FROM THE ANALYSTS: EQUITIES

DANAHER—EXCEPTIONAL CAPITAL ALLOCATION WITH A FOCUS ON LIFE SCIENCES

By Donovan Stefan (Analyst)

Danaher is a specialised platform investment company listed on the New York Stock Exchange. It comprises five platforms and four operating segments including dental, with 20 companies that run autonomously, unified by a common business model and shared purpose. The story of Danaher's growth has been one of exceptional capital allocation by the founders, the Rales brothers, for more than 35 years. The core competency of the company is capital allocation and their strategy is to target areas of the market that demonstrate high growth and high levels of recurring earnings. In this way they have transitioned from a diversified industrial holding company, with inherent cyclicality, to a focus on science and technology companies, which design and manufacture products (equipment and consumables) used in curing, preventing, treating or diagnosing diseases and other health conditions.

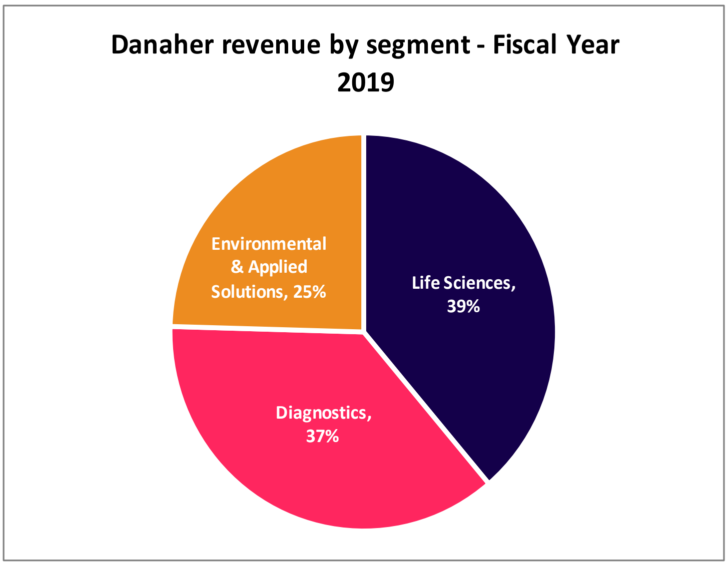

Figure 2. Danaher revenue by segment—Fiscal year 2019. *Source:* Danaher annual report.

Danaher's approach to business, and the value they bring to the companies they acquire, is defined in their business model – Danaher Business Systems (DBS) – a highly defined playbook for realising synergies. DBS is a set of processes and tools that enable sustainable growth and profitability by creating a virtuous cycle of improvement. It represents a core competitive advantage that enables them to shift into higher growth, higher recurring revenue and higher margin businesses. They have tended to make "dipping a toe in the water" acquisitions as they test markets followed by large strategic acquisitions and numerous smaller bolt-on acquisitions to strengthen their position.

An uncommon holding for Northstar

Danaher is not the type of investment that we at Northstar would ordinarily gravitate towards. Businesses that grow through aggressive M&A often use their well-rated stock to buy earnings by acquiring companies with lower rated stock and create little (or even destroy) value for long term shareholders. So, readers may be surprised to hear that Northstar clients have held an interest in Danaher since 2014.

However, Danaher's strategy to target high growth markets characterised by high recurring revenue and free cash flow generation makes sense to us. We also like their unrivalled record in effective capital allocation over many decades.

Strong free cash flow generation and high recurring revenues

Danaher has consistently delivered strong returns on capital and its total shareholder return has exceeded that of its sector and the broader market over three, five and ten years. This is delivered through excellent free cash flow growth and conversion. Reported returns on invested capital are diluted by goodwill associated with M&A, however returns on tangible capital is more than satisfactory demonstrating their ability to build long term capital.

The group has seen a meaningful improvement in their recurring revenue base driven by higher consumables and the separation of several industrial businesses in the Fortive spinoff in 2016. Currently 70% of revenue is recurring compared to 45% in 2015.

A history of excellent capital allocation

Since 2000, Danaher has allocated 80% of available capital to M&A (their first priority), 12% to capex, 5% to dividends and 3% to share repurchases. This has been funded 94% from operating cash flow, demonstrating their ability to effectively repurpose funds generated.

Over the last ten years Danaher has spent 111% of operating cash flow on net M&A and it has been the driving force behind their sustained growth for decades. They have acquired hundreds of businesses since 1994. More than half of current total revenue comes from businesses acquired in the past seven years. They have the youngest portfolio in their history with a strong runway for improvement in their growth trajectory and margin expansion using the tools and processes of DBS.

GE Biopharma acquisition

Danaher is in the process of buying the Biopharma business of GE Life Sciences for $21.4 billion. This will materially increase their exposure to the Life Sciences market segment and will be growth and earnings accretive.

Addressable market

The group has a strong organic growth profile, good profitability and participates in large and growing markets. Danaher's current total combined addressable market across their segments is $135bn (including Dental) with a weighted average category growth in the mid-single digits.

Their focus on Life Sciences shows promise. The market is approximately $50 billion and is growing at high single digits. Danaher currently has approximately 13% market share in the Life Sciences segment, leaving plenty of room to consolidate and grow above the market rate. In all other segments they also maintain roughly 15% markets share.

Excluding Dental and including the GE Biopharma purchase, Life Sciences and Diagnostics make up approximately 79% of current revenue, up from 56% in 2014.

Risks

The size of the GE Biopharma transaction brings some risk into the equation as a significant amount of debt is required to finalise the transaction. Consequently, we have reduced the position in our funds, reflecting the increased risk in the business. However, we believe that the strong free cash flows the companies in the group generate will enable Danaher to reduce debt over a reasonable period and we are comforted by the fact that Danaher management has a record of under promising and over delivering.

Northstar's assessment of value

In our base case valuation scenario we allocate no value to future acquisitions. However, our bull case scenario recognises the founders' demonstrated skills in capital allocation and models potential future acquisitions scenarios, with the assumption that approximately half of their future free cash flow generated is used for further acquisitions.

Danaher remains a core holding across Northstar global strategies. Its defensive nature and the durability and attractive fundamentals of its end markets is demonstrated by its year to date performance of -9.6% which compares favourably to the

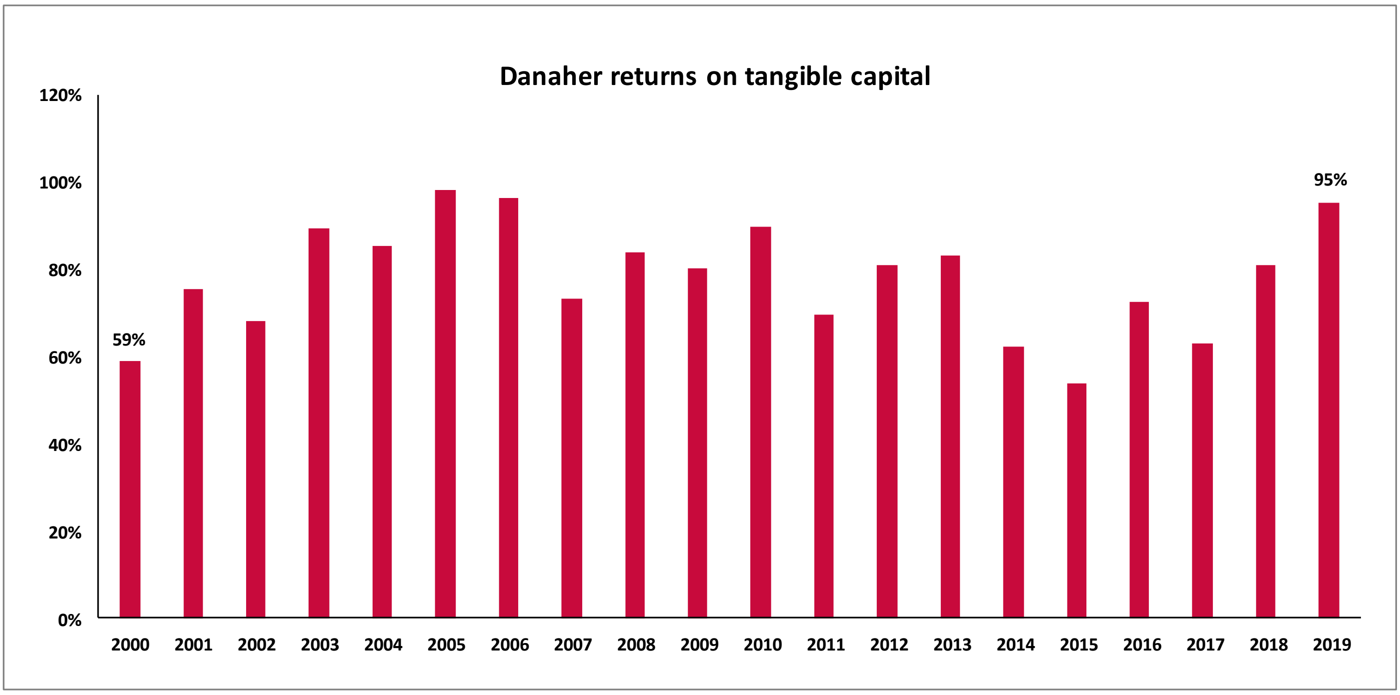

Figure 3. Danaher returns on tangible capital. *Source:* Bloomberg Northstar calculation.

MSCI world index's drawdown of -22.1%. Danaher trades at a discount of 18% to our base case valuation scenario and an even steeper discount to our bull case scenario which incorporates value attributable to accretive M&A which continues to be the company's core competency, in our view.

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