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The new way to pick TSX winners: Target acquisitive companies

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Gone are the days when Canadian investors looked askance at companies relying on acquisitions for growth. In this era of tepid economies and low yields, the hunt for returns has made a virtue of the strategic acquisition and has ranked its most prominent practitioners among the darlings of the Canadian stock market.

Growth by acquisition is the “flavour of the decade” for the country’s main index, CIBC analysts said in a recent report. “In an environment where Canadian economic growth will probably lag over the next several years, these companies will likely provide most of the real growth in earnings that the S&P/TSX can muster,” said Ian de Verteuil, head of portfolio strategy for CIBC World Markets.

With the forces driving the consolidation trend unlikely to abate any time soon, as the report suggests, investors will likely continue to profit from targeting acquisitive companies at reasonable valuations.

Traditionally, the prevailing attitude toward acquisitions in Canada has been a much more skeptical one. “Canadian investors have a long and unpleasant perception of growth-by-acquisition companies,” Mr. de Verteuil said. And for good reason. The performance of persistent deal makers have tended to lag the index, consistently and meaningfully, the report said.

The analysts constructed an index of stocks included in the S&P/TSX composite index that had undertaken deals of at least 10 per cent of their assets within the past two years, on a trailing basis. Over the past 20 years, that index generated substantially less than half the cumulative returns of the market benchmark. But the financial crisis seems to have brought about a reversal of that relationship. Over the six years since the composite bottomed out, CIBC’s acquisition index has produced total gains 66-per-cent higher than the benchmark.

Renewed emphasis on acquisitions is explained, in part, by ultra-low interest rates. The cost of debt is low, giving companies easy access to funds in pursuit of potential targets. “Low interest rates make it a lot easier to make an acquisition work,” said Martin Pelletier, portfolio manager at TriVest Wealth Counsel. “It masks the troubles inherent with doing a bad deal.” Cheap debt is a mixed blessing, facilitating acquisitions good and bad, both of which seem to attract market interest these days, making it risky for investors to indiscriminately chase acquiring companies.

“We believe that growth by acquisition is most effective when the buyer is acquiring in-market, where the unique positioning of the acquirer allows it to drive operational improvements,” Mr. de Verteuil said, naming Alimentation Couche-Tard Inc. and Intact Financial Corp. as fitting the description.

Mediocre economic trends also support acquisition activity. In a weak economy, companies can struggle to boost revenues organically. Buying a competitor can provide a quick boost to sales.

The current low-yield environment also pushes investors toward consolidating companies in search of elusive returns. “People are investing in art, they’re investing in anything they think can get them a return,” said Brad Cherniak, co-founder of Sapient Capital Partners.

And there’s nothing on the horizon likely to alter Canada’s low-rate, low-growth profile, Mr. Cherniak said. “To me, there’s a megacycle of events that’s going to drive acquisitions for a generation.”

If so, it will be a markedly different generation from the one previous, when high-growth Canadian companies were more likely to be prey than predator. Whereas Canadian companies inclined to acquire others may have been taken over themselves by U.S. corporations in the past, Canada’s tax and regulatory framework has created the “ideal location to house North American, and even global, growth-by-acquisition companies when compared [with] the U.S.,” Mr. de Verteuil said.

Canadian corporate tax rates sit well below the Group of Seven average. Corporate tax regulations also exempt most or all income earned outside of Canada, which differs from U.S. policy. Canadian securities regulation is also more corporate-friendly and “less intimidating” in Canada than in the U.S., with a faster IPO process and less stringent disclosure requirements, Mr. de Verteuil said.

Of course, any investment decision hinges on valuation. While acquisition-focused names have done well in recent years, they can still be considered reasonably priced on average, Mr. de Verteuil said. A grouping of a dozen popular, relatively successful Canadian growth-by-acquisition stocks has an average forward price-to-earnings multiple of about 18, roughly in line with the composite.

In addition to Couche-Tard and Intact Financial, CIBC analysts also have the equivalent of “buy” ratings on the following growth-by-acquisition stocks: CGI Group Inc., Cott Corp., Element Financial Corp, Open Text Corp. and Valeant Pharmaceuticals International Inc. Four other stocks have “hold” ratings: DH Corp., MacDonald Dettwiler and Associates Ltd., Parkland Fuel Corp. and Saputo Inc. Meanwhile, Constellation Software Inc. rates a “sell” as a result of a high valuation, the report said.