers.

Magnus: What did you analyze and monitor?

Adnan: Yes, I was an analyst in Corporate Advisory. I had a very unique role and was the only one at the bank who did this.

Peter: How long were you at Swedbank?

Adnan: Two years and before that I was at Danske Bank for 12 years in various roles. Started on the relationship side with companies but the last 7-8 years with analysis. Partly with credit, but with financial corporate advisory to medium-sized and large companies.

Peter: Was that where you started your journey to serial acquirers?

Adnan: I wouldn't say that. I myself have been interested and have been active with stocks privately for almost 20 years. The interest was born in high school. Funny when you think back to how I found the way to the stock interest. At that time, Quartr didn't exist. Then it was teletext page 202 you went and looked at. Remember that my first two purchases were HM and Eniro, except for Sandvik as I have an origin from Sandviken. I didn't know what I was doing so I went and bought the ones that were at the top of the list and I realized after some time that I was buying the ones that had the highest volume. I have learned a lot along the way, and I think this development that many investors have, you start with high risk and then you find your investment process and philosophy over time.

Magnus: Didn't you buy the biggest and safer ones from the start?

Adnan: Eniro wasn't the safest. All the mistakes have been made along the way. Bought all sorts of things. Over time, I discovered this with acquiring companies. You look at the fact that they have given very good returns on the stock market and then you start to think about why. Then I started digging a little deeper into it and realized a lot of different interesting features that I think we're going to get into today. The real spark for me was during the hysteria in 2020 that started with gaming companies and then other companies, and I thought that acquisitions should be difficult. Is it really this simple that every acquisition you make, the share price reacts by 10-15-20%? Then I started to do more in-depth research with a broader base of companies and tried to find the factors that determine whether an acquisition is good or bad.

Then I started at Swedbank in the fall of 2021 and that's where the hype was quite big around serial acquirers. That's when I started a study on acquisition-driven companies with the theme "What drives long-term shareholder value?". This was right on the hype, and I started at Swedbank 5 days before Storskogen was listed and I didn't really understand what was happening in the market.

Peter: For the listeners. Before we delve into serial acquirers as a theme, it may be good if we mention a few company names to make it easier to make connections to actual companies. Today we're not going to go deep into cases, but more about serial acquirers as a concept. Feel free to name a few serial acquirers that you should know about and what we will talk about.

Adnan: There are many interesting ones. This study that I was doing at Swedbank. My idea was to present it to 10-15 companies and it ended up with over 100 companies, managements, owners and actually a lot of boards. It was a snowball effect of this that it felt like I was a bit contrarian there on all the hype, but it was received very well. At that time, I looked at about 80 companies in Sweden and looked at characteristics that make them very good over time, and one can mention Indutrade, which has done very well, Addtech, Lagercrantz and Lifco. Then we have companies such as Assa Abloy, Hexagon under Ola Rollén, Atlas Copco has been doing well for a very long time even if it's not a serial acquirer per the definition we use and we're going to talk about why I don't like to talk about serial acquirers. Nibe is another example that has been doing well for a very long time. There are many good examples from Sweden that have done very well for a very long time.

Peter: It's interesting because they're slightly different types of serial acquirers so you can do it in more ways. Through synergies or other things. Do you want to talk about different themes then you can place some such as platforms, holding companies or accumulators such as Constellation Software as examples. Do you tend to categorize these into different categories?

Adnan: We have a taxonomy around this. There are definitions on roll-ups, platforms, accumulators and holding companies but we tend to want to keep it pretty simple so we're talking about specialists and generalists. Specialists are that you are in an industry, niche, sector and usually you are more on the roll-up side, and you consolidate an industry or niche.

Magnus: Is Embracer an example?

Adnan: Yes, Embracer is an example. Another example of this is Assa Abloy. Could be an Instalco in electricians/plumbing. Then there are what we call generalists who are more sector-agnostic. There we find more of an Indutrade, Lifco, Addtech etc. in Sweden. The difference between them is that if we're talking specialists, they can scale M&A very quickly. You get the best knowledge and a name so that you become a preferred buyer for those who are going to sell. Generalists have more challenges scaling M&A but on the other hand, a generalist doesn't have a limited selection of companies to buy. There you can fish out of a large pool of companies and choose only the best and cherry pick a little bit while specialists can run into problems of you becoming way too narrow and running out of quality items to buy. Quality is a bit underestimated in this context.

Magnus: It's a question that has come up many times. Are there new objects to be discovered? Is there no more good stuff or are there enough of them in Sweden and the Nordic countries?

Adnan: I would say absolutely. We have done a survey where we look at the Nordic countries as an example. We have found that there are about 55,000 privately owned companies with a turnover of less than SEK 500m, EBIT above 5m and a margin above 8%. It's just the Nordic countries. If we go to the EU, there are about 22 million privately owned companies with 249 employees and the transaction volume is about 15-20,000 companies per year. There is no shortage of companies. What we see is that there will be more and more generational shifts in the future, so there is no shortage of companies to buy in that sense.

Peter – It might get harder when a serial acquirer gets bigger. Then I think that in this order of magnitude it might move the needle just as much for an Indutrade. It becomes a challenge because if a serial acquirer gets bigger, they have to make bigger deals, which is more complex.

Adnan – I wouldn't say it's more complex, but definitely that if you go up a lot in size, you also tend to pay a little more for the acquisitions and with size, the price will be higher and if we look at those who have done it well for a very long time, it's that they stay within their core, which is somewhere between 100-200m in turnover. EV/sales we have seen is 1.0 – 1.5x. They stay within their core. Then there's the matter of going up in size of acquisitions. I think you don't necessarily need to go over this 400 million to 500 million in turnover where private equity comes in and looks. What it's all about for a generalist is being able to scale M&A in a good way. And how do you scale M&A? An important factor is to have some kind of long-term mindset in this. To be able to prepare the organization well in advance and to get people to learn M&A. Let me give you an example. If we take Lifco as an example, Per has under him 10-12 portfolio managers who have been trained in the Lifco school. They all started out as subsidiary CEOs and over time they became more and more involved in the acquisition discussions.

Another example is Addtech. There, you don't have a central M&A team, but everything takes place in the five divisions with sourcing deals, making sure to wine and dine with the entrepreneurs, getting to know

them, etc. The decision itself is then made centrally. Scaling M&A for me means scaling people. To make sure that people know what is a typical acquisition? I think a mistake and something you forget is that you don't look at the quality of the acquisitions. If you want to build a company in the long term, you must not forget what is a good acquisition. It's easy to get caught up in multiples. Even if you paid 5x, the quality doesn't have to be good. You might have acquired on top profits. Quality is very important, but it comes down to knowing what typically is a good acquisition for us. To have people who have been in the organization for a very long time who can recognize that when you go into a company, you notice how the receptionist receives you. Is he/she happy or not? How is the atmosphere at the company and how does the CEO talk to his employees? It's soft factors most of the time and something you learn a lot more over time from having seen a lot of acquisitions rather than just hiring a lot of people to do M&A. It's the easy way but the harder way is to do it for real.

Peter: I was going to ask that if you were going to define quality, how would you do it?

Adnan: Of course it's hard to say because it will vary. Very soft factors. What you tend to see when you look at those who have done very well for a very long time, they have criteria that they stick to strictly and know what they are looking for and don't go beyond those criteria.

Magnus: Do you have examples of any criteria?

Adnan: It could be that there should be a very long financial history. It may be that a company should have long product life cycles, that there is a second man and that you are not just dependent on one person or CEO, that you have a diversified customer base or supplier base. These soft factors are very important and there are examples and I don't know if you know Heico which is a distributor of aftermarket parts to the aircraft industry. Their CEO and founder often talk about this when you get down on the factory floor, how does a CEO talk to their employees? If he speaks to his/hers first name, if he asks how the family and the children are doing? These soft factors are difficult to see from the outside. I myself have looked at any number of subsidiaries and there are examples of when you take a group of 15 companies in a smaller serial acquirer and look at the history of all subsidiaries, it looks very good, but then something happens after the acquisition when the entrepreneur/seller leaves. How do you maintain the culture in the companies? It's hard to quantify it in numbers.

Magnus: How, for example, does Lifco ensure that there is a generational change so that the company they acquire is not entirely dependent on the person they acquire?

Adnan: Lifco acquires companies where they underwrite that the CEO would be leaving the company tomorrow. It should be such a good acquisition that the management should be able to quit tomorrow and go home and they should be able to pursue it further. That is their case. In part of our analysis, we sometimes call the sellers/entrepreneurs. I can take an example where I called a seller to one of our portfolio companies quite recently. He is 65 years old and has sold his company and I sometimes call the entrepreneurs and ask how the process went and why did you sell to this company and was it on price?

I talked to a seller quite recently and I called him at 7 AM in the morning because that was when we had arranged to meet. I started by asking "are you in the car and do you have the time to talk right now?" to which he says "I've already been in the office for an hour and a half since half past six in the morning." It turns out that here is an entrepreneur who is 65 years old, sold his company and received a lot of money but he loves what he does and yet he is in the office at half past six in the morning as if he was still the owner. In this case, it was not on price, and they had sold to one of our portfolio companies even though there were two bids that were higher, one from private equity and one from an American industrial buyer.

That's often very much what we encounter when we call these sellers. And why are you allowed to buy a company? A lot of it has to do with the fact that these acquirers who have been doing well for a very long time don't come in and talk about multiples, but about the business. How should we develop the business? You talk about production, customers, suppliers, products, i.e. the soft factors. They are usually the ones they get to win. They understand the business and therefore make a good home.

Peter: It is often said that acquisitions are generally not value-creating, but rather are more value-creating for the seller than for the buyer. Is this something that you would say is true and if it is true, there are a lot of companies that make acquisitions despite this, which I think is exciting. Then I think that many people have an incentive to just build a big group, a big company. You may be incentivized on the wrong things, etc. Feel free to talk a little about this and if it is true and what you think are the key factors. Synergies might be a lead-heavy variable, for example, or a decentralized model, and incentivizing, for example, the entrepreneur like the one you're talking about who is 65. Maybe he still had the incentive via earn-out. Talk about the most important factors in making a good acquisition.

Adnan – Great question. There are a lot of good things that make a good acquisition. If we start with how they make the acquisitions, these companies doing it very well. Usually, they do a lot of the sourcing themselves at these companies. You may have got to know the entrepreneur 5, 10, 15 years ago and followed him and wanted to acquire but it hasn't been the right time. On the one hand, you remove some of this cultural risk if you acquire someone you've known for a long time. It might be a customer, supplier or partner. Back to quality, a lot of it is about people around acquisitions. You buy people. To also be able to identify the fact that the entrepreneurs who sell – why do they sell? Is it a natural retirement or does he just want to take the money and go down to Marbella and drive a Ferrari? I.e. are they just after the money? I think many of these people who have been doing it for a very long time are good at identifying that. A lot of it comes down to pattern recognition, gut feeling and knowing what is the right acquisition.

Peter – Would you say that, as a rule, this is true that acquisitions are not value-creating? That statistic has appeared in a few books I've read.

Adnan – That's a common occurrence and a very good question. If you look at what these companies do, there are a couple of things that differ. Partly because the acquisitions are usually very small, and partly because you make acquisitions quite frequently with 4.5, 6 or 10 acquisitions per year, which means that

you get a good playbook on how to make acquisitions. When you're making acquisitions that are maybe 0.5% – 1% of your revenue per acquisition, then you don't have this when you're making large transformative acquisitions that the cultural risk destroys the company and that something goes wrong.

There are many examples in history where major acquisitions have gone wrong. What's also interesting is that they never count on synergies, especially when we're talking about the generalists. The companies must stand and walk on their own two feet. We are not going to include synergies, but then you get soft synergies such as help with pricing, the price may not have been raised for a long time, help with sourcing if you get into an organization, you get X% help with a better price. It may also be just that you add energy to the companies. There may have been a CEO/entrepreneur who has been there for a long time and stagnated on the journey and needs to take the next step – then these companies bring a lot of energy and knowledge that leads to a new start.

What's also important when it comes to acquisitions is to avoid buying turnarounds. You should buy companies that have a very long history, often family owned. These families are usually allowed to stay and operate in their towns. We get into decentralization that the entrepreneur who sells can be sure that this is a safe harbor for my company. The staff can stay, the company name can stay, jobs and everything that goes with it are retained. That's when you dig a little deeper, it's the small factors that mean that many small pieces are important. It's not necessarily that acquisitions destroy value. There are what we call programmatic acquirers who have this playbook of making acquisitions frequently and that they're small and they're building slowly, which is an important factor.

Peter – I can imagine that turn-arounds are a thought that comes to mind. You may also not want an acquiring company to go bad and then make a large acquisition, i.e. that the acquiring company should not be a turn-around either. It can be a signal that you may be making a panic move and now we are making a major acquisition because something needs to happen. I guess that's something dangerous.

Adnan – It could be something dangerous. You shouldn't cover losses with acquisitions, but we like to see acquisitions from a position of strength. You shouldn't make acquisitions just for the sake of acquiring and it should add some value and you shouldn't do it just because you can.

Peter – If we turn that question around. What are typical acquisition warning signals?

Adnan – It's very interesting and I think if we go to the stock exchange, and I don't want to point out anyone particular There are a lot of companies who have gone very wrong in recent years on the acquisition front. A few companies have to bear the brunt of the media but I think that if you look in general, there are a lot of things that we look at that are red flags and that can be characteristic when you go about acquisitions. One example is that the pace of acquisitions is far too fast. You get caught up in some form of FOMO and we have seen many people do that.

Peter – Then I can interject with an example when you don't want to, but maybe Storskogen comes to mind spontaneously.

Adnan: – Yes, that's one example, but there are a lot of others, I can say, who have fallen into the same trap, so it's not just Storskogen. Then I think that also, and this is difficult to know at the time of acquisition, but the quality of the acquisitions that have been made has not always been so good.

Magnus – But it may well be the same right as well. If you do it too quickly, you don't really know the quality.

Adnan – Yes, it's usually connected. Then there is also the fact that when you are a new acquirer, the question is what type of company can I buy? For example, if you are a Lifco or Addtech, you have a brand. You know it's a safe haven but if I'm the new guy in town, how am I supposed to convince that I'm a good buyer? Then I think there is a risk that you will have to buy companies of poorer quality, and I know that Patrik Wahlén has talked a lot about this when they started Volati. If they hadn't done Tornum in the end, there might not have been any Volati and that it is very difficult as a new acquirer to find acquisitions. You have to convince brokers, you have to call companies and it's not always easy, so it's difficult.

Peter – Speaking of Patrik Wahlén, I listened to an interview with him quite recently with Niklas Andersson in the Montrose podcast and he talked a lot about countercyclical capital allocation. Is there generally one thing that you would say is good? That is, you don't get this FOMO in an economic boom and spend all the money, but rather can then be mentally disciplined and build a balance sheet and then you use that capital when there is less competition in a worse capital. It's rational when you put it up like that and I guess it's something that you're looking at.

Adnan – It definitely is, and debt, of course, is often something where you often go wrong. You take on way too much debt, which means that you may have run a little too fast. When we think about acquisitions and the model, for us it's about the compounding effect. What is important when it comes to compounding? It's like Warren and Charlie say it's important not to interrupt the compounding. It's easy to run too fast and then you have this thing with 2-3-4-5 consolidation years, but then the beauty of compounding disappears when it's interrupted. When it comes to the very thing you mention. Let's take the example of Indutrade. If we look at Indutrade, Lifco, Addtech and Lagercrantz, they have never been above ND/EBITDA above 2.5x, and we are talking about a history of 20 years plus. Never above 2.5x EBITDA:

Magnus - Not even in the financial crisis?

Adnan – Not even in the financial crisis. Let's take an Indutrade as an example. They went into the financial crisis with a debt of around 1x or just under 1x EBITDA – and what are these companies doing? Well, they tend to sprint their way out of crises and then when times are good, they don't continue to be aggressive. They are very long-term in what they do and work very countercyclically. When FOMO has been in the Nordic region and Sweden with acquisitions in recent years, these companies have basically acquired

abroad. If we take Lifco as an example, they have hardly made any acquisitions in Sweden and the Nordic region in recent years.

An important factor when it comes to leverage is that we look at the owners. People tend to miss talking about owners sometimes. Having the long-term owners who build companies over 10-20-30-40-50 years, you don't need to max out the balance sheet here and now. An interesting example of this is when I had a lunch with a former CEO of a company. He talked about how they had a big owner and a chairman. The CEO told me it was once when he had a dry pipeline and maybe wasn't sleeping well and was a little worried about not having anything to acquire for the moment. Then he went to his chairman who said, "You don't have to worry. We are not in a hurry. It doesn't matter if you don't find an acquisition in two or three quarters. We are building this company for the long term." In the same way, I think the opposite is true, to find these stable owners who can say "now we're running too fast, now we're going to take it easy here".

Peter – And on those KPIs. Is it the case that ND/EBITDA is lower when things are going really well and is it generally higher in a high or recession?

Adnan – I would say that they operate regardless of the cycle.

Peter – So it's normally at that level?

Adnan – I'd say it's normally around 1-2x EBITDA.

Peter – Now I was thinking of Berkshire who hoard a lot of cash in a good climate and then they get a lot of criticism and then they just sit and then can deploy as much as they want when everything just collapses.

Adnan – When talking about debt, it's easy to forget that these companies are basically completely self-financed. Especially when we're talking about these bigger ones that have done very well. If you look at the capital allocation of an Indutrade, Addtech, Lifco or Lagercrantz, we can use these 4 as examples here, but there are also many others. If you adjust for the dividend, these companies are in principle completely self-financed. You could say that the debt they have is to finance the dividend. They would have been completely self-financed without the dividend and that's the beauty of this model, that it can be done.

When you look at what has happened in recent years, we have seen too many companies perhaps make it a little too easy for themselves. It's easy to issue shares and easy to take on debt. When it comes to stocks, we prefer companies that don't issue shares, but we understand that there have been times in history where it has been successful to do so. There are also many examples of where things have not turned out well. When you don't use shares as a means of payment, you get management discipline.

Peter – In addition to being good in a value-creating context, it also sends a signal that you are calm and disciplined and long-term.

Adnan – Exactly. And as I said, there are examples of where it has gone well, Nibe acquired Climate Control Group in 2016, Hexagon acquired Leica Geosystem in 2006 and Integraph in 2010, and Sweco acquired Grontmij in 2015 where it has worked very well. Conceptually, I think that when you issue shares frequently to pay when you run out of dry powder on the balance sheet, it's the easy way out for managements. If you have done it once, we believe that there is a risk that you will continue to do it again. At the same time, valuation may be high so theoretically it is very good to issue shares at high levels and then you pay less for acquisitions, but again it can be a fragile situation what shares trading at, how the valuation is, and it is not certain that you can issue if you are in a financial crisis. It will be a lot more difficult than financing with your own cash flow. We like companies that can be completely self-financed, although there are examples in the history of when it has worked.

Peter – If we take these big 4, Indutrade, Lagercrantz, Lifco and Addtech. Then you usually buy with cash and not with equity and very little leverage or no borrowing at all? This is the model you prefer and which tends to be best over a long period of time.

Adnan – Definitely. Own cash flow. I don't know if you know of Halma in the UK, which is an acquirer in life science. Now their founder and CEO David Barber has passed away but he had an interesting speech in 1997 that can be found on the internet that said that "if you think your own stock is the best thing you know, why should you share it?". That's the thinking we apply.

Magnus – You're a bit into life science there. Which industries do you think are better to make acquisitions in and are there any that are worse?

Adnan – Generally speaking, I wouldn't say we prefer any specific industry. We can start with what we don't like and that is where there is a great cyclicality, where there is very high competition when there are 2-3 big players consolidating, it can be project-dependent and it can be industries where human capital is very important, i.e. when people who work at the company walk out the door, all the capital from the company disappears with those people. What we like is fragmented markets, especially when we're talking about specialists. When we like specialists, we like that there are large and fragmented markets and a global market potential.

Peter – Isn't Assa Abloy an example of that?

Adnan – Yes, Assa Abloy is an example of that. Bufab is another example. Atlas Copco, Nibe and Beijer Ref are also examples. There are many examples where there is global market potential where no single player is dominant.

Peter – Then it's usually small acquisitions?

Adnan – Yes, generally small acquisitions. We also like industries that have some form of structural growth. Speaking of Assa Abloy, if you read the 1994 annual report after the spin-off, it says that the TAM was SEK

150 billion – and that is the size of Assa today. They have managed to expand their market and expand into new adjacent niches, which has been interesting. Part of their success story is that they have gone from mechanical to electromechanical to now offering a full range of access solutions.

Peter: Another advantage, couldn't it be that they buy private companies? Feel free to talk a little bit about that. If it is better to buy private than to buy public companies.

Adnan – Of course, the price is much lower for an private company than a listed one and an important factor is that you stick to these private companies with a reasonable price tag.

Peter – That's what you like?

Adnan – Yes, definitely. What we see is that our companies are good at sourcing and closing deals in the private market at attractive multiples.

Peter – Is it because there's less competition?

Adnan – Yes, there is less competition and a more inefficient market. These entrepreneurs don't always think in terms of multiples. They think this is a good home for my business. Then I also want to talk about, speaking of which industries we like, is that we like to acquire niche companies that are asset light and do not tie up a lot of capital in growth. What we also see is that many of the companies that are acquired are selling some form of product that is a small part of the customer's total cost, but it is mission critical. If that product is not available, a production line does not work, for example. The item is a small part of the customer's total cost and an operating expense rather than capital expenditure. An example is Bufab and C-parts, small details that must be in a product and that product will not work, but it does not cost much.

Peter: And what that means is that you get pricing power because it's mission critical? There's no incentive to replace it because it's such a small part of the cost?

Adnan – Exactly. You get a lot of pricing power, and we see that around our companies, they have pricing power. They don't grow a lot organically and we don't want them to grow too much organically. We are satisfied with the mid-single-digit.

Magnus – Why don't you want them to grow too much?

Adnan – It ties up too much capital sometimes to grow aggressively. Then these companies are niched in many cases and there may not be potential to grow 20-30-40% per year. There are very few companies that can sustainably grow at those levels over time.

Peter – Speaking of organic growth, how much do you focus on total growth versus just organic? It becomes an important component.

Adnan – Great question and here we get into what I said at the beginning about why we don't like to just call them serial acquirers. For us, it's about that, and this is the attraction of the model, and as we see this with the serial acquirer model, we come in from the risk side of the model. What is it that attracts us to the model? Well it's that you usually have diversified cash flow streams. You are spread across many customers, products, geographies, markets and industries, which means that you get a risk-mitigating effect on it. Most often, the companies that do well have a low level of debt and you get a high level of insider ownership among the best.

Over time, we have also realized that there is an interesting return aspect in these companies. Then we come to the question of what kind of company you are buying. You buy nice family companies at attractive multiples of 5-6-7x and then you have an implicit 20% return on day 1 if you buy 5x. If you buy at 8x, you have a 12.5% return on capital.

What is also interesting about this model, and then to your question Peter, is that in this model you get dual growth engines. You have acquired growth but also the organic growth. What we see is that in crises when organic growth declines, you free up a lot of cash flow that you can use for acquisitions. We think the organic aspect is important because it says something about the ability to develop a company over time. That you don't buy companies just to buy them or to pile them up, but there is a thought behind.

Organic growth doesn't have to be 10%, it's enough for GDP+ and that's pretty good. Most of the time, the return on organic growth is high. Many of the companies have a 50-70% return on invested capital on organic growth. Then you have the acquisition price that matters. If we take Lifco as an example, they report ROCE ex goodwill, and it is well above 100%. The companies they are acquiring are very fine at the core. Organic growth is important because the bigger you get, the more important it is to work with organic growth. If you listen to Assa Abloy or Indutrade as examples, they talk about organic growth. If we take Lifco, they measure their operations managers only on organic growth.

Peter – So that's what they have incentives for?

Adnan – Yes, that's what they have incentives on and not on acquired.

Magnus – But they also deal with the acquisition part?

Adnan – Absolutely. It's about looking at organic growth and how these companies develop that over time. You bring some kind of energy to these companies and that's what makes the difference over time between a good and a bad acquirer. To get these people on board with the acquired companies, to develop them. When it comes to organic growth, one should not stare blindly at short-term fluctuations in it as we are seeing now. Currently, organic for Lifco is -5% and for some others, 0% or 1%. It's very short-term, and it's the ability over time to create organic growth and not what happens in a single quarter. I'm not going to

say that it's not interesting, but that's not what says anything about their ability, because cycles have an effect.

If we take Indutrade as an example and in terms of sales, they have only had negative organic growth on an annual basis since the IPO only during the financial crisis, otherwise it has been at least 0% or positive. This says something about the ability to buy the right companies, quality, but also to develop these companies over time. I think Niklas at Addtech says that "it's easy to buy companies, but what they are most proud of at Addtech is getting these companies to develop over time":

That brings me to another interesting aspect and the mindset you have when you are a serial acquirer. We usually distinguish between an industrial mindset and a financial mindset. Is my mindset to just buy companies at 5x, do an IPO and then expect a multiple arbitrage and then I'm at home and then I check out, or is it the industrial mindset where we see that there are owners and management who are passionate about this and want to build this long-term. They're not here to maximize their companies in 5 years. They love what they're doing. We like to say that "we want our CEOs to retire, not quit". We like that type of company and that way of thinking. There must be a long-term perspective on what they do. Indutrade, for example, has only had its 3rd CEO since 1978. We see this across our entire portfolio. We are looking for the right owners and the right management who are really passionate about what they do. They should think this is the best thing they know when they go to work every day.

Peter – When it comes to incentives and governance models, I think it's exciting. Would you like to give an example of a successful model?

Adnan – We can talk about Constellation as an example, the world's largest acquirer of vertical market software companies. Their incentive program is interesting where 2/3 of the bonuses you receive are to be bought in CSU shares on the stock exchange that are vested over a number of years. What we've seen in Constellation is that this has worked well, and you get a lot of shareholders in the company, and they buy on the same terms as everyone else and across markets. There are many in Constellation who have done it well and for a long time and many of them are today millionaires and are going in the same direction. I think that's very important. That the right incentives are in place and to measure the right things. What we see about the top performers is that they measure some form of return on capital, margin, and growth mainly in profit and not so much turnover. Then there is the capital aspect of it, there should be a good return on capital.

If we look at skewed incentives, we can take an example of a company that has been a fast acquirer in recent years, and today is a fallen star and has lost 90% of market value since its peak. If you read the press releases on the acquisitions made in 2020 and 2021, it says that the targets for achieving the earn-outs are based on certain financial targets. It sounds very good, but if you go in and read the annual report, it turns out that the goals have been set on the sales and order book. What then are the incentives for the seller to maximize? Profit, or just grow topline at every cost? In this case, when the Annual Report was published, the stock had already fallen 60%. This was hard to see in the press releases and it's a lesson to dare to ask.

We have also seen incentives where management has been incentivized to only acquire and acquire in absolute terms. In these companies, it is not uncommon for us to have seen share issues. You're incentivized on weird things that you can't explain. Another example of a bad incentive is where a third was on absolute acquired EBITA, a second on other things that I don't remember and a third on “other”.

Peter – I think it's interesting what you said that it can't be explained. It is interesting from several aspects. On the one hand, those who make this decision, i.e. those who control the company, they do not have the competence obviously over what actually creates value and then on top of that, many people are incentivized to the wrong thing, which could also be value-destroying. These are two things that make this really, really bad.

Adnan – It is, and somewhere it's partly about the fact that there are weak owners who don't know, or where the CEO owns a lot and where the board is weak. For us, it's also about the culture at these companies. There is too little talk about culture when it comes to serial acquirers. What is the culture internally? When you meet these companies, how do they talk? Do they just want to build this as quickly as possible or are these people who want to build it long-term?

When we look at the best, they work a lot with succession planning. That there is a second, third, fourth or fifth man who can take over. There will be no change of course. Let's take Atlas Copco as an example, the division presidents under the CEO have all worked at Atlas for 10, 20, 25 years. The same is true of Indutrade. Per at Lifco says that no one is leaving Lifco. We must have those culture carriers in these companies. We are careful to make sure that the right type of culture and the right incentives are in place. Where we have most often gone wrong in our companies is in corporate governance. That we have misjudged management and their incentives. We have seen many examples in recent years where the CEO is around for 3, 4, 5 years, makes many acquisitions, and then leaves.

Magnus – Do you think culture is more important for serial acquirers than regular companies, considering what can go wrong?

Adnan – Definitely. Let's take an example. If you are a company that was started 5-6 years ago, perhaps private-equity owned, only had a focus on growing companies and then the CEO leaves, and then the CFO and then the business area managers leave – who is the culture carrier at this company? And then you may not have a strong board or owners either. Acquisitions aren’t easy, it's hard, and you don't know what's going to come out. I usually say that when it comes to acquisitions, the hard job is not to make acquisitions, but the hard job starts when all the earn-outs are paid, and the entrepreneur checked out. That's when the hard work begins for serial acquirers.

Peter - But it's still so well known that acquisitions are a difficult process and difficult to execute in a good way. I've always been a bit puzzled why there is this institutional imperative or whatever you want to call it, that there are so many companies that want to make acquisitions. What would you say to that question?

That you are incentivized to sales or to acquire companies? Why is it an acquisition frenzy?

Adnan – It's been like that in recent years and it's clear that the stock market has been an attractive place to IPO companies, and I think many people have wanted to do the multiple arbitrage. My feeling is also after meeting a lot of companies that many have wanted to get rich quickly. And Warren Buffett says it when asked why people are not as successful as you and he replies that no one wants to get rich slowly. When you look at these companies, what are the incentives again? Are these really company builders? When you talk about growth as well, we are not drawn to explosive growth. We are drawn to sustainable growth, and when you talk about acquirers, I think that is perhaps the most important aspect of that – the duration aspect. That is, how long can they go on like this? The faster you grow in the beginning, the less optionality you have on the upside, especially if take on too much debt. We would rather that you grow by 10 – 15 – 20% sustainably over many decades than that you grow 50% for 5-6-7 years – that's a much worse model. That's where I think choosing the right type of horse to bet on is important.

That brings us to specialists and generalists when it comes to the duration aspect. We tend to gravitate a bit more towards generalists because there you have so many companies to choose from that you can actually afford to say no to a company, and you are not forced to buy. If you are a very niche acquirer, you may be forced to buy a company even if you would not want to, in order to maintain your growth numbers, and then you overpay or buy poorer quality and it usually ends in many sorrows. Not always, as there are many good examples as well, but this and this is usually where we see those blowups.

For us, it's about avoiding blowups rather than finding rockets. That's how we look at the model and speaking of generalists. When we look at the generalists, they have a very long runway of acquiring, but you have to do it in the right way and at the right pace and scale at a moderate pace. If you listen to Per at Lifco, he gets the question "why don't you grow faster?". He says they could do that, but they need to be able to scale the organization at the right pace – that's what it's all about. It's not just about buying 10 or 15 companies. It's about getting the organization on board, that it's the right type of people who can make these acquisitions. To work very early with this in your process and get people on board with M&A. Addtech, for example, has an M&A school where you get people to understand this. Runway is very important, but the duration is what is talked about the least when it comes to the serial acquirers.

Peter – If we take two still quite famous blowups. I don't know if you want to comment on those specifically, but what would you have gone wrong in Storskogen and Embracer?

Adnan – I'm sure there are a lot of factors. A rapid pace of acquisitions, very high debt, it has turned out. Large acquisitions and very many. Then it’s also about culture, for example, and not to point out these specifically. What happens to your culture when you grow so fast? What is your culture then? Because culture takes time to develop. Let me give you a few examples. We talk a lot about when you acquire a company, how to manage the company.

If we take the Bergman & Beving sphere – they have this thing called P/NWC which is a business system. How to measure capital efficiency in the organization. That's not something you put on paper and say now we're going to do that. That is something that takes time to develop. That culture of doing what they want. Let's take the Danaher Business System, DBS, which consists of kaizen and lean. It's not just a system. Systems are made up of people, and getting people to understand and be on board takes time. That's why we think when we talk about cash culture. The model is based on generating as much cash flow as possible to the parent company in order to be able to reinvest that capital. You have to get people to understand this. What is our culture? How do we work with accounts receivable? How do we work with price and customer relations? I have read the "Mind and Soul" that exists within the Bergman&Beving sphere and my first thought when I read it was that it will be about acquisitions, but nothing is about acquisitions but about how to conduct business.

When it comes to culture. When you're growing very fast, it's hard to get this in. You have to do it slowly because it takes time. Change takes time for many. Many of these companies that have been sold have worked in a certain way for a very long time. It doesn't work overnight to get them to change their mindset with, for example, now we have to get paid. Let's have an example where the CFO told his subsidiaries that we set all accounts receivable down to 0 after 30 days. And what do you do? Well, then you make sure you get paid on time. I have examples of companies I have met that had P/NWC in their public reports and I have asked them "do your subsidiaries understand that?". The answer is "no they didn't". Now they have removed it from their reports and no longer report it.

Peter: - It's exciting that a lot of this valuable information nuggets is talking to the companies and hearing their reasoning.

Adnan – Very much.

Adnan - Numbers are very important, but it's about understanding the conditions that exist for this company to do this in the long term. What's the incentive for this?

Peter – Speaking of numbers. I think it's pretty tricky to value a serial acquirer. What is your go-to model for valuing?

Adnan – I think there are many ways to do it. We are very long-term investors. We turn to family offices, institutions, wealthy people, pension funds, foundations, i.e. long-term capital. When you talk about valuation, you can't do it without talking about the time aspect of your investment. These are not companies in my world where you are looking for short-term triggers, e.g. an order will come in 3 months. It may suit other companies but not this space. What you often hear is that they look very expensive at multiples. That's the classic thing. The way we look at it, yes we look at multiples but multiples we also find to be a bit treacherous to look at.

For us, it's all about what return do you get the incremental capital, how long can you get it, and how much you reinvest as well. If you have a 20% return on capital and you reinvest 80% of your cash flow, which we see throughout our portfolio that it is 70-80%, then you get just over 15% growth in profit over time. Here, it matters a lot how long you think the compounding will last. If you reinvest 80% of your cash flow at a 20% return on capital, if you dare to look out 10-15-20 years, you will have a very good journey. Just to exemplify for listeners: if you reinvest 75% of your free cash flow at a 20% return on capital, you'll have a 300% return on investment in 10 years. If you do it over 15 years, you have a return of 700% i.e. 8x the money. Compounding effect and making sure it is not interrupted.

Then we can come back to this thing with multiples. Does it look expensive on multiples or not? Let's take an example where you reinvest 75% of your cash flow at 20% return for 10 years. If you pay a multiple of 25x, you'll get your 15% a year if the multiple stays constant. Even if the multiple drops to 15x, you'll still get a return of 9% per annum, which is still better than the stock market. If we're talking 15 years, you get an annual return of 11% given the same assumption when the multiple falls from 25x to 15x. When we look at this, the duration aspect is very important to us, perhaps the most important thing with what return they can get on that capital. So basically, reinvestment rate times return on capital times duration, simplified.

Peter – And then you calculate an IRR?

Adnan – Exactly.

Peter – I was going to ask about free cash flow. Because you want them to deploy almost everything because it indicates that you can do it as a serial acquirer, but at the same time it might be misleading sometimes that free cash flow looks low for many? Feel free to talk a little bit about it because you mentioned the sweet spot 70-80% reinvestment rate.

Adnan – Exactly. And the rest is dividends. Free cash flow for us is before acquisitions and if you want to tighten it up, even before growth capex. But usually to make it simple, it is before acquisition. Then we see that these companies that we look at, when we talk about business systems or P/NWC or capital efficiency, is that they have very high cash conversion. The companies they acquire are capital-light and have a high cash conversion, which means that you get cash flow that you can reinvest. When we talk about free cash flow, there is one thing we look at and that is free cash flow per share that counts.

Peter – Is there a general focus from the qualitative acquirers on free cash flow per share or are many talking about EBITA?

Adnan - Yes, the focus is on cash flow, but they also talk about EBITA. You can also tell when you hear the companies talk that there is a focus on cash flow. Then the question arises very often, how long can this go on for? We spent a lot of time understanding it. We have Indutrade and Lifco around SEK 30 billion in sales, an Addtech around SEK 20 billion in sales and a Lagercrantz around SEK 10 billion. How long can they go

on for? The advantage we have of having two funds, one Global and one Nordic, so we have a good grasp of the global market. Sometimes we tend to have some form of home bias, i.e. in our Swedish little duck pond, a Lifco or an Indutrade look big – but if we look globally, they are very small.

We can take an example of Illinois Tool Works, where before 2007 they entered a different type of phase, they had 850 companies and $16 billion in sales. Indutrade and Lifco are as big as ITW was in 1993 and the journey is very similar to ITW. Another example is Amphenol, a company that I don't think many people recognize or have heard of, which supplies various cables and is a distributor of various communication network systems. Also SEK 16bn in sales and market cap of USD 60-70bn – like an Atlas.

Magnus – How difficult will it be to go outside the Nordic region for an Indutrade or similar?

Adnan – They've embarked on that journey, of course. Before I get into that, I want to say that it's funny with Amphenol when speaking of durability, I read Bergman & Beving's prospectus from 1976 the other day and in it they have a list of their suppliers and Johan Lagercrantz AB, which is today's Lagercrantz, had Amphenol as a supplier at that time – speaking of durability and that you can keep going for a long time if you do it right. This was in 1976, almost 50 years ago.

Peter – Speaking of size, already 30 years ago, it's not a typical serial acquirer, there was talk that Berkshire was so big and it wouldn't be able to continue. Everyone knows what has happened since then.

Adnan – To your question Magnus here. What we have seen is that those who have done very well have built a stable base in the Nordic region, a tree that has stable roots. When you have been building it for a long time it's easier to take the step to Europe and you can have more of a trial-and-error approach to it and you usually buy companies that are half a percent or a percentage of your turnover. If it goes wrong, you don't risk the company. It has been proved that an entrepreneur in Germany, UK, Benelux or Northern Italy thinks exactly the same way as an entrepreneur at home. They face exactly the same challenges. It has also been a cultural journey for them to understand the decentralized way of working.

For us, decentralization is very important. Entrepreneurship is more important than potential synergies. In Germany, for example, we hear that decentralization is different. These is a lot of control, there are synergies and maybe it's private equity that buys, so it's taken a little while to penetrate and get these people to understand, but then comes this snowball effect of people talking to each other and you get a name and become a preferred buyer. People realize that it is as they said and promised, that they are allowing the companies to continue as they have always done.

Lifco hardly makes acquisitions at home in Sweden and the Nordic region. Indutrade is also moving around a lot more towards Europe. Assa Aboy and Atlas have been international for a very long time as well. What I think we have seen in the market is that too many young companies have taken the European step far too early. If you haven't built a stable base at home with culture, cash flow and all that entails, there is a

much higher risk of going outside the Nordic borders. We prefer companies to build slowly. We like that the companies build a stable base and test themselves at the right pace.

Magnus – Do you have a favorite case in Sweden or internationally you want to talk about?

Adnan – There are a lot of interesting cases. We tend not to want to talk so much about cases but talk more about the theme and why it's so interesting and we've been talking about it; High reinvestment rates, low debt, high insider ownership, good at making small private trades, two engines of growth. In the Nordic region, we have about 100 companies on our radar. Not all tick the criteria however, and globally we follow around 300 companies. We like history and there should be a proven track record.

Then when it comes to serial acquirers, we call them acquisition-driven compounders because there is an industrial mindset. We like to see that in our companies, the right owner, the right management, the right incentives. There are a lot of interesting companies and now Karnell will IPO tomorrow and I think it's fun that the IPO market is getting started and we will certainly see even more listings and that makes my life a little more fun. Then I think that many who have lost their way in the last few years, maybe in a couple of years will come back and look a little different and have learned things. There are a lot of people who have lost their way who could come back and have got their balance sheets in order and learned lessons.