A Golden Age of Event-Driven Investing? (pt 5)

SEPTEMBER 2, 2021 / PUPPYEH / EDIT

I am continuing my intermittent series of event-driven setups/trades I find interesting. Today's study is a bit of what I would call a 'low latency' trade, ie a high likelihood of modest (~20-30%) upside, with some optionality around a higher payoff; but at the same time a very low likelihood of material downside. I am instinctively attracted to these situations because, even if the absolute upside is not large, if there is a hard, near-term catalyst to extract 25%+ upside with limited downside, the risk/reward on that type of setup is tough to beat. Let's dig in.

Cardno Ltd (Australia: CDD) – last price 1.03 – $390mm market cap, $300-400k ADV

(apologies in advance, this stock is not as liquid as I would have liked and given the low latency nature of the trade I would especially advise all readers to exercise discipline. This makes a ton of sense around $1-1.1, but progressively less sense, from a risk/reward perspective, much higher than that. Because of the natural limitation here I will keep this write-up briefer than usual).

According to the blurb on their website, Cardno is 'a professional infrastructure and environmental services company, [that] engages in the development and improvement of physical and social infrastructure for communities worldwide.' That bland

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description doesn't really give you a sense for what they do, concretely, so here is how they present their activities in their latest presentation materials:

Suffice to say, perhaps, this is a very diversified set of businesses, or at least end-markets. I believe the segment of the market Cardno occupies – infrastructure services and environmental contracting – is very much a 'black box' of sorts, where outfits like Cardno are asked to do all manner of projects – run tollroads; oversee bridge construction; environmental assessment for ports, harbors, etc; manage facilities like airports – all under the amorphous banner of 'infrastructure services.' Cardno is by no means unique in this realm: if you look at the corporate websites of some of their larger competitors, like Aecom, Stantec, or WSP, you will see a similar amalgam of industries and buzzwords.

As a result, this will not be an investment pitch full of complex financials, or divsion-by-division modeling. It is instead all about the setup, and imperatives for the owners of the company. I think CDD is a compelling investment today for four reasons:

- it is likely to be sold in the very near-term;
- the sale is likely to be competitive, given the natural synergies available to a strategic buyer;
- in most any sale scenario I think there is a high likelihood of 25-30% upside without stretching;
- and even if there is no consummated sale downside looks quite modest (10-15%).

Let's unpack these points one by one.

CDD seems like it is about to be sold, and the process will likely be competitive

This is fairly straightforward. The company announced a 'Strategic Review' in early June (code for exploring a sale). Of note, they specifically mentioned they were contacted by a number of parties (ie more than one), and that the major shareholder, Crescent, approves the pursuit of a sale:

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9th June, 2021

Cardno Announces Strategic Review

more than one bidder

Following receipt of a number of unsolicited approaches from interested parties, the Board of Cardno Limited (ASX:CDD) (Cardno) has decided to commence a strategic review process with the objective of maximising Cardno shareholder value. This process will involve an assessment of Cardno's strategic options and the alternative strategies available to unlock and enhance value for Cardno shareholders. There are no assurances that the Board will decide to pursue, nor that any transaction or transactions will result from, this review.

Crescent Capital Partners, Cardno's largest shareholder, has advised the Cardno Board that it is supportive of Cardno conducting the strategic review. 56% shareholder, sale only exit strategy

Cardno will continue to keep shareholders informed in accordance with Cardno's continuous disclosure obligations. No action is currently required by Cardno shareholders.

Cardno has appointed Baird and Gresham Advisory Partners as its financial advisors and Gilbert + Tobin as its legal adviser, in relation to the strategic review.

Crescent's approval here is obviously key as they own 56% of the company. More importantly, though, Crescent's managing partner is Chairman of CDD's board – this was a bungled takeover transaction from 2015 that somehow stayed listed and went through the ringer (see this article for more details), with Crescent basically taking a bath on the investment. They still have two board seats, including Chairman, and given the natural dynamics around private equity fund timelines, it stands to reason they are quite happy to sell now (six years in), as a full sale of the company is the only realistic exit strategy for them given the illiquidity of the stock and their huge ownership position.

Keep in mind, too, the timeline of events. CDD announced the review in early June; at the time the stock price was in the mid-70s range. I doubt CDD management would have been willing to pursue alternatives, let alone announce the approval of its largest shareholder, for a small-premium transaction. That is to say, *I believe the initial exploratory bids for the company were probably already at healthy premiums*, call it in the 90c+ range, if not much higher.

So we know a strategic review is ongoing and – probably – that initial bids were maybe 10% below where we currently trade (or maybe a good deal higher). More than this, though, the most recent annual results significantly derisk the proposition, to me, and make a near-term transaction by far the most likely outcome. I say this because in its FY report – which was much better than expected – the company included this quite curious comment at the bottom of the PR:

> "As we advised last year, in FY22 some Cardno businesses will undoubtedly be impacted by the COVID-19 pandemic, but equally some businesses stand to gain both market share and share of wallet.
>
> "The Board expects that the business will continue to grow from its FY21 level, but the Board has chosen to not provide explicit earnings guidance to the market for FY22 due to the ongoing Strategic Review process".

There are many companies listed on the ASX who choose not to provide explicit earnings guidance; many indeed cited the uncertainties of COVID as part of that reason. But to give generically bullish commentary around the next fiscal year, and yet refuse to provide numbers specifically because of the ongoing discussions – that seems highly unusual to me. It would be one thing if there was an announced and/or agreed transaction on the table (which often happens with earnings or conference calls post deal announcement) – but that is certainly not the case here. *This may well be the first time I have seen a listed company specifically decline to provide guidance because of an*

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ongoing Review. I can only conclude, in concert with the earlier disclosures around core shareholder support and multiple interested parties, that the process is very much advanced.

Who could be interested, and what would they pay?

This is where it gets interesting. The vast majority of larger players in this space – Aecom, Arcadis, WSP, Stantec – have all been built through acquisition, because the synergies available to acquirers make a 'roll-up' model inherently attractive. Large entities already operating in a geography can simply staple on bits of other companies' backlog into their platforms, employing many of the same workers (contractors/consultants) but without a lot of the middle management/overhead. This is why, for example, when some of these companies tout acquisitions, they claim extremely large cost synergies as part of the acquisition rationale.

Take a recent deal (December 2020) done by WSP, for example (one of the leading serial acquirers in this space). In the deal deck announcing the purchase of Golder, they suggested *a huge 3.3% of acquired revenues would turn into cost synergies*, alone, taking the purchase multiple from 10.4x to 8.4x:

FINANCIAL HIGHLIGHTS

- Acquisition of Golder for an enterprise value of US$1.14B (approx. CAD$ 1.5B) representing 10.4x Golder's 2020 pre-IFRS 16 adjusted EBITDA or 8.4x post-synergies[1,4].
- Immediately accretive[2] to WSP's adjusted earnings per share[3], with accretion[2] increasing to the mid-teens once synergies are fully realized[4].

Cost synergies alone at 3.3% of revenues...

- Annual cost synergies of approximately $55 million expected to be achieved over a 24-month period with 50% to be realized within the first twelve months after the closing date. Costs required to realize such annual cost synergies estimated not to exceed $55 million in the aggregate[4].

We will come to what this means for CDD shortly, but the simple takeaway is that acquirer's EBITDA in these kinds of roll-up deals can be quite a bit larger than standalone EBITDA. Thus, for example, CDD recently reported $51mm (AUD) of EBITDA in the just-completed FY21...

		REMOVING FX			
$M	FY21	FY20 @ FY21 FX Rate	% change year on year	FY20	% change year on year
Gross Revenue	890.4 M	939.6 M	(5.2%)	978.3 M	(9.0%)
Fee Revenue	612.7 M	626.9 M	(2.3%)	677.1 M	(9.5%)
Underlying EBITDAI[1]	78.5 M	68.0 M	15.5%	73.5 M	6.8%
Underlying EBITDAI Pre AASB 16 impact[2]	51.2 M	38.9 M	31.6%	43.0 M	19.0%
Underlying NOPAT[3]	27.7 M			9.4 M	194.7%
Net profit after tax	32.7 M			56.6 M	(42.2%)
Operating Cash Flow	62.6 M			73.5 M	(14.8%)
NOPAT EPS - basic (cents)	6.69			2.10	218.6%
Backlog	1,177.3 M	1,188.1 M	(0.9%)	1,214.3 M	(3.0%)

[1] Underlying EBITDAI = EBIT plus underlying adjustments, depreciation, amortisation and impairment losses
[2] Underlying EBITDAI = EBIT plus underlying adjustments, depreciation, amortisation and impairment losses pre AASB 16 impact
[3] Underlying NOPAT = NPAT plus underlying adjustments and impairment losses

...a number that they are simply guiding to 'grow' in FY22, largely a function of the US infrastructure-led boom:

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November 2019 (1)
October 2019 (1)
August 2019 (2)
July 2019 (3)
April 2019 (1)
March 2019 (3)
July 2016 (1)
March 2016 (1)
February 2016 (2)
December 2015 (1)
October 2015 (1)
September 2015 (2)
August 2015 (3)
July 2015 (1)
June 2015 (1)
May 2015 (2)
April 2015 (4)
March 2015 (6)

For argument's sake, let's assume this means 10% growth in EBITDA – hence to $56mm. To an acquirer gaining CDD's $1bn backlog and ~$900mm in gross revenues, though, you would think at the bare minimum 1%, maybe 1.5% of sales could be extracted in cost synergies (keeping in mind the 3.3% of revenues taken in the Golder example). That alone would imply **acquirer's EBITDA of say $65-70mm this year**, and I don't think that is at all aggressive as CDD margins (high single digit) are well below some of the large players (mid-teens).

Who might the 'interested parties' be?

The above all suggests there is a strong industrial logic for a business like this to be folded into a larger player. The question is, which larger player? I think there are two obvious potential buyers: Stantec, and Aecom. There may well be others, and financial buyers as well too, but for now I think these two names will be involved in the bidding. Let me explain why.

Let's look at Stantec first. Whilst a Canadian holding company, Stantec has significant global interests – one of which MWH, is where CDD's CEO, Susan Reisbord (an American, still running CDD from the US), used to work (see here). Moreover, if you look at Stantec's investor materials, you will note that when it comes to M&A, they are particularly focusing on Australia/NZ and the US:

The Cardno business is essentially a large and profitable mainstay North American platform; and the large-but-in-need-of-cost-cutting Australia/NZ business. I think ~85% of revenues (and backlog) relates to these two markets, so it is hard to think of a better geographic fit for an acquisition on this basis, than CDD. The personal history with the CEO appears to line up as well. Stantec is also apparently looking for 'small and mid-size' opportunities – meaning CDD could well be the right size they are looking for:

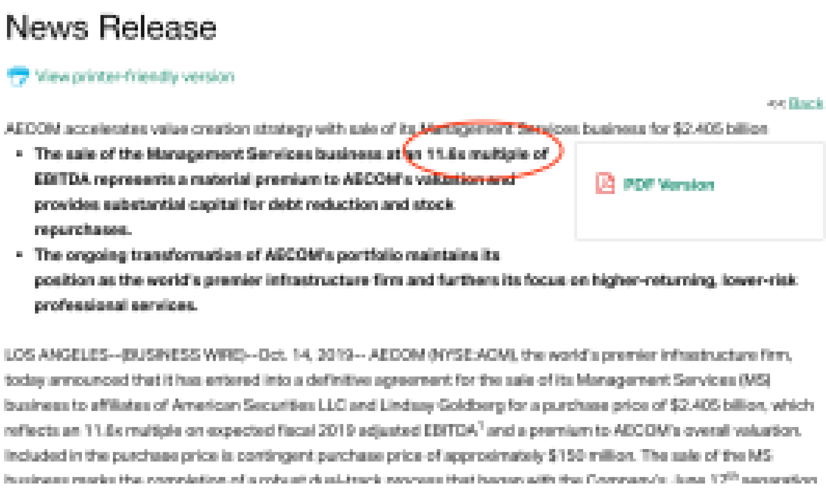
Then there is Aecom. A globally diversified player with a very large Australian (and of course US) business, Aecom is less specific than Stantec in their materials, but nevertheless highlighted again these two geographies as areas they want to grow inorganically in:

Again, CDD would make sense geographically, and could be plugged in fairly seamlessly (and synergistically) into the Aecom platform. Note that these are just two potential acquirers, and there could well be others (like WSP). But it really only takes two to get a bidding war going – and remember the company has already told us there were multiple interested parties…

What is the right price?

If you accept the conceit that CDD is highly likely to be sold near-term and that there are probably a number of buyers who could make the acquisition quite accretive, the only real question then is what is the right price? Well, whether it is Aecom, WSP, Stantec, or Arcadis, basically all these names trade at rich valuations (13-15x NTM EV/EBITDA), meaning even paying a premium to where CDD trades and getting no synergies is accretive to their equity valuations. Still, I think 10x EV/EBITDA, pre-synergies, is quite achievable and may well be exceeded – but 10x NTM EV/EBITDA of say $56mm still implies a ***$560mm market cap (there's no debt) and a $1.35 stock price (FDSO is 420 shares, I think), ie good for 31% upside.***

As per above, Golder was the last transaction in the space that I could find, and that went off above 10x EV/EBITDA. Earlier (late 2019), Aecom sold their management services business for 11.6x EV/EBITDA, to private equity:


News Release

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AECOM accelerates value creation strategy with sale of its Management Services business for $2.405 billion

- The sale of the Management Services business at an 11.6x multiple of EBITDA represents a material premium to AECOM's valuation and provides substantial capital for debt reduction and stock repurchases.
- The ongoing transformation of AECOM's portfolio maintains its position as the world's premier infrastructure firm and furthers its focus on higher-returning, lower-risk professional services.

PDF Version

LOS ANGELES--(BUSINESS WIRE)--Oct. 14, 2019-- AECOM (NYSE:ACM), the world's premier infrastructure firm, today announced that it has entered into a definitive agreement for the sale of its Management Services (MS) business to affiliates of American Securities LLC and Lindsay Goldberg for a purchase price of $2.405 billion, which reflects an 11.6x multiple on expected fiscal 2019 adjusted EBITDA[1] and a premium to AECOM's overall valuation. Included in the purchase price is contingent purchase price of approximately $150 million. The sale of the MS

No doubt this is a better business than CDD and American cost of capital is different; it is also difficult to granularly analyze the differences between some of these smaller-scale infrastructure service providers. But nevertheless in the context of prior transactions; synergies; and where their own equities trade, I think 10x EV/EBITDA is eminently reasonable. And again, I expect we have more than one bidder involved…

What is the downside if no deal happens?

I think the likelihood of no deal being done is incredibly low, given the imperatives of Crescent in this situation – in other words I think it much more likely they sell into a weak bid around $1 and just get out, than leave us hanging and waiting. Still, if worst came to worst I still don't think the stock would trade much below 90c. Keep in mind this is a totally unlevered entity now and has committed to paying out 70% of net income, and just guided to growing earnings again this coming year, just after earning 7c EPS normalized. To me that means something like 8c in EPS and, I would guess ~5.5c in dividends, thus at 90c you'd be looking at 11x (unlevered EPS) and a >6% yield – hardly aggressive multiples in the context of the US-led infrastructure boom of which CDD is a primary beneficiary. Moreover CDD retired a huge amount of the stock (10%) through a buyback last year, I would expect that program to be reinitiated if the Strategic Review somehow didn't result in a transaction.

So all in all I like the risk-reward hear and expect to hear something definitive in the coming months, if not sooner, and have added CDD.AX to the event book.

Disclosure: long CDD.AX

Uncategorized

CDD.AX

← DXLG thoughts post the 2Q print

A Golden Age of Event-Driven Investing? (part 6) →

15 thoughts on "A Golden Age of Event-Driven Investing? (pt 5)"

Shreeni I

SEPTEMBER 2, 2021 AT 4:05 PM

Thanks for the idea!

REPLY EDIT

jehu molina

SEPTEMBER 2, 2021 AT 4:25 PM

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REPLY EDIT

D P

SEPTEMBER 2, 2021 AT 5:05 PM

fabulous idea.

REPLY EDIT