Thriving in Tough Times

REQ CAPITAL

INVESTING WITH INSIGHT

As we approach a phase of lower expectations for organic growth, how should we look at Acquisition-driven Compounders in such a landscape?

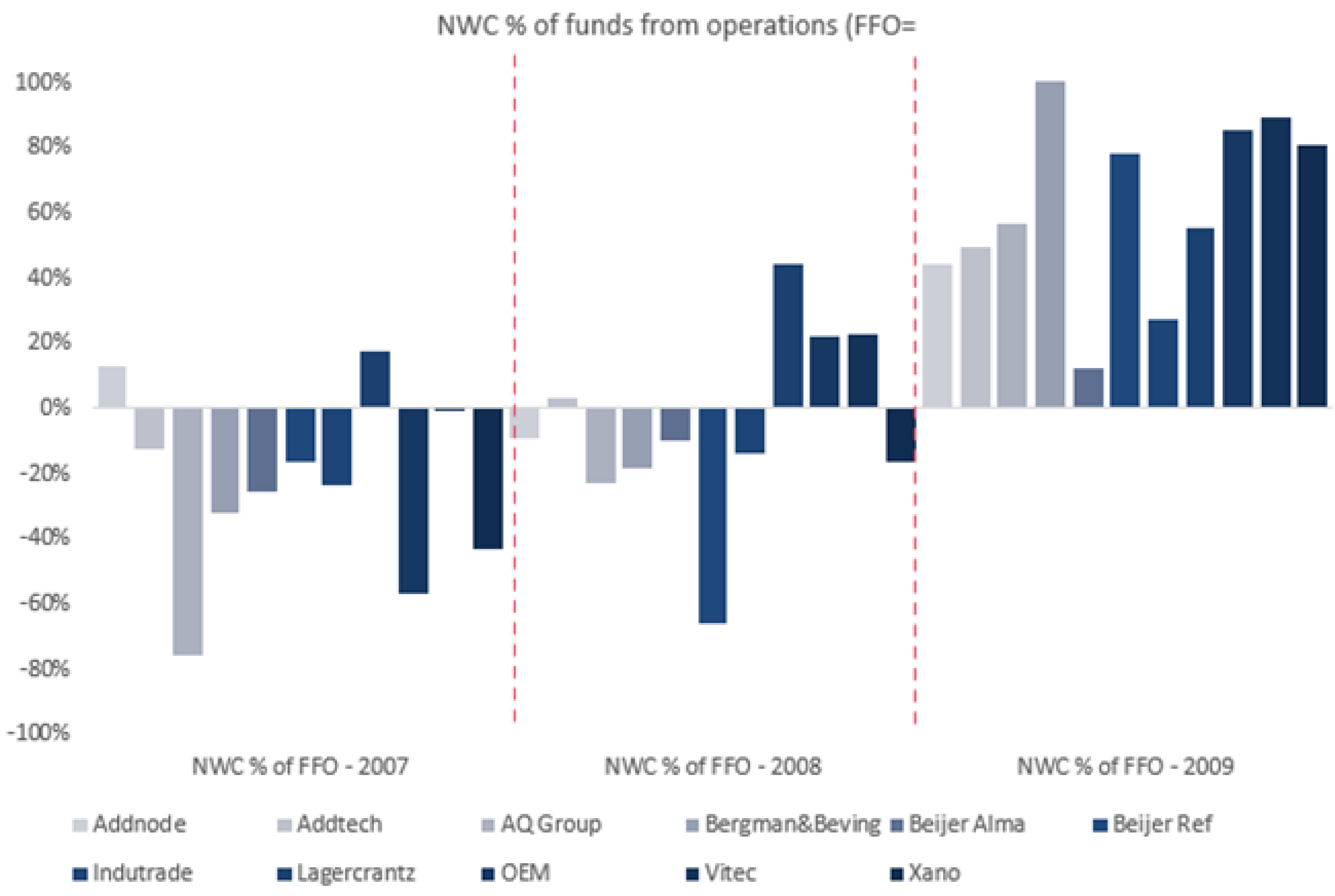
To begin with, the strength of these frequent acquirers often lies in the combined effect of dual growth engines – organic and acquisitions. What do we mean by this? The fundamental model employed by these companies involves acquiring small qualitative specialized private companies, frequently family-owned, with strong market positions in their specific niches.

These companies have traditionally demonstrated healthy organic growth (mid single digit) and solid cash flows. Upon entering larger decentralized structures, these companies retain their core values and business acumen, continuing to prosper and generate cash flow for their new owners. Reinforced by skilled capital allocation strategies, these acquisition-driven compounders deploy the generated cash flow to acquire new companies in a disciplined manner, supporting the second engine of growth: acquisitions.

In a situation with slower/declining organic growth, a common occurrence is the release of cash flow, enabled by a reduction in tied-up net working capital (NWC). This is often also stimulated by smart internal return on capital systems, such as Profit/NWC.

Consequently, the second growth engine enables these companies to some extent offset the decline in organic growth. However, if we see a sharp decline in organic growth, similar to that of 2009, combined with overall market uncertainty, transaction volume would probably decline, hence the inorganic growth may not be sufficient to offset the organic decline.

Looking at the years 2007 and 2008. many companies tied up significant capital during these years of strong growth, but witnessed significant releases in net working capital in 2009 during the Great Financial Crisis. This is illustrated in the chart below. We saw a similar pattern during the 2020 COVID outbreak



A noteworthy observation from Jörgen Wigh, CEO of Lagercrantz, in a Redeye Q3 interview adds depth to this perspective of the dynamics in play:

Jörgen Wigh: "*I've been doing it for quite some years now, and when we see a slowdown in our topline, which happened during the financial crisis, we see strong cash flows. We release quite a bit of working capital, and this is sort of the fuel for making more acquisitions*.“

Transitioning into a phase of lower (or negative) organic growth has the potential to release important cash flow for these companies, allowing them to capitalize on inorganic growth opportunities, thereby sustaining overall growth.

Reflecting on the Great Financial Crisis once again, the operating cash flow before changes in net working capital (FFO) in 2009 decreased by 34% (median), but however increased by 4% (median) after net working capital movements. As seen by the chart, many companies maintained overall good cash flow.

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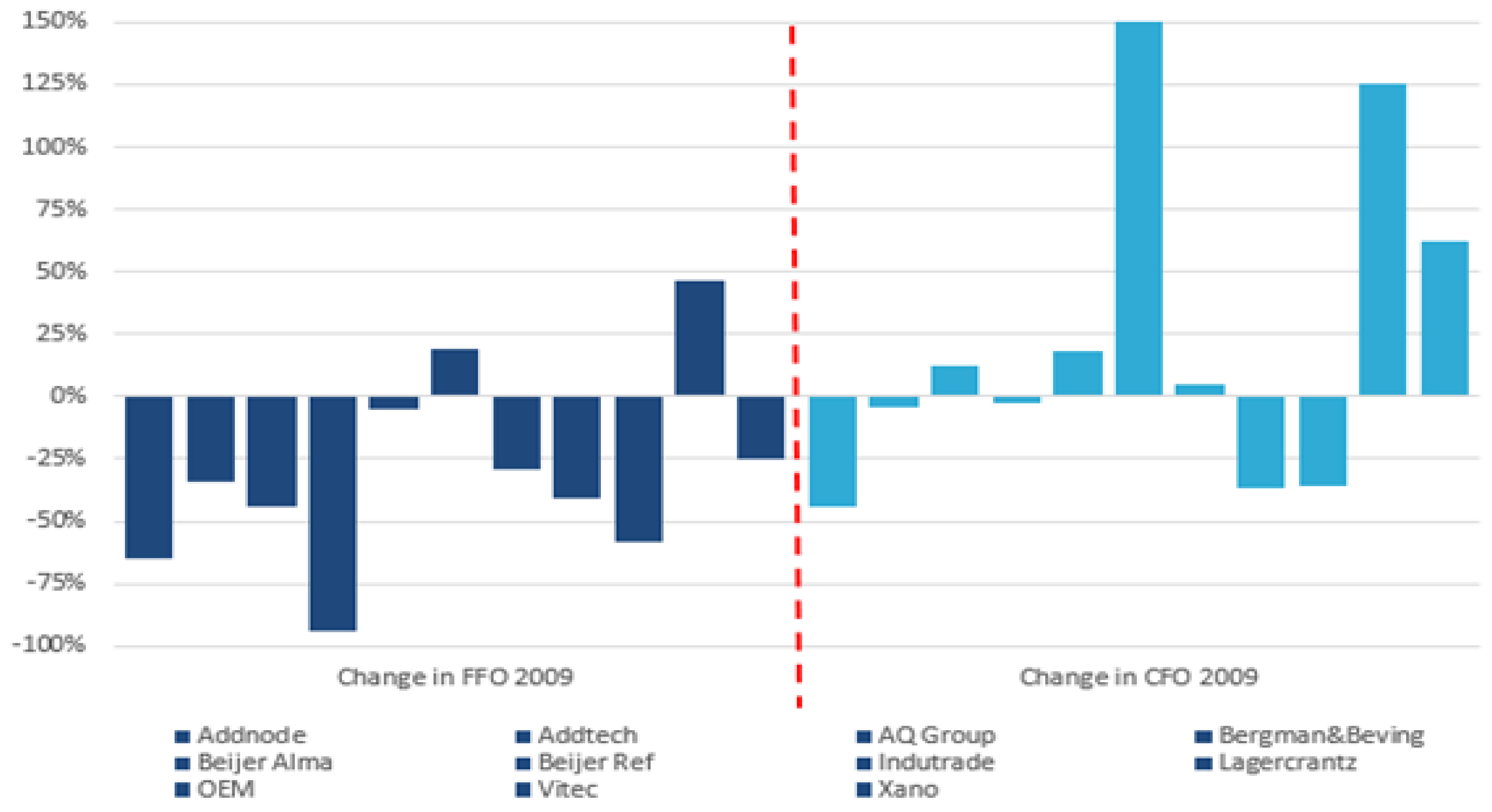

If historical patterns persist in the upcoming year or years, a broader expectation of stronger cash flows may materialize, paving the way for the inorganic growth engine.

In summary

Supported by proprietary M&A pipelines built over many years, sound balance sheets, and healthy cash flows, resilient Acquisition-driven Compounders are well-positioned to seize opportunities when economic conditions decelerate.

Disclamer: REQ Capital holds positions in several of these companies