Why lifecycle matters in company demergers

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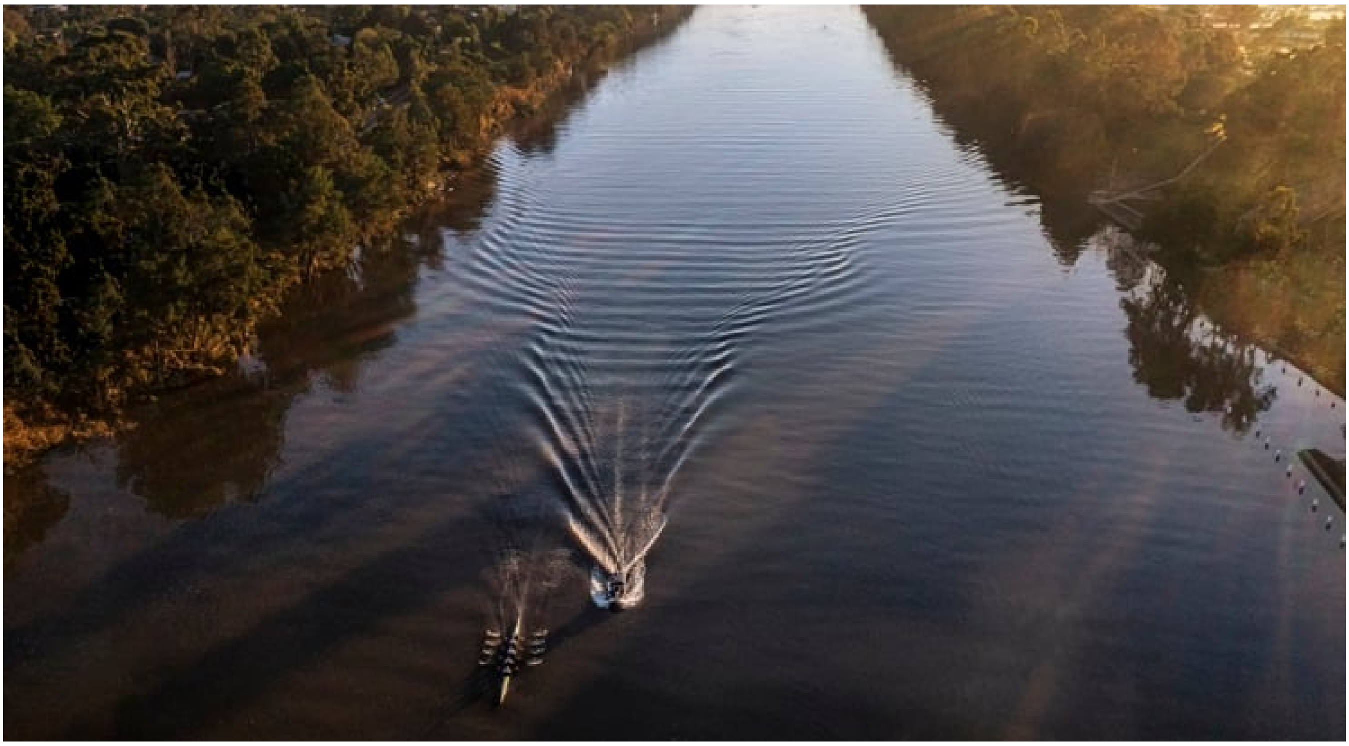

For some investors, the development arcs, decision-making and corporate culture of large companies remains relatively set and businesses can be easily pigeonholed. However, for Portfolio Manager Anthony Aboud and Deputy Portfolio Manager Sean Roger, the lifecycles of companies can create significant opportunities …especially if the right demerger occurs at the right time.

It is easy to fall into the trap of thinking that some companies are natural market leaders with a great culture baked into them while other companies are badly run with a poor culture that is likely to eventually be terminal to the business. Most companies are somewhere between these two absolutes. They go through periods of good decision making and periods of poor decision making.

From our research, we note that the poor decision making often occurs when things are going well. Either the cycle is in the company's favour, or the management team are basking in the glory of some previously astute decision making. The trend we note here is that the worst decisions are generally made when times are good. We believe the contra is also true. When people/companies have their backs against the wall, the research suggests that management teams tend to make their best decisions.

One example is the supermarket sector in Australia. While there are smaller competitors competing for market share, it is essentially an oligopoly with two major players, Coles and Woolworths. The last couple of decades has seen the ascendancy in terms of size, profitability and share price swing between the two heavyweights. We have observed an almost seven-year cycle as each of the major retailers moves from "outhouse to penthouse" relative to the other and vice versa.

When Woolworths had the ascendancy in the mid to late noughties, it focussed on rolling out new stores, maximising short term profitability through price increases and thought it was a good idea to start a new hardware business, Masters, from scratch. This ended badly for shareholders as the company stretched its balance sheet and, in our view, got distracted away from their core business – selling groceries.

However, this is when we observed the board and new management start to make smart investment decisions. These included shutting down Masters, taking the short-term profit hit by improving their service and dropping prices. It also invested in the store network and its supply chain, developed a best-of-breed online offering, and demerged their bottle shop and pubs business, Endeavour. This example illustrates one of the reasons that demergers tend to work. That is, they are executed when a company is going through that part of its lifecycle where it works out that it cannot be all things to all people. Our observation is that this tends to be a decision made by a humble CEO and board who are focussed on shareholder value and understand what that company's core skillset.

Markets prefer pure plays

A final point on successful demergers is that they often tend to work because the market generally prefers 'pure play' companies over conglomerates. In doing so, the market regularly ascribes a higher value to a pure play company than they would for a division within a conglomerate. For us, the fact that market participants are unwilling to assign the same valuation to the same business within a corporate structure as it would if it were to be standalone creates opportunity. When the sum of the parts is worth materially more than the market value, it may make sense for the company to demerge in order to realise that value.

Further, retail investors often follow a specific investment theme and this may break down when assessing a company which has two divisions with materially different investment traits. Take Graincorp pre-demerger as an example. The malt business (subsequently called United Malt) was perceived to be a "low growth compounder". The rest of Graincorp would be put into the "deep cyclical" camp. The low growth compounder investors didn't like the volatility associated with the cyclical part of the business and the deep cyclical investors didn't like the boring United Malt business as it diluted the cyclical leverage. As a result, these investors looked elsewhere to get a more pure play "low growth compounder" or "deep cyclical" respectively.

By separating these different businesses, you get a completely different shareholder base for the two companies over time. Management can then run capital management and make investments based on its specific earnings stream and shareholders preference rather than a hybrid of the two. While this is a poor reason to initiate a demerger in isolation, it is an explanation as to why the right demergers tend to work. As value investors, we like finding companies like these hidden gems within larger conglomerate companies where the market has been unwilling to ascribe a proper value and a demerger could potentially unlock even more value.

Click here for our analysis of some recent demergers, why they have succeeded or failed and insights into what we think makes for a good demerger candidate.

Find out more about Perpetual's SHARE-PLUS Long Short Fund.