



Trojan Income Fund Newsletter

Protect & Grow No.11

The allure of dull

Back in 2017, the Lex column at the FT speculated that companies rarely in the headlines make better returns than those frequently on the airwaves¹. We see some logic in this, given news services generally focus on bad news. The Lex team picked out some of the 'least newsworthy' large UK companies and noticed that they have tended to be consistent outperformers. We share a common love for the quiet compounder. In particular, there is a cohort of business-to-business (B2B) companies who by their very nature are non-consumer facing and rarely in the limelight. These are global, defensive businesses that make steady progress year-on-year without fanfare, often by performing vital, but unexciting and inexpensive, roles in our global economies. Ironically, the very mention of some of them by Lex (and us!) draws more attention to these discrete corners of the market, but we still like them. Names held in your Fund that we would highlight are shown below, along with their weightings:

	3.7%	Leading global distributor of non-food consumable products to markets like grocery and healthcare.
	2.5%	Niche, value-add distributor of small, vital industrial products such as seals, fasteners, and cabling.
	1.6%	Maker of health and safety technology including fire alarms, sewer leak detectors, and equipment for eye testing.
	3.9%	Leading global provider of outsourced catering for businesses, serving venues including Wimbledon.
	1.8%	Maker of accounting and payroll software for small and medium size businesses.
	4.1%	World's largest credit bureau, providing data and analytics for billions of credit decisions each year.
	6.3%	B2B data and analytics company serving sectors such as law firms, insurers, banks, academia, and online retailers.

Source: Troy Asset Management. The reference to specific securities is not intended as a recommendation to purchase or sell any investment.

¹ FT Article: [Index investing: Bad news bears](#), see also: [FT Article: XFT index: it's the quiet ones you gotta watch](#).

² McKinsey & Company: [Perspectives on merger integration](#).

³ McKinsey & Company: [Quarterly](#).

⁴ In brief, an attractive ROIC means making healthy margins and using your capital spend efficiently.

This newsletter zooms in on the first three, which are notable both for their strong long-term total returns to shareholders, and for the source of much of those returns – namely, the acquisition of dozens of other companies over the years.

The right kind of M&A

Mergers and acquisitions are often rightfully viewed with scepticism. Studies by McKinsey (among many others) have found that most M&A deals fail to generate value – by their reckoning, more than two thirds are value neutral or destructive². However, there is a wide spectrum of deals that fall under the 'M&A' moniker – from mega-buyouts and mergers like the ill-fated combination of Kraft Foods and Heinz in 2015, through to minuscule 'bolt-ons' that are barely noticed. Perhaps unsurprisingly, it is the big deals where most risk lies – high prices, complex integrations, and reliance on cost synergies to make the numbers work all come into play. More interestingly, the same studies have found that 'programmatically acquirers' – those consistently making small acquisitions - generated by far the most value³. Bunzl, Diploma, and Halma all sit in this bracket; Bunzl has acquired over 200 companies since 2004, while both Diploma and Halma have bought roughly 100 each since the early 1990s.

One obvious attraction of M&A is as an alternative source of growth. Growing your revenues and earning an attractive return on invested capital (ROIC)⁴ are the two vital components to generate growing free cash flow. And we think growth in free cash flow is the key long-term driver of value creation and share prices.

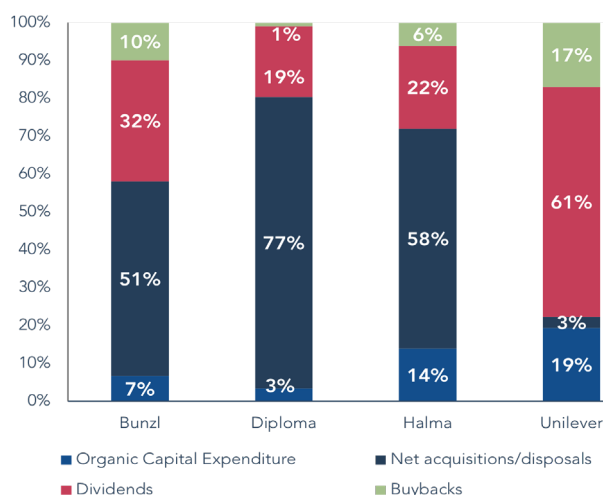


Troy's portfolios all have an aggregate ROIC well above the average of the wider market – one indication of our focus on high-quality businesses. We are also comfortable that all our companies have good long-term opportunities for growth – they are aligned to strong growth trends and can reinvest profits into them. Organic growth is almost always the most valuable, typically generating the highest returns on invested capital. Theoretically, we want our companies to retain and reinvest as much cash as possible given the attractive returns they can earn. However, maintaining high organic growth is difficult for many reasons. For example, the planet has finite people and companies to act as customers, meanwhile strong organic growth opportunities attract competition. Finite opportunity means our companies tend to generate far more excess cash than they can feasibly reinvest in themselves.

For example, Unilever could choose to spend all their excess cash on opening new factories or setting up facilities in new geographies. But management know their business and industry and know there are limits to how much capacity they can add – they could build a new factory but the demand may not be there, leading to a poor return on the investment. As a result, our portfolio companies tend to return a significant portion of excess cash to shareholders (via dividends and buybacks) or use it to strengthen the balance sheet (accrue cash/pay down debt). There is much wisdom in these actions, and we welcome management teams observing such capital discipline.

Bunzl, Diploma, and Halma are distinct in their ability to continually reinvest the majority of their excess cash into regular acquisitions (see chart), while maintaining attractive rates of return (and with their acquisitions earning higher returns than the 'occasional' acquirer). This offers a way to supercharge growth over and above organic sources and offers a compelling alternative to simply returning cash to shareholders.

PRIMARY USES OF CASH (LAST FIVE YEARS)



Source: Troy Asset Management Limited, 31 May 2024. The reference to specific securities is not intended as a recommendation to purchase or sell any investment.

What makes their approach successful and distinct from much of the M&A we see in the headlines? We highlight a few common themes:

Buying quality businesses

This may sound obvious but is pivotal. Bunzl, Diploma, and Halma are not buying broken businesses – they are buying well-run, often family-owned and founder-led, small enterprises that are successful, profitable, and likely to keep performing well. It is not about the buyers thinking they can run it better or fixing a problem. It is about nurturing what is special about them, which generally entails retaining the existing management, employees, and strategy.

Buying at attractive valuations

Many acquisitions fail to generate value simply because the buyer paid too much, even if the asset is good. Markets are competitive and filled with smart people so quality companies tend to rightly command premium prices. How can Bunzl, Diploma, and Halma buy successful businesses and still generate strong returns?

They buy small, private companies. By their very nature these are illiquid assets and may have some risks such as dependence on a small number of suppliers, customers, or managers. Valuations are logically much lower than for large public companies, making return on your investment higher if they are successful. Interestingly, we note how stable the valuations



for small private businesses have proven over decades – a key reason why Bunzl, Diploma, and Halma have generated strong returns for so long.

To give an example transaction, Diploma recently bought a leading industrial distributor of fasteners for c.£236m at a multiple of 7x expected operating profit, implying it will make c.£34m profit – a c.11% addition to Diploma’s existing business. This is an excellent starting point, suggesting a year-one pre-tax ROIC of over 14% (£34m divided by £236m). This is a highly compelling return in our view, both relative to Diploma’s own cost of capital and as an alternative to returning cash to shareholders. Many public company transactions occur at much richer multiples, creating more pressure to drive future growth or extract synergies to generate value for shareholders.

Acquisitions are modest and self-funded

The vast majority of acquisitions by all three companies have been funded using their own internally generated free cash flow. Instead of needing to leverage up heavily or consistently issue equity, they have managed to buy companies every year with their own resources. They can do this because acquisitions are modest in size and valuation. And because all three companies grow well organically almost every year, generating a growing internal source of profits and cash to support purchases. We agree with one of Halma’s founders, David Barber, who noted in the 1990s that growth by this type of self-funded acquisition is in many ways closer to organic growth than to large-scale M&A. The small size also means that each transaction is low risk in the group context.

Decentralisation

The table below highlights the small number of employees at ‘head office’ for our three companies. We think decentralisation is critical. Bunzl, Diploma, or Halma are not single entities – they are collections of many individual operating companies. Indeed, there is no customer-facing brand called ‘Halma’. Halma is c.50 companies covering different brands in different niches. Acquisitions of new companies are not made to extract synergies or be combined into a large central entity. They are bought to continue being run locally, with managers operating close to their

customers and being incentivised directly on the growth of their own unit. Each operating company tends to have its own management team and P&L. Local managers will set and drive strategy - the top team at HQ understand that these people know their markets best and give them the operating leeway. Meanwhile, top management dedicate more time to capital allocation. This is distinct to many companies where CEOs are required to be talented capital allocators as well as excellent operations people.

	# employees at HQ	Total # employees	Ratio
Bunzl	84	24,528	1:292
Diploma	38	3,319	1:87
Halma	c.80	8,141	1:102

Given this structure, what value does being part of the bigger group bring? Acquired companies have access to capital as part of a well-financed group, creating greater ability to invest and take risks. A parent like Halma is happy to provide capital for a portfolio company to try something that would be an existential risk as a standalone small business – for example, expanding to a new continent or investing into a risky new R&D project. HQ can also provide best practices and resources on functions such as IT, HR, and working capital management. They can facilitate shared learnings across the group – for example, one company connecting with another who has already gone through an expansion into a particular geography.

Culture, experience, and reputation

Acquisitions are central to the culture and strategy of these companies alongside organic growth. They have accrued decades of learnings across hundreds of transactions and constructed dedicated teams for acquisition and integration. We think this is an underappreciated skill in comparison to the occasional purchaser. These companies build internal databases of hundreds or thousands of possible targets and cultivate relationships with owners/managers over many years. This reduces reliance on investment bankers in sourcing or deal-making. Reputation plays a pivotal role. Bunzl, Halma, and Diploma are established as indefinite owners of their assets, unlike most private equity funds which typically have a finite life of 5-7 years.



They have long track records to demonstrate that acquired businesses can thrive and grow under their ownership. They have developed incentivisation structures that make sure acquired management teams can still share in future growth within the group. It is instructive to note Bunzl’s CEO himself joined the group through acquisition in the 1990s. The result is that these companies have become preferential buyers for many founders seeking the right home. In many cases, they are chosen even if they are not the highest bidder.

Considering the risks

Having run through some of the factors we attribute to their success, what are some of the key risks for these businesses beyond those that most companies face?

Can they keep growing?

A key reason that Bunzl, Diploma, and Halma have successfully acquired for growth is that they have large opportunity-sets – sectors with large, fragmented pools of small private businesses. Probably the most common pushback we hear is whether they can keep scaling – sourcing enough acquisitions to maintain attractive rates of growth. We are confident all three have significant depth of future opportunity. As an example, Diploma has almost zero revenue exposure to the entire continent of Asia. Acquisition targets are generally ‘SMEs’ – companies with 1-250 employees. SMEs account for 99.9% of all UK businesses, and the percentages are similar overseas. Growing in size does also mean scaling people and processes – something we have spoken at length about with all three companies.

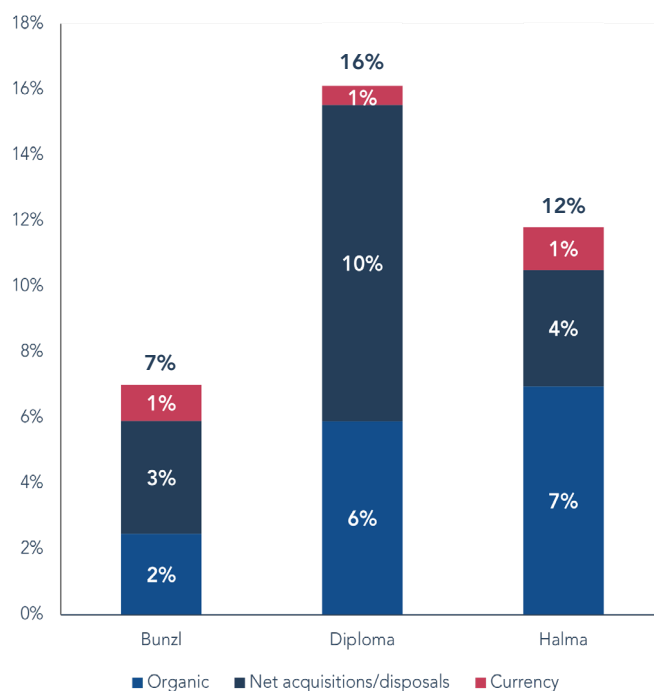
In general, we think the market underestimates the duration of growth possible from these businesses. One nice feature is they can still grow (through acquisition) in tough economic periods when many companies are suffering organically. Sell-side analysts do not factor in acquisitions to their models until they are announced, meaning consensus estimates of future growth are almost always under-clubbed. We also take comfort from the much larger companies existing globally who are still able to regularly acquire – names such as

Constellation Software (c.£46bn market cap) or Danaher (c.£150bn).

Finally, seeing good organic growth is a vital sign of health for us – this generates the fuel for future acquisitions, and demonstrates these are good operating companies that continue to thrive under new ownership.

The chart below breaks down the components of the average revenue growth for each company over the past 10 years. These splits have been similar over longer time periods as well, highlighting how durable acquisitions have been as a source of growth.

10Y AVERAGE ANNUAL REVENUE GROWTH BY SOURCE



Source: Troy Asset Management Limited, 31 May 2024. The reference to specific securities is not intended as a recommendation to purchase or sell any investment. Note, numbers may not sum due to rounding.

Change in capital allocation, messaging, or culture

It is important for us to see consistency in acquisition execution and strategy. These companies have proven a formula that works and we look for continuity, even if top management changes. Warning signs could be higher acquisition multiples, entering materially different sectors, or talk about centralising or synergies. The top management teams of these companies need to be comfortable being ‘hands off’ – one CEO remarked



to us the importance of being 'low ego' and having no desire for 'empire building'. Relatedly, we note that each of the three companies has had only two CEOs over the past c.20 years⁵ – another positive reflection on their culture and quality.

Final thoughts

We hope for ongoing consistency and discipline from Bunzl, Diploma, and Halma. Their mix of organic and inorganic sources has led to highly defensive and reliable growth over many years. Halma recently achieved its 21st year of consecutive profit growth. All three have also been wonderful income growth stocks – Bunzl has managed 30 years of consecutive dividend growth, Diploma c.25, and Halma 45. The compound annual growth rates for their dividends over the past 20 years are 9%, 15%, and 7% respectively.

We know some investors query whether these companies should pay dividends at all rather than spending all their capital on acquisitions. From our perspective, we like the dividends – they instil discipline and create healthy competition for capital, ensuring management focus acquisition spend on the best opportunities. Many employees are also shareholders alongside long-term investors. The dividend enables them to realise some value from their holdings without selling shares. All three companies have sensible payout ratios of c.40% or less. In the case of Halma and Diploma, they tend to grow their dividends below the rate of earnings (and cash flow) growth – reducing the payout ratio each year and freeing up more capital for acquisitions while still increasing income.

In short, we think these are three special companies that encapsulate much of what we look for in investments at Troy, and what we consider the right type of income stock. Excepting our own future commentaries and newsletters, we hope they remain un-newsworthy!

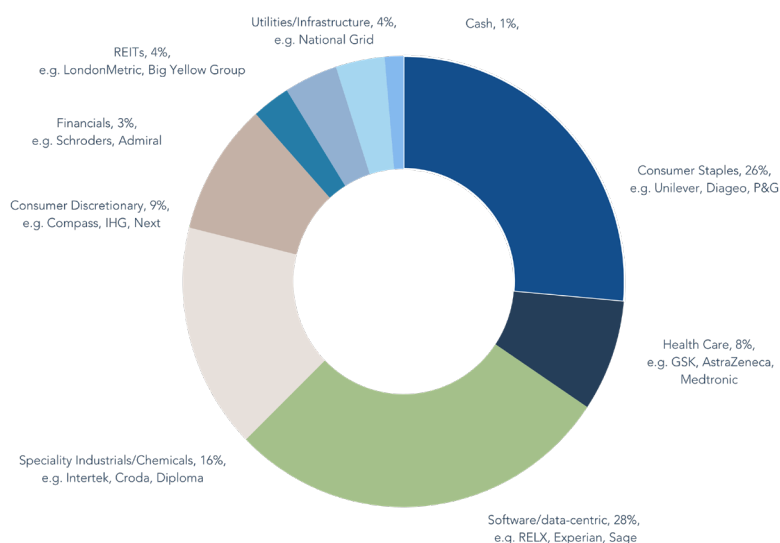
Fergus McCorkell
Blake Hutchins
June 2024

⁵ We do exclude a short-lived CEO at Diploma who was in place for just four months in 2018.



SECTOR BREAKDOWN

(custom definition by Troy)



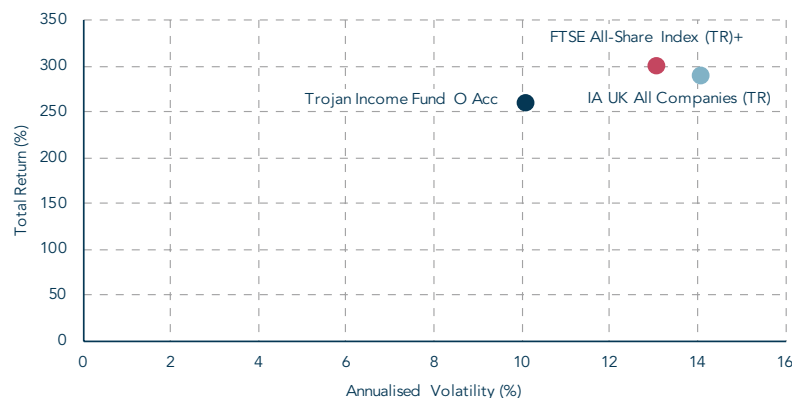
Source: Troy Asset Management Limited, 31 May 2024. Asset allocation subject to change.

Top 10 Holdings

Unilever	7.5%
RELX	6.3%
Diageo	5.9%
Reckitt Benckiser	4.5%
Experian	4.1%
LSEG	4.1%
Compass	3.9%
Bunzl	3.7%
GSK	3.3%
Smiths	2.8%
Total Top 10	46.0%
31 Other Equity holdings	52.6%
Cash	1.4%

Source: Factset. Holdings subject to change.

RISK AND RETURN SINCE INCEPTION (30/09/2004)



Source: Lipper, 31 May 2024. Past performance is not a guide to future performance.

ESG

Troy achieved the following scores from the UN PRI (July 2022) in relation to Direct and Active Ownership of assets.

Score	Topic
★★★★★	Policy Governance and Strategy
★★★★★	Listed Equity - Active fundamental
★★★★★	Fixed Income - SAA (Sovereign, Supranational and Agency)
★★★★★	Confidence building measures



The Net Zero Asset Managers initiative



TROY UK EQUITY INCOME TEAM



Blake Hutchins



Hugo Ure



Fergus McCorkell



Aniruddha Kulkarni



Disclaimer

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