Uncovering the qualities that set compounders apart

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Compounder companies ("compounders") are those with highly visible and long-duration growth. Lindy's Law explains an anti-ageing process for such companies — the longer they exist, the stronger they become to survive well into the future. This enables many to become industry leaders and dominant global players. We refer to these types of venerable companies as "marathon runners". They form the bedrock of the returns we generate for our clients. It's not just their age that sets these companies apart. It's the combination of unique corporate culture and resilience that keeps them growing in good and bad times.

Over decades — even centuries — these bastions of business have used their resilience and built up competitive moats yielding exceptional free cash and healthy balance sheets. Their secret is spending this cash wisely on opportunities to unlock new pathways for organic growth. They filter out noise and have a clear strategy for pursuing their long-term goals.

Turning M&A into long-term success

Mergers and acquisitions (M&A) can highlight the qualities that separate compounders from the rest of the pack. Compounders grow predominantly using in-house resources, but M&A can serve as a valuable litmus test for their investing prowess.

Leveraging their free cash flow and balance sheets, compounders seize on M&A opportunities to fuel future organic growth. Their size enables synergies which smaller peers can only dream of attaining. Their abundancy of cash provides them the optionality to buy into new growth avenues independent of the state of capital markets. These are two ingredients crucial to success in M&A.

There are many pitfalls in M&A. It can be often inconsistent and pro-cyclical. Assets can turn out to be too big to integrate. The risk of over-paying is high. Compounders are savvy investors and know how to deal with the complexity of M&A.

Take, for instance, the 2023 acquisition of luxury brand Aesop for US$2.5 billion in cash by L'Oréal, the company's largest deal to date. Cash-strapped Natura was under pressure to sell their crown jewel Aesop. Cash-rich L'Oréal seized the opportunity[1]. Much like L'Oréal's previous acquisition of skincare company CeraVe from Valeant, also financially challenged, we see the potential for significant synergies. CeraVe sales shot up more than 7x in the 6 years following their acquisition[2].

Both deals were driven by an opportunity to globalise another high-quality brand through L'Oréal's worldwide distribution footprint. By expanding into new markets, this beauty behemoth continues to boost sales and establish fresh avenues for organic growth.

Another example comes from our Comgest Global Compounders strategy: Microsoft's US$26 billion acquisition of LinkedIn in 2016[3]. The tech titan's US$100 billion pot of cash was more than 70 times greater than that of Salesforce, which was also in the running to acquire the social media platform. Since the acquisition, Microsoft has leveraged LinkedIn's network to expand their cloud services customer base. By 2023, sales at LinkedIn had tripled to US$15.7 billion[4].

Buying wisely

Marathon runners want to ensure that each new acquisition fits into their long-term strategy. They usually avoid exceptionally bulky – that is to say, risky – M&A activity. This is often referred to as "transformational M&A", which is aimed at creating radical growth over a short period of time. When companies fail to generate value and growth in their core business, they may try to renew themselves through transformational M&A. Why would a successful company want to transform? For this reason, marathon runners have no need for such a makeover.

In 2016, Comgest sold its stake in the German pharmaceutical and biotechnology company Bayer. Why? The company's decision to buy the American agrochemical and agricultural biotech business, Monsanto. The deal should have transformed Bayer into a global leader in agriculture and life sciences. Years later, the deal mired the company in debt and lingering poor reputational issues, which have had long-term ramifications.

Home-grown growth

M&A is not a prerequisite to be considered a compounder. Many can generate organic growth without M&A.

Danish pharmaceutical giant Novo Nordisk illustrates this fact. A decade ago, the company edged out French rival Sanofi when the primary treatment for type-2 diabetes shifted to the hormone glucagon-like peptide-1 (GLP-1). Ultimately, Sanofi lost the innovation race.

Novo Nordisk, now the market leader in GLP-1[5] and a global leader in diabetes medication, spends substantially on R&D, which has opened up an entirely new market. The rise in type-2 diabetes has coincided with an increase in global obesity rates and GLP-1 has also proven to be an effective anti-obesity drug. Marketed under the name Wegovy, this drug is a gamechanger across adjacent industries. Unfortunately, the sad reality is that the market is only expected to grow.

Patience and consistency

These marathon runners epitomise Comgest's sustainable, quality growth approach. They are built – and building – on consistent organic growth and patience, not "make or break" decisions. Compounders have solid financials built around strong moats. They know how to spend their cash wisely and have the scale, experience and culture to seamlessly fit newly acquired businesses into their long-term growth strategy. When choosing companies for our Comgest Compounders portfolios, M&A can help uncover some of the qualities that we seek for investors willing to go the distance.

MAIN RISKS

- Investing involves risk including possible loss of principal
- The value of all investments and the income derived therefrom can decrease as well as increase
- Changes in exchange rates can negatively impact both the value of your investment and the level of income received

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For more information, visit our webpage on Comgest Compounders strategies

COMGEST

[1] Source: Comgest analyst and Company Reports

[2] Source: L'Oreal and company meetings

[3] Waters, Richard. Bidding war drove up Microsoft's LinkedIn bill. The Financial Times, 2-Jul-2016.

[4] Iqbal, Mansoor. LinkedIn Usage and Revenue Statistics (2024), Business of Apps, 18-Apr-2024

[5] Novo Nordisk 2014 Annual Report

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