Poor Governance Makes These Companies Acquisition Targets

ESG (Environmental, Social, Governance) investing has grown to a $20 trillion business, but the investing community still lacks a clear definition of exactly what ESG means. In particular, many investors don't appreciate the importance of the "G", corporate governance.

One of the most, if not the most, important factors in corporate governance is executive compensation because it determines executives' performance incentives. In our opinion, tying executive pay to return on invested capital (ROIC) is essential for any ESG strategy to have credibility with investors. ROIC is crucial to both maximizing shareholder value and building a business that is sustainable over the long-term. Nevertheless, just 30% of U.S. companies tie executive compensation to ROIC.

Sometimes poor corporate governance make companies potential targets for activist investors. This week, we're highlighting two companies with poor corporate governance that would be better off selling themselves entirely.

Buyout Target #1: Mattel Inc. (MAT: $17/share)

Mattel has failed to adapt to the changing toy business. Instead, it relies on outdated toy brands while not investing enough in building those brands by producing original entertainment and expanding digital distribution capabilities. As a result, the stock is down 62% over the past five years while competitor Hasbro (HAS), a previously featured Long Idea, is up 123%.

A lack of focus on ROIC can lead to overinvestment, but it can also lead to underinvestment. Mattel's executive compensation plan, which ties long-term bonuses to total shareholder return instead of fundamental improvements in the business, led to complacency and a focus on maintaining its high dividend. As a result, the company didn't make the necessary investments to adapt its business and maintain its competitive advantage.

As Mattel stagnated, Hasbro innovated and increased its invested capital by ~16% since 2013 (compared to 4% for MAT) as it expanded its TV and film production operations and invested in digital gaming. These investments helped the company turn many of its popular toys, such as *Transformers, G.I. Joe,* and *My Little Pony*, into successful film and TV franchises, which helps sell more toys as well as make money on their own.

These investments have helped Hasbro surpass Mattel as the largest U.S. toymaker while maintaining a high ROIC. Hasbro ties long-term compensation to ROIC, so its executives are more focused on the long-term health of the business instead of paying out a high dividend. As a result, HAS earns an ROIC of 13% compared to -4% for MAT over the trailing twelve months.

Figure 1 shows that ROIC explains 71% of the difference in valuation for the six toy and juvenile products companies we cover. As a result of its higher ROIC, HAS earns an enterprise value/invested capital (a cleaner version of price/book) that is 3 times higher than MAT.

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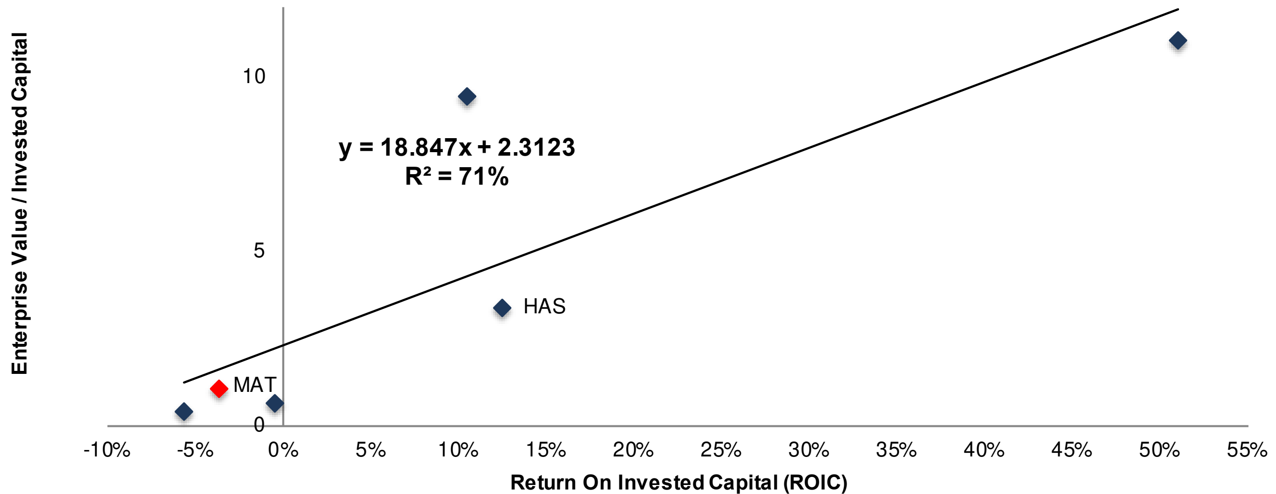
Figure 1: ROIC Explains 71% of Valuation for Toy and Juvenile Products Companies



Sources: New Constructs, LLC and company filings

Mattel still has a number of highly valuable brands – including Barbie, Hot Wheels, and American Girl – and could create more value under the right management. Investors clearly want the company to follow the Hasbro route of investing in film production to support and grow brands, as the stock jumped 5% earlier this month after the announcement of a new film division.

However, Mattel would be better off selling itself to Hasbro and merging its brands into Hasbro's existing entertainment infrastructure, rather than building out its own studio business. We believe Hasbro could justify paying anywhere from $20-$42 per share for Mattel without destroying shareholder value. Even the bottom end of that range represents a 20% premium to MAT's current stock price. Alternatively, Disney (DIS), the king of monetizing brands and characters, could also be a potential bidder at a similar price.

Mattel has rejected Hasbro's acquisition offers in the past, but the company's ongoing struggles suggest the buyout may be the best way for managers to create value for investors since they've not been able to do so on their own. Southeastern Asset Management, which has a history of activism, holds a 10.25% stake in MAT. Their position is currently passive, but they could turn active and push management to accept an acquisition if the right offer materializes.

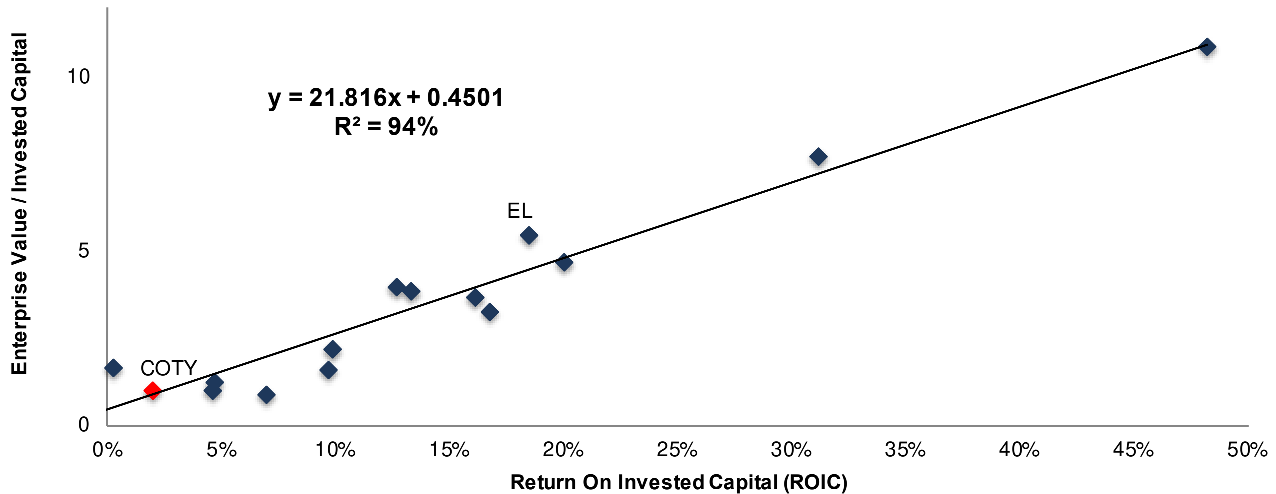
Buyout Target #2: Coty Inc. (COTY: $13/share)

Beauty company Coty has struggled significantly since its $12.5 billion acquisition of Procter & Gamble's (PG) beauty business. Not only have the acquired brands failed to live up to the price tag, the company has blamed the "distraction" of integrating this large purchase – which more than tripled its invested capital – for the underperformance of existing brands.

The company has also blamed macro-headwinds for its struggles when we think its own corporate governance is at least part of the problem. Competitor Estee Lauder (EL), which ties executive compensation to ROIC, quickly debunks any macro-headwind-based argument for COTY's poor performance. Over the past year, EL is up 27% while COTY is down 25%. Over the past five years, EL is up 97% while COTY is down 23%.

Figure 2 shows that ROIC explains 94% of the difference in valuation for the 16 personal products companies we cover. COTY is valued right on the trendline based on its low ROIC of just 2%, while EL garners a premium valuation.

Figure 2: ROIC Explains 94% of Valuation for Personal Products Companies



Sources: New Constructs, LLC and company filings

Despite the obvious struggles of the acquired P&G brands, the strain on the balance sheet from $8.5 billion in debt (98% of market cap), and the need to invest in areas such as online sales, emerging markets, and direct-to-consumer channels, Coty maintains that it won't sell off any of the acquired brands.

If Coty is determined not to sell off any assets, it probably needs to merge with a larger business that has the resources to service its debt and make the necessary investments required to optimize its brand portfolio. German conglomerate JAB Holdings, which holds a significant stake in Coty and is reportedly interested in acquiring full control, could take over the company and easily provide the necessary resources to undertake this turnaround.

Ideally, JAB would also push Coty to incentivize executives with ROIC in the future to help avoid any more wasteful acquisitions. By reforming Coty's corporate governance, JAB could make the company both more valuable to shareholders and more sustainable as a long-term business.

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Disclosure: David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, style, or theme.

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