

# PROTEAN™

SEPTEMBER 2021 • PARTNER LETTER

Dear partners,

Protean Capital Management closed the month of September up 9.1%. The market return for the period has been negative (boy that's an intro I hope to be able to write often!).

The exposure has varied between 20-50% net and 60-100% gross, keeping in line with the ambition to take company specific risk that I can understand and be comfortable with (leaving not too many stocks to choose from!) whilst at the same time trying to mitigate market risk. Both the long and short side has contributed with positive returns. The portfolio currently has a slight value bias and is cautiously positioned. I anticipate this will change some time in the coming quarter.

I keep building on the allocation philosophy of three imaginary buckets now contain a couple of names each ("40% core quality", "30% growth with runway" and "30% opportunistic special situations", paired with market hedges and select single-stock shorts). I do not believe in detailing holdings to any great extent publicly, as it creates unnecessary biases and other mental gunk. You will never see me on the front page arguing "this company is 50% overvalued" or "here are five illiquid small caps that should double". Specific marketing, just like size, I believe is anathema for sustainable returns. Protean is returns focused, not AuM focused.

Since launching this private venture also publicly I have received questions on whether I would be interested in opening for external investors. The short answer is "Yes! But...". Without (relatively sizeable) commitments in place, it's hard to justify the cost, time and effort to go through a cumbersome permit and structuring process. That said, I strongly believe the strategy is scalable, and adding more investors would come with benefits like better access to deals, research and corporates, a colleague or two and perhaps even a salary one day? One must be allowed to dream. If you have ideas on how to achieve this, I'm all ears and don't hesitate to get in touch. The protean approach is to be open to both change and opportunity.

## Compounders gonna compound?

For those that follow me on Twitter (@stckpkr, alas, Swedish only) it will come as no surprise that I enjoy reading books about investing. One of the seminal classics is "The Outsiders" by William Thorndike. It chronicles eight successful capital allocators that certainly did not paint inside the lines. One that stands out is Henry Singleton of Teledyne fame. His story deserves repeating in today's M&A frenzied compounder-loving world. For most of the 1960's, acquisitive conglomerates were in vogue. They traded at lofty multiples which, in turn, provided a clear logic to do

multiple arbitrage and pay with own stock. Singleton progressed to buy 130 companies over an 8-year period. His approach differed from the norm in that he believed in extreme decentralization – there was little or no attempts at synergy extraction and the corporate headquarter was kept at a bare minimum. This all sounds familiar to the 2021-onlooker.

It's what he did next that's the inspiration however: when prices for acquisitions crept upward, and Teledyne's own multiple started fading as a result of the slowing earnings growth, Teledyne first turned inwards – reducing working capital and improving margins, focusing almost solely on cash flows. "If anyone wants to follow Teledyne, they should get used to the fact that our quarterly earnings will jiggle. Our accounting is set to maximize cash flow, not reported earnings" he said. Refreshing indeed. So, secondly: acquisitions expensive, strong cash flow, low multiple on own stock. What to do? Buy backs! Between 1972 and 1984 he bought back no less than 90% of the company's stock. Suffice to say he outperformed the market.

What I take away is Singleton's ability to change. He was truly Protean. When the market changed, he changed his mind and the direction of the company's capital allocation.

In light of this historical parable perhaps it shouldn't come as a surprise that today's market is littered with roll-ups, bolter-oners and serial acquirers of all kinds. In fact, Sweden has a long history of roll-ups and acquisition driven strategies, dating back all the way to the 1920's when Ivar Kreuger, via a series of mergers and acquisitions, controlled no less than 72% of the World's safety match production. Today's Volvo, Electrolux, Assa Abloy and ABB and are, or have been, roll-ups in their own industries.

To roll-up, or "buy and build", is also a favourite Private Equity past-time. One can understand why. When prices on assets are competed up, a buy-and-build strategy offers an alternative route to returns, compared to the classic "Falling Interest Rates and Stable GDP Growth Plus Leverage" returns of the past. If you pay a premium multiple just once for a platform business, followed on by a string of cheaper bolt-ons, you have thus created a vehicle that can outbid others because you have synergies they don't. In innovation-driven industries like software, medtech and pharma, small companies often struggle to ramp sales while the product is hot, which offers an opportunity to industry behemoths to gobble them up and accelerate the product revenues, leaving everyone happy.

The public equity market, for natural reasons, quite likes the serial acquirers – almost without exception. Not only do they grow, but they also generate consistent earnings upgrades if they keep doing deals, as sell-side analysts still rarely dare to put unannounced M&A into models,

always valuing the companies as is. Thinking about that, it's remarkable how sell-side still most often refuse to put future M&A into assumptions for serial acquirers, citing "it's too uncertain". Like the rest of the accounts are dead sure to be right? If there's a big white space to consolidate, with ample targets willing to transact, topped with a benign financing situation, surely one could be excused to add some future M&A? Judging by the valuation on some of these companies, the buy-side appears quite confident to discount a long inorganic growth runway regardless.

Also helping the allure of the space is the fact that quite a few have done tremendously well over the past decade, particularly in the midcap space.

But. There's something itching here. Some undefined feeling of discomfort. One is what do these conglomerates really contribute? How can the same little company be worth 2-3 times more simply because the name on the title changes? 1+1 equals 2, not 8. It's almost as irrational as Investment Companies trading at a significant premium to a (mostly listed) NAV. What are you paying for? It does not economic sense make. Plus, if this really is an arbitrage, it will be competed away, like every other arbitrage in the financial history of the world, always. Reading the prospectus of ongoing IPO "Storskogen" there's at least in my mind no doubt we're about to accelerate the competitive pressure for small and midsized companies. Nota bene already today an entrepreneur in Nordic manufacturing or infrastructure has several potential deal-hungry conglomerates to sell to.

Everything is cyclical, and so is the market's appetite for conglomerates. But I'd venture to argue it's slightly different this time. Right now, it appears fashionable both to be a serial acquirer and to de-conglomerize. Utterly fascinating. There are funds focused solely on spin-offs, and there are more and more companies focusing solely on acquisitions. My head is spinning.

I wonder if the deal frenzy is a reaction to the fact that running a mature company, optimizing the day-to-day operations, the slow daily grind, is boring? Doing a deal, with sassy investment bankers, the thrill of the negotiation, the reaction of the market: much more exciting. Like the Economist wrote "...it does stand to reason that the best way to make a material difference to a company's future in a short time is to lead a highly publicised transaction. With executive compensation increasingly linked to stock performance, the prospect of more money adds a substantial incentive to pursue a merger than may not be entirely in the best interests of the company".

Back to Storskogen, a 64bn SEK IPO lined up with 9 banks and 11 anchors. Like Spinal Tap these guys have an amplifier volume dial that goes to 11: since they can acquire anything anywhere they believe they have a

competitive advantage. Actual quote from the prospectus: “Storskogen believes that it has a competitive advantage over [PE, other compounders, family offices] due to applying its robust investment criteria in a broader set of industries, verticals and geographies, which leads to a larger group of potential acquisitions.” Just wow. All the way up to 11.

I’ll be the first to admit: this will probably work. There is an arbitrage there, there is a rationale to be looking at companies like this as a nano-cap fund offering exposure to well-run smaller and local businesses at undemanding multiples. And with a low “management fee” as well (although we must not forget dilution from LTIPs). The management and directors of the company are articulate and honest looking. The shareholder base reads like a who’s who of professional money management. One thing that strikes me is that it looks a very replicable process: outsource financial and operational due diligence to the big 5, run business DD, funding and marketing yourself with a skeleton staff (Storskogen has 80 HQ employees). What’s keeping someone else from doing exactly this? And is the implied franchise value justifiable?

Bottom line: pay 29x EBITA for pro-forma 2021, 1% organic growth, 9% margins and 13% ROCE? With the books covered after 15 minutes and peers rolling over? When there are peers with higher returns, higher growth and longer track-records out there at similar multiples? Too-hard-pile for me. Like Henry Singleton said: “If everyone’s doing it, it must be wrong”.

I stress there’s nothing particularly wrong with Storskogen. I’m impressed with the execution and the outsourced M&A model (efficient!), and I’m sure there’s a backlog of acquisitions that will flood through the gates in the first quarters after the IPO, forcing analysts (who still don’t put M&A into their models remember) to raise estimates. There’s no lack of TAM, which is what they’ve got going for them.

Finally, it’s not like these businesses come without risks. As many books on accounting will tell you, acquisitions offer a multitude of ways to massage reported numbers. There’s restructuring, there’s reserves, there’s write-downs, inventory valuations, depreciation schedules, intangibles and God knows what to fidget with. No wonder some of the more spectacular company failures throughout history have been found in this sector.

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