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BTN Earnings Quality Review

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Thermo Fisher Scientific (TMO)

What stands out immediately upon reviewing TMO's results is its long string of acquisitions over many years. We would not classify TMO as a true "roll up" in that it tends to do one or two good-sized deals a year rather than seeking to consolidate a stagnant industry by buying everything in sight. Nevertheless, regular acquisitions are a key part of the TMO story and any serial acquirer deserves attention. Typical red flags associated with serial acquirers include:

1) buying to mask lackluster growth in the core business
2) failure to integrate the acquisition profitably, leading to falling core returns
3) amassing excessive debt
4) taking huge charges to essentially write off huge parts of the acquired company, destroying value in the process

We evaluate TMO's acquisition history on each point below.

History of Deals for the Last Four Years

For reference, the below table shows the company's acquisitions since 2013 with prices paid and amounts allocated to goodwill and intangible assets broken up by customer relationships, product technology, tradenames and in-process research and development (IPR&D).

	Date	Price	Goodwill	Customer Relationships	Product Technology	Tradenames	IPR&D
2017 Acquisitions							
Pantheon	8/29/2017	$7,358.0	$3,255.0	$3,618.0		$112.0	
Core Informatics	3/2/2017	$94.0	$63.0	$6.0	$29.0	$3.0	
Finesse Solutions	2/14/2017	$221.0	$136.0	$68.0	$32.0	$2.0	$2.0
Other		$110.0	$64.0	$16.0	$35.0		
2016 Acquisitions							
FEI	9/19/2016	$4,082.1	$2,125.0	$1,051.0	$740.0	$42.0	$105.0
Affymetrix	3/31/2016	$1,341.8	$615.0	$501.0	$253.0	$46.0	$14.0
Other		$32.5	$16.0	$9.0	$7.0		
2015 Acquisitions							
Alfa Aesar	9/30/2015	$389.5	$125.1	$137.1		$15.6	
Advanced Scientific	2/15/2017	$288.8	$124.4	$90.0	$36.5	2.3.	
Other			$8.9	$7.9			
2014 Acquisitions							
Life Technologies	2/3/2014	$15,303.8	$7,167.0	$5,883.0	$2,626.9	$619.1	$58.4
Other		$35.8	$12.5	$7.0	$5.5		

Is TMO Buying Things Just to Boost Growth?

In short, this does not appear to be case at TMO. Reported revenue growth was 14% in 2017, but this was backed by a solid 5% organic growth with only a slight impact from currency. Likewise, 2016 saw 8% reported growth backed by 4% organic growth, and 2015 saw 5% organic growth being offset by a currency drag.

We are concerned when we see companies with no or even negative organic growth having to make acquisitions to post an increasing top line. TMO does not appear to fall into that category.

Is Value Being Created?

This is a little less clear for TMO. It is typical for serial acquirers to make promises of huge integration synergies leading to improving returns for shareholders. However, these promises are often never made good on, and shareholders instead experience eroding returns on their capital. The following table calculates a simple pretax return on invested capital for TMO for the last four years:

	Year ended: 12/31/2017	12/31/2016	12/31/2015	12/31/2014
Adjusted Operating Income	$4,860	$4,222	$3,828	$3,695
Shareholders' Equity	$25,413	$21,539	$21,350	$20,548
Total Debt	$21,008	$16,628	$12,472	$14,564
Total Investment	$46,421	$38,167	$33,822	$35,112
Pretax ROI	**10.5%**	**11.1%**	**11.3%**	**10.5%**

We utilize the company's own adjusted operating income figure in the numerator which adjusts for one-time charges (more on that in the next section) and adds back amortization of intangible assets. While we do not necessarily agree with the concept of ignoring intangible amortization, it does serve to smooth out returns from period-to-period which is helpful in this exercise.

The first thing to note is that TMO's pretax ROI is being held down by both the numerator not including a full year's impact of the acquired businesses while the denominator is impacted by the full amount of new capital issued for the deals. Let's dig a little deeper and make some adjustments to the last three years to get an idea of the trajectory in returns.

In order to adjust for the partial contribution of acquisitions, we start with the pro-forma sales growth from the 2017 10-K which is adjusted to give the effect as if the Pantheon acquisitions had been made on January 1, 2016 and the FEI and Affymetrix acquisitions had been made on January 1, 2015. (referring to table 1 above shows these are the meaningful acquisitions made during those periods.)

	Year ended: 12/31/2017	12/31/2016	12/31/2015
Reported Sales	$20,918.0	$18,274.1	$16,965.4
Adjusted Operating Income	$4,860	$4,222	$3,828
TMO Reported Adj Op Margin	23.2%	23.1%	22.6%
Pro forma sales	$22,144.0	$20,807.0	$18,230.0
Estimated Adjusted Operating Income	$5,144.84	$4,806.97	$4,113.02
Shareholders' Equity	$25,413	$21,539	$21,350
Total Debt	$21,008	$16,628	$12,472
	$46,421	$38,167	$33,822
Pretax ROI on Pro Forma Sales	11.1%	12.6%	12.2%

We then apply the reported adjusted operating margins for those years to the pro-forma sales to come up with an estimate of a full year's impact of the acquired sales in each period. We realize this is not perfect, but we believe it is a reasonable estimate. What we see is that the estimated pro-forma reported pretax ROI has actually declined over the last three years. To be fair, both the Pantheon and FEI acquisitions were made late in the year which does not allow for any integration synergies to kick in. Nevertheless, the downward trajectory in pro-forma adjusted ROI casts some doubt on how much value the company is creating for shareholders with its acquisition strategy. We will continue to monitor this trend going forward.

What About the Debt?

A third concern with serial acquirers is if they accumulate an unmanageable amount of debt. Again, this is not a major problem for TMO. In the case of TMO, net debt-to-EBITDA is about 3.7x which is itself not too alarming given the relative defensiveness of the company's business. More importantly, TMO generates about $3.5 billion in free cash and the dividend consumes less than $250 million, so the company could easily throttle back on acquisition activity and reduce debt quickly. Incidentally, this would also result in an increase in the total company ROI.

Are Charges Excessive?

TMO takes charges every year related to integrating acquisitions. The following table shows these charges by income statement line item:

Charges reported in:	Year ended: 12/31/2017	12/31/2016	12/31/2015	12/31/2014
Cost of revenue	$123	$102	$9	$328
SG&A	$78	$104	$46	$131
Restructuring & Other	$97	$189	$115	$162
Total	$298	$395	$171	$620

The detailed disclosure on these charges indicate they are for items such as headcount reductions, facility closures, transaction costs, charges to conform acquired companies to TMO accounting policies, and the sales of inventories revalued at the date of acquisition. When viewed relative to pre-charge operating income and the size of the acquisitions they are related to, they are not especially alarming. Also, they do not appear to include write-offs relate to past acquisitions that are already going sour, as so many serial acquirers so often have. We will continue to monitor the frequency, size and content of future charges, but are not particularly concerned by what the company has done to date.

Summary

In summary, while ROI trends show signs that the company's acquisitions over the last few years have not produced improved returns for the company, TMO's acquisition program does not exhibit many of the red flags often associated with serial acquirers such as excessive charges and write offs, unmanageable debt build up, and no underlying growth of the core business.

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