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MEASURING AND MANAGING THE
VALUE OF COMPANIES

TIM KOLLER · MARC GOEDHART · DAVID WESSELS

MCKINSEY & COMPANY

31

Mergers and Acquisitions

Mergers and acquisitions (M&A) are an important element of a dynamic economy. At different stages of an industry's or a company's life span, resource decisions that once made economic sense no longer do. For instance, the company that invented a groundbreaking innovation may not be best suited to exploit it. As demand falls off in a mature industry, companies are likely to have built excess capacity. At any time in a business's history, one group of managers may be better equipped to manage the business than another. At moments like these, acquisitions are often the best or only way to reallocate resources sensibly and rapidly.

Acquisitions that reduce excess capacity or put companies in the hands of better owners or managers typically create substantial value both for the economy generally and for investors. You can see this effect in the increase in the combined cash flows of the many companies involved in acquisitions. Even though acquisitions overall create value, however, the distribution of any value they create tends to be lopsided, with the selling companies' shareholders capturing the bulk. In fact, most empirical research shows that for large acquisitions, one-third or more of acquiring companies destroy value for their shareholders because they transfer all the benefits of the acquisition to the selling companies' shareholders.

For companies in growth mode, acquisitions can be an effective way to accelerate their expansion or fill in gaps in products, technologies, or geographies. Typically, numerous smaller acquisitions can help companies access markets faster or help smaller companies get their products to market faster.

The challenge for managers, therefore, is to ensure that their acquisitions are among those that *do* create value for their shareholders. To that end, this chapter provides a framework for analyzing how to create value from acquisitions and summarizes the empirical research. It discusses the archetypal approaches that are most likely to create value, as well as some other strategies that are often attempted but have longer odds of executing successfully. It provides practical advice on how to estimate and achieve operating improvements and whether to pay in cash or in stock. Finally, it reminds managers that stock markets respond to the expected impact of acquisitions on intrinsic value, not accounting results.

A FRAMEWORK FOR VALUE CREATION

Acquisitions create value when the cash flows of the combined companies are greater than they would have otherwise been. If the acquirer doesn't pay too much for the acquisition, some of that value will accrue to the acquirer's shareholders. Acquisitions are a good example of the conservation of value principle (explained in Chapter 3).

The value created for an acquirer's shareholders equals the difference between the value received by the acquirer and the price paid by the acquirer:

$$\text{Value Created for Acquirer} = \text{Value Received} - \text{Price Paid}$$

The value received by the acquirer equals the intrinsic value of the target company as a stand-alone company run by its former management team plus the present value of any performance improvements to be achieved after the acquisition, which will show up as improved cash flows for the target's business or the acquirer's business. The price paid is the market value of the target plus any premium required to convince the target's shareholders to sell their shares to the acquirer:

$$\begin{aligned}\text{Value Created for Acquirer} = &\ (\text{Stand-Alone Value of Target} \\ &+ \text{Value of Performance Improvements}) \\ &- (\text{Market Value of Target} \\ &+ \text{Acquisition Premium})\end{aligned}$$

Exhibit 31.1 uses this framework to illustrate a hypothetical acquisition. Company A buys Company B for $1.3 billion, which includes a 30 percent premium over its market value. Company A expects to increase the value of Company B by 40 percent through various operating improvements, so the

EXHIBIT 31.1 **Acquisition Evaluation Framework**

$ million

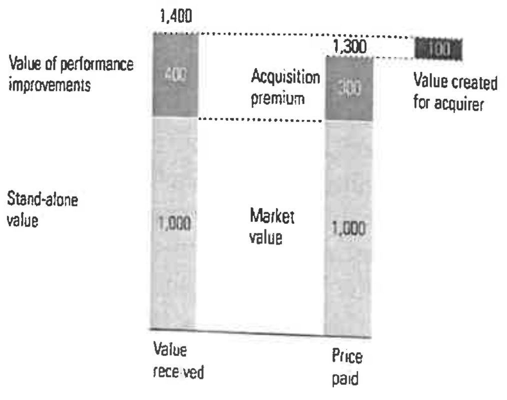


Exhibit 31.2 Value Creation for Given Performance Improvements and Premium Paid

Value creation as % of deal value

Premium paid, % of stand-alone target value	10	20	30	40	50
0	10	20	30	40	50
10	0	9	18	27	36
20	−8	0	8	17	25
30	−15	−8	0	8	15

Value of performance improvements, % of stand-alone target value

value of Company B to Company A is \$1.4 billion. Subtracting the purchase price of \$1.3 billion from the value received of \$1.4 billion leaves \$100 million of value created for Company A's shareholders.

In the case where the stand-alone value of the target equals its market value, value is created for the acquirer's shareholders only when the value of improvements is greater than the premium paid:

$$\text{Value Created} = \text{Value of Improvements} - \text{Acquisition Premium}$$

Examining this equation, it's easy to see why most of the value created from acquisitions goes to the seller's shareholders: if a company pays a 30 percent premium, then it must increase the value of the target by at least 30 percent to create any value.

Exhibit 31.2 shows the value created for the acquirer's shareholders relative to the amount invested in acquisitions at different levels of premiums and operating improvements. For example, Company A, from the example just considered, paid a 30 percent premium for Company B and improved Company B's value by 40 percent, so the value created for the acquirers' shareholders represents 8 percent of the amount Company A invested in the deal.

If we further assume that Company A was worth about three times Company B's worth at the time of the acquisition, this major acquisition would be expected to increase Company A's value by only about 3 percent: \$100 million of value creation (see Exhibit 31.1) divided by Company A's value of \$3 billion. As this example shows, it is difficult for an acquirer to create a substantial amount of value from acquisitions.

While a 40 percent performance improvement sounds steep, that's what better acquirers often achieve. Exhibit 31.3 presents estimates of the value

EXHIBIT 31.3 **Selected Acquisitions: Significant Improvements**

%	Year	Value of improvements relative to target value[1]	Premium paid	Net value created relative to price[2]
Abbott Labs/Alere	2016	45–55	35	10–20
Tesoro/Western Refining	2016	45–55	35	10–20
RF Micro Devices/Triquint Semiconductor	2014	60–70	10	50–60
InBev/Anheuser-Busch	2008	35–45	20	15–25
Henkel/National Starch	2007	60–90	55	5–25
Kellogg/Keebler	2000	45–70	15	30–50
PepsiCo/Quaker Oats	2000	35–55	10	25–40
Clorox/First Brands	1998	70–105	60	5–25

[1] Present value of announced performance improvements divided by target value

[2] Net value created from acquisition divided by purchase price.

created from a sample of deals over the past 20 years. To estimate the gross value creation, we discounted the announced actual performance improvements at the company's weighted average cost of capital (WACC). The performance improvements were substantial, typically exceeding 50 percent of the value of the target. In addition, Kellogg and PepsiCo paid unusually low premiums for their acquisitions, allowing them to capture more value.

EMPIRICAL RESULTS

Acquisitions and their effects on value creation are a perennial topic of interest to researchers. Empirical studies of acquisitions have yielded useful insights into when they occur, whether they create value, and for whom they create value.

When Do Acquisitions Take Place?

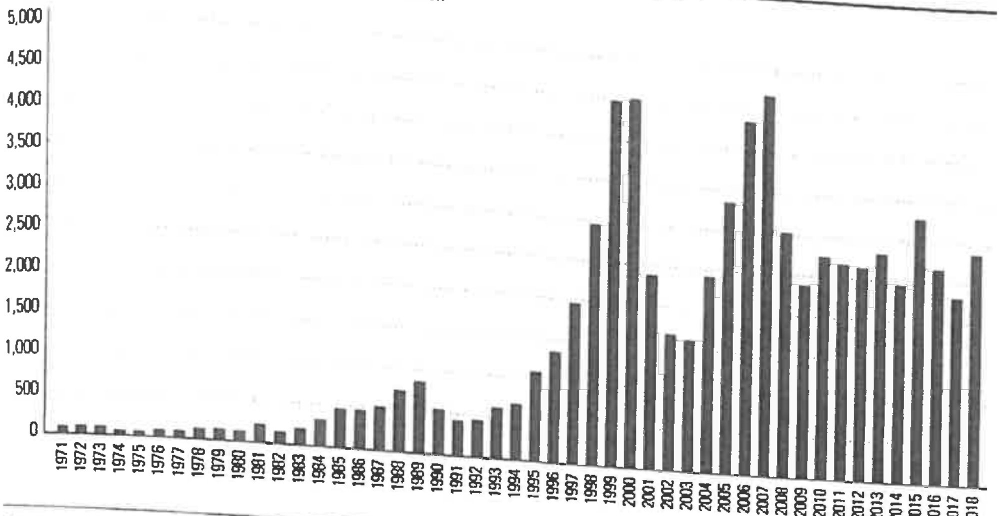
Acquisition activity tends to occur in waves, as shown in Exhibit 31.4. Several factors drive these waves. First, we tend to see more acquisitions when stock prices are rising and managers are optimistic (though to maximize the amount of value created, they should really make acquisitions when prices are low). Low interest rates also stimulate acquisitions, especially heavily leveraged acquisitions by private-equity firms. Finally, one large acquisition in an industry encourages others in the same industry to acquire something, too.

Do Acquisitions Create Value?

For decades, academics and other researchers have studied the question of whether acquisitions create value. Most studies have examined the stock price reaction to the announcement of acquisitions. One effect of this approach is

EXHIBIT 31.4 **Historical M&A Activity: U.S. and European Transactions**

Inflation-adjusted value of M&A transactions, 2018 $ billion



Source: Dealogic, Capital IG, Mergerstat, Thomson Reuters

that large acquisitions (relative to the size of the acquirer) tend to dominate the results. The market's assessment of small acquisitions is hard to discern, yet 95 percent of acquisitions by large companies are of targets that are smaller than 5 percent of the acquirer's market capitalization.

Researchers have shown that acquisitions do create value for the collective shareholders of the acquirer and the acquired company. According to McKinsey research on 1,770 acquisitions from 1999 through 2013, the combined value of the acquirer and target increased by about 5.8 percent on average.[1] So we can conclude that acquisitions tend to create value for the economy, through some combination of cost and revenue synergies.

For Whom Do Acquisitions Create Value?

To see who benefits from acquisitions, we'll begin by reviewing the studies driven mostly by large acquisitions. While buying and selling shareholders collectively derive value from acquisitions, large acquisitions on average do not create any value for the acquiring company's shareholders. Empirical studies examining the reaction of capital markets to M&A announcements find that the value-weighted average large deals lower the acquirer's stock price between 1 and 3 percent.[2] Stock returns following the acquisition are no better. Mark Mitchell and Erik Stafford have found that acquirers underperform

[1] D. Cogman, "Global M&A: Fewer Deals, Better Quality," *McKinsey on Finance*, no. 50 (Spring 2014): 23–25.

[2] S. B. Moeller, F. P. Schlingemann, and R. M. Stulz, "Do Shareholders of Acquiring Firms Gain from Acquisitions?" (NBER Working Paper W9523, Ohio State University, 2003).

comparable companies on shareholder returns by 5 percent during the three years following the acquisitions.[3] The United Kingdom has new rules requiring a shareholder vote on larger acquisitions. Research by Marco Becht, Andrea Polo, and Stefano Rossi showed that in situations where shareholders voted, the stock price reaction of the acquirer was much more likely to be positive than when shareholders didn't vote. They also showed that in larger transactions in the United States, where shareholders don't vote, the stock price reactions were also more likely to be negative.[4]

Another way to look at the question is to estimate the percentage of deals that create any value at all for the acquiring company's shareholders. McKinsey research found that one-third created value, one-third did not, and for the final third, the empirical results were inconclusive.[5]

It comes as no surprise to find conclusive evidence that most or all of the value creation from large acquisitions accrues to the shareholders of the target company, since the target shareholders are receiving, on average, high premiums over their stock's preannouncement market price—typically about 30 percent.

Most of these studies examine the stock market reaction to an acquisition within a few days of its announcement. Many people have criticized using announcement effects to estimate value creation. The evidence on whether announcement effects persist is inconsistent. Sirower and Sahna have shown that the initial market reactions are persistent and indicate future performance for the next year.[6] Some of our colleagues, however, examined a different sample of larger transactions over a two-year period and found inconclusive evidence of persistence.[7]

Although studies of announcement effects give useful results for large samples, the same approach cannot be applied to individual transactions. While the market correctly assesses the results of transactions on average, that statistic does not mean its initial assessment of a single transaction will always be correct.

To overcome the large acquisition bias of the studies described, several of our colleagues looked at acquisition programs of companies rather than single acquisitions.[8] They examined 1,645 nonbanking companies from 2007 to 2017 and grouped them into four categories:

[3] M. L. Mitchell and E. Stafford, "Managerial Decisions and Long-Term Stock Price Performance," *Journal of Business* 73 (2000): 287–329.

[4] M. Becht, A. Polo, and S. Rossi, "Does Mandatory Shareholder Voting Prevent Bad Acquisitions? The Case of the United Kingdom," *Journal of Applied Corporate Finance* 31, no. 1 (Winter 2019): 42–61.

[5] W. Rehm and C. Sivertsen, "A Strong Foundation for M&A in 2010," *McKinsey on Finance*, no. 34 (Winter 2010): 17–22.

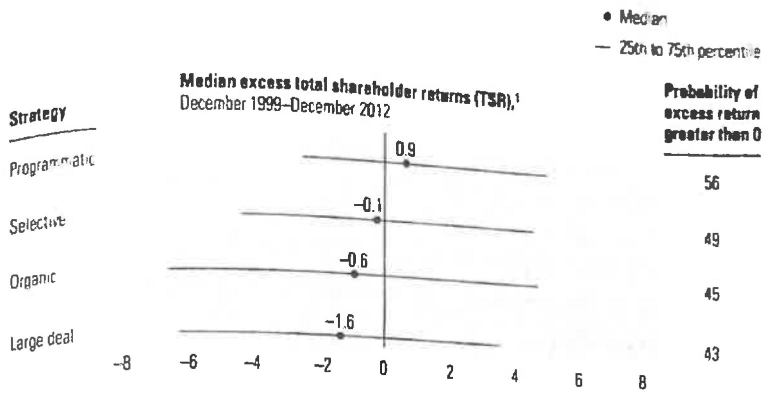
[6] M. Sirower and S. Sahna, "Avoiding the Synergy Trap: Practical Guidance on M&A Decisions for CEOs and Boards," *Journal of Applied Corporate Finance* 18, no. 3 (Summer 2006): 83–95.

[7] Rehm and Sivertsen, "A Strong Foundation for M&A in 2010." An unpublished update in 20[illegible] showed similar results.

[8] Updated and expanded analysis of W. Rehm, R. Uhlaner, and A. West, "Taking a Longer-Term Look at M&A Value Creation," *McKinsey Quarterly* (January 2012), www.mckinsey.com.

EXHIBIT 31.5 Success Rates of Observed Acquisition Strategies

1,645 nonbanking companies, 2007–2017, %



[1] Outperformance against global industry index for each company

Source: Dealogic

1. Programmatic acquirers[9] completed many acquisitions.
2. Large-deal companies completed at least one deal that was larger than 30 percent of the acquiring company's value.
3. Organic companies conducted almost no M&A.
4. Selective acquirers did not fit into the other three categories.

Exhibit 31.5 shows the results, including median total shareholder returns (TSRs) versus peers, along with the 25th and 75th percentiles, and the number of companies outperforming peers. Programmatic acquirers performed best, with a median outperformance of 0.9% TSR per year. The large-deal companies performed the worst, consistent with the studies of announcement effects.

That said, the medians conceal important details. Note that the band of 25th to 75th percentiles is very large and overlaps across the different acquisition strategies. Of all the categories, the distribution of the programmatic acquirers has the most positive skewing, and these acquirers also have the highest percentage of companies outperforming. Large deals skewed heavily negative. The case of organic companies is interesting for its very wide distribution of results. This is not surprising, since the sample includes fast-growing, younger companies with high TSRs that may think it too early to embark on much M&A, as well as declining or troubled companies focused on managing decline. We also found that the results varied by industry. For

[9] We define programmatic acquirers as companies that make more than two small or midsize deals in a year.

example, large acquisitions tended to be more successful in slower-growing, mature industries, where there is great value to reducing excess capacity. By contrast, large deals in faster-growing sectors underperformed significantly. In those companies, the inward focus required to integrate a large acquisition diverted management's attention from the need for continual product innovation. Only the programmatic acquirers tended to outperform across most industries. The results are also consistent with 2017 research by Fich, Nguyen, and Officer, who found that large companies acquiring small companies tend to create more value than when they buy large companies.[10]

The news is not all bad for large acquisitions. Researchers have identified specific factors that differentiate successful deals from unsuccessful ones, based on returns to the acquirer's shareholders. This research points to four important characteristics:

1. *Strong operators are more successful.* According to empirical research, acquirers whose earnings and share price grew at a rate above the industry average for three years before the acquisition earn statistically significant positive returns on announcement.[11] Another study found similar results using the market-to-book ratio as a measure of corporate performance.[12]
2. *Low transaction premiums are better.* Researchers have found that acquirers paying a high premium earn negative returns on announcement.[13]
3. *Being the sole bidder helps.* Several studies have found that acquirer stock returns are negatively correlated with the number of bidders; the more companies attempting to buy the target, the higher the price.[14]
4. *Private deals perform better.* Acquisitions of private companies and subsidiaries of large companies have higher excess returns than acquisitions of public companies.[15]

[10] Eliezer M. Fich, Tu Nguyen, and Micah S. Officer, "Large Wealth Creation in Mergers and Acquisitions" (paper presented at American Finance Association 2013 annual meeting, San Diego, CA, January 4–6, 2013, revised November 8, 2017), available at http://dx.doi.org/10.2139/ssrn.2020507.
[11] R. Morck, A. Shleifer, and R. Vishny, "Do Managerial Objectives Drive Bad Acquisitions?" *Journal of Finance* 45 (1990): 31–48.
[12] H. Servaes, "Tobin's *q* and the Gains from Takeovers," *Journal of Finance* 46 (1991): 409–419; and Fich et al., "Large Wealth Creation in Mergers and Acquisitions."
[13] M. L. Sirower, *The Synergy Trap* (New York: Free Press, 1997); and N. G. Travlos, "Corporate Takeover Bids, Methods of Payment, and Bidding Firms' Stock Return," *Journal of Finance* 42 (1987): 943–963. The result was statistically significant in Sirower but not significant in Travlos.
[14] Morck et al., "Do Managerial Objectives Drive Bad Acquisitions?"; and D. K. Datta, V. K. Narayanan, and G. E. Pinches, "Factors Influencing Wealth Creation from Mergers and Acquisitions: A Meta-Analysis," *Strategic Management Journal* 13 (1992): 67–84.
[15] See, for example, L. Capron and J. Shen, "Acquisitions of Private versus Public Firms: Private Information, Target Selection and Acquirer Returns" (INSEAD Working Paper Series, 2005); and P. Draper and K. Paudyal, "Acquisitions: Public versus Private," *European Financial Management* 12, no. 1 (2006): 57–80.

Perhaps it is just as important to identify the characteristics that don't matter. There is no evidence that the following acquisition dimensions indicate either value creation or value destruction:

- Whether the transaction increases or dilutes earnings per share
- The price-to-earnings ratio (P/E) of the acquirer relative to the target's P/E
- The degree to which the acquirer and the target are related, based on Standard Industrial Classification (SIC) codes
- Whether deals are made when the economy is strong or weak[16]

This empirical evidence is important because it shows that there is no magic formula to make an acquisition successful. Like any other business strategy, acquisitions are not inherently good or bad, just as marketing or research and development (R&D) are not inherently good or bad. Each deal must have its own strategic logic, and the company must have the relevant skills to execute deals or deal programs. In our experience, acquirers in the most successful deals have well-articulated, specific value creation ideas going into each deal. The strategic rationales for less successful deals tend to be vague, such as to pursue international scale, fill in portfolio gaps, or build a third leg of the portfolio.

ARCHETYPES FOR VALUE-CREATING ACQUISITIONS

The empirical analysis is limited in its ability to identify specific acquisition strategies that create value. This is because acquisitions come in a wide variety of shapes and sizes and also because there is no objective way to classify acquisitions by strategy. Furthermore, the stated strategy may not be the real strategy. Companies typically talk up all kinds of strategic benefits from acquisitions that are really all about cutting costs.

In the absence of empirical research, our suggestions for strategies that create value are based on our acquisitions work with companies. In our experience, the strategic rationale for an acquisition that creates value for acquirers typically fits one of the following six archetypes:

1. Improve the performance of the target company.
2. Consolidate to remove excess capacity from an industry.
3. Create market access for the target's (or, in some cases, the buyer's) products.

[16] Fich et al., "Large Wealth Creation in Mergers and Acquisitions."

4. Acquire skills or technologies more quickly or at lower cost than they could be built in-house.
5. Exploit a business's industry-specific scalability.
6. Pick winners early and help them develop their businesses.

If an acquisition does not fit one or more of these archetypes, it's unlikely to create value.

The strategic rationale for an acquisition should be a specific articulation of one of these archetypes, not a vague concept like growth or strategic positioning. While growth and strategic positioning may be important, they need to be translated into something tangible. Furthermore, even if your acquisition conforms to one of these archetypes, it still won't create value if you overpay.

Improve Target Company's Performance

One of the most common value-creating acquisition strategies is improving the performance of the target company. Put simply, you buy a company and radically reduce costs to improve margins and cash flows. In some cases, the acquirer may also take steps to accelerate revenue growth.

Pursuing this strategy is what the best private-equity firms do. Acharya, Hahn, and Kehoe studied successful private-equity acquisitions where the target company was bought, improved, and sold with no additional acquisitions along the way.[17] They found that the operating profit margins of the acquired businesses increased by an average of about 2.5 percentage points more than at peer companies during the private-equity firm's ownership. That means many of the transactions increased operating profit margins even more.

Keep in mind that it is easier to improve the performance of a company with low margins and low return on invested capital (ROIC) than that of a high-margin, high-ROIC company. Consider the case of buying a company with a 6 percent operating profit margin. Reducing costs by three percentage points from 94 percent of revenues to 91 percent of revenues increases the margin to 9 percent and could lead to a 50 percent increase in the value of the company. In contrast, if the company's operating profit margin is 30 percent, increasing the company's value by 50 percent requires increasing the margin to 45 percent. Costs would need to decline from 70 percent of revenues to 55 percent, a 21 percent reduction in the cost base. That expectation might be unreasonable.

Consolidate to Remove Excess Capacity

As industries mature, they typically develop excess capacity. For example, in chemicals, companies are constantly looking for ways to get more production

[17] V. V. Acharya, M. Hahn, and C. Kehoe, "Corporate Governance and Value Creation: Evidence from Private Equity" (working paper, Social Science Research Network, February 17, 2010).

out of their plants at the same time as new competitors (for example, Saudi Arabia in petrochemicals) continue to enter the industry. The combination of higher production from existing capacity and new capacity from new entrants often leads to more supply than demand. However, it is in no single competitor's interest to shut a plant. Companies often find it easier to shut plants across the larger combined entity resulting from an acquisition than absent an acquisition, to shut their least productive plants and end up with a smaller company.

Reducing excess capacity is not limited to shutting factories but can extend to less tangible forms of capacity. For example, consolidation in the pharmaceutical industry has significantly reduced sales force capacity as merged companies' portfolios of products have changed and they have rethought how to interact with doctors. The larger pharmaceutical companies have also significantly reduced their research and development capacity as they have found more productive ways to conduct research and pruned their portfolios of development projects.

While there is substantial value to be created from removing excess capacity, the bulk of the value nevertheless often accrues to the seller's shareholders, not the buyer's. In addition, all the other competitors in the industry may benefit from the capacity reduction without having to take any action of their own (the free-rider problem).

Accelerate Market Access for Products

Often, relatively small companies with innovative products have difficulty accessing the entire potential market for their products. For instance, small pharmaceutical companies typically lack the large sales forces required to access the many doctors they need to see in order to promote their products. Larger pharmaceutical companies sometimes purchase these smaller companies and use their own large-scale sales forces to accelerate the sales growth of the smaller companies' products.

IBM has pursued this strategy in its software and services businesses. Between 2010 and 2013, IBM acquired 43 companies for an average of $350 million each. By pushing the products of these companies through IBM's global sales force, IBM estimated that it was able to substantially accelerate the acquired companies' revenues, sometimes by over 40 percent in the first two years after each acquisition.[18]

In some cases, the target can also help accelerate the acquirer's revenue growth. In Procter & Gamble's acquisition of Gillette, the combined company benefited because P&G had stronger sales in some emerging markets while Gillette had a bigger share of others. Working together, they were able to introduce their products into new markets much more quickly.

[18] IBM Investor Briefing website, 2014.

Acquire Skills or Technologies Faster or at Lower Cost

Many technology-based companies buy other companies whose technologies the acquirers need to enhance their own products. They do this because they can acquire the technology more quickly than developing it themselves, avoid royalty payments on patented technologies, and keep the technology away from competitors. For example, Apple bought Siri (the automated personal assistant) in 2010 to enhance its iPhones. In 2014, Apple purchased Novauris Technologies, a speech recognition technology company, to further enhance Siri's capabilities. During the same year, Apple also purchased Beats Electronics, which had recently launched a music-streaming service. One reason for the acquisition was that Apple could quickly offer its customers a music-streaming service as the market was moving away from its iTunes business model of purchasing and downloading music.

Cisco Systems, the network product and services company (with $49 billion in revenue in 2018), used acquisitions of key technologies to assemble a broad line of network solution products during the frenzied Internet growth period. From 1993 to 2001, Cisco acquired 71 companies at an average price of approximately $350 million each, helping it to increase revenues from $650 million in 1993 to $22 billion in 2001, with nearly 40 percent of its 2001 revenues coming directly from these acquisitions.

Exploit a Business's Industry-Specific Scalability

Economies of scale are often cited as a key source of value creation in M&A. While they can be, you have to be very careful in justifying an acquisition by economies of scale, especially for large acquisitions. That's because large companies often are already operating at scale, in which case combining them will not likely lead to lower unit costs. Take big package-delivery companies, for example. They already have some of the largest airline fleets in the world and operate them very efficiently. If they were to combine, it's unlikely that there would be substantial savings in their flight operations.

Economies of scale can be important sources of value in acquisitions when the unit of incremental capacity is large or when a larger company buys a subscale company. For example, the cost to develop a new car platform is enormous, so auto companies try to minimize the number of platforms they need. The combination of Audi, Porsche, and VW allows the three companies to share some platforms. For example, the Audi Q7, Porsche Cayenne, and VW Touareg are all based on the same underlying platform.

Companies also find economies of scale in the purchasing function, but such benefits often come with nuances. For example, when health insurance companies combine, they can negotiate better rates with hospital systems—savings they can pass to their customers. However, merging health insurers typically derive these savings only in cities where both insurers are alread

Beginning in the 1960s, Service Corporation grew from one funeral home in Houston, Texas, to almost 2,000 funeral homes and cemeteries in 2018. The strategy works when the businesses as a group can realize substantial cost savings or achieve higher revenues than the individual businesses. For example, Service Corporation's funeral homes in a single city can share vehicles, purchasing, and back-office operations. They can also coordinate advertising across a city to reduce costs and realize higher revenues.

Size per se is not what creates a successful roll-up. What matters is the right kind of size. For Service Corporation, having multiple locations in the same city has been more important than simply having many branches spread over many cities, because the cost savings, such as sharing vehicles, can be realized only if the branches are near one another.

Because roll-up strategies are hard to disguise, they invite copycats. As others tried to copy Service Corporation's strategy, prices for some funeral homes were eventually bid up to levels that made additional acquisitions uneconomic.

Consolidate to Improve Competitive Behavior

Many executives in highly competitive industries hope consolidation will lead competitors to focus less on price competition, thereby improving the industry's ROIC. However, the evidence shows that unless an industry consolidates down to just three or four competitors and can keep entrants out, competitor pricing behavior does not change: there's often an incentive for smaller companies or new entrants to gain share through price competition. So in an industry with ten competitors, lots of deals must be completed before the basis of competition changes.

Enter into a Transformational Merger

A commonly mentioned reason for an acquisition or merger is to transform one or both companies. Transformational mergers are rare, however, because the circumstances must be just right, and the management team needs to execute the strategy well. The best way to describe a transformational merger is by example. One of the world's leading pharmaceutical companies, Novartis of Switzerland, was formed by the $30 billion merger of Sandoz and Ciba-Geigy, announced in 1996. But this merger was much more than a simple combination of businesses. Under the leadership of the new CEO, Daniel Vasella, Sandoz and Ciba-Geigy were transformed into an entirely new company. Using the merger as a catalyst for change, Vasella and his management team not only captured $1.4 billion in cost synergies but also redefined the company's mission and strategy, portfolio and organization, and all key processes from research to sales. In all areas, there was no automatic choice for either the Ciba or the Sandoz way of doing things; instead, a systematic effort was made to find the *best* way of doing things.

Novartis shifted its strategic focus to innovation in its life sciences business (pharmaceuticals, nutrition, and agricultural) and spun off the $7 billion Ciba Specialty Chemicals business in 1997. Organizational changes included reorganizing research and development worldwide by therapeutic rather than geographic area, enabling Novartis to build up a world-leading oncology franchise. Across all departments and management layers, Novartis created a strong performance-oriented culture, supported by a change from a seniority-based to a performance-based compensation system for its managers.

Buy Cheap

The final way to create value from an acquisition is to buy cheap—in other words, at a price below the target's intrinsic value. In our experience, however, opportunities to create value in this way are rare and relatively small.

Although market values revert to intrinsic values over longer periods, there can be brief moments when the two fall out of alignment. Markets sometimes overreact to negative news, such as the criminal investigation of an executive or the failure of a single product in a portfolio of many strong products. Such moments are less rare in cyclical industries, where assets are often undervalued at the bottom of the cycle. Comparing actual market valuations with intrinsic values based on a "perfect foresight" model, we found that companies in cyclical industries could more than double shareholder returns (relative to actual returns) if they acquired assets at the bottom of a cycle and sold at the top.[19]

However, while markets do provide occasional opportunities for companies to buy below intrinsic value, we haven't seen many cases. To gain control of the target, the acquirer must pay the target's shareholders a premium over the current market value. Although premiums can vary widely, the average premiums for corporate control have been fairly stable, near 30 percent of the preannouncement price of the target's equity.

For targets pursued by multiple acquirers, the premium rises dramatically, creating the so-called winner's curse. If several companies evaluate a given target and all identify roughly the same synergies, the one who overestimates potential synergies the most will offer the highest price. Since the offer price is based on an overestimate of value to be created, the supposed winner overpays—and is ultimately a loser.[20] A related problem is hubris, or the tendency of the acquirer's management to overstate its ability to capture performance improvements from the acquisition.[21]

Since market values can sometimes deviate from intrinsic values, management must also be wary of the possibility that markets may be overvaluing a

[19] T. Koller and M. de Heer, "Valuing Cyclical Companies," *McKinsey Quarterly*, no. 2 (2000): 62–69.
[20] K. Rock, "Why New Issues Are Underpriced," *Journal of Financial Economics* 15 (1986): 187–212.
[21] R. Roll, "The Hubris Hypothesis of Corporate Takeovers," *Journal of Business* 59 (1986): 197–216.

potential acquisition. Consider the stock market bubble during the late 1990s. Companies that merged with or acquired technology, media, and telecommunications companies saw their share prices plummet when the market reverted to earlier levels. Overpaying when the market is inflated is a serious concern, because M&A activity seems to rise following periods of strong market performance. If (and when) prices are artificially high, large improvements are necessary to justify an acquisition, even when the target can be purchased at no premium to market value.

ESTIMATING OPERATING IMPROVEMENTS

As we've been discussing, the main sources of value created through M&A are the cost, capital, and revenue improvements, often referred to as synergies, that the combined company makes. Rarely does a cheap purchase price make the same sort of difference. So estimating the potential improvements is one of the most important success factors for M&A—along with executing on those improvements once the deal is completed.

Before getting into the estimation, it's worth emphasizing that estimating improvements from combining corporate entities is not a one-time event. It's done multiple times: first, before negotiations even begin; second, during negotiations, as the acquirer gets more information; and finally, after the deal closes. Some companies give short shrift to the last step, but it is critical. Some of our colleagues found that almost 50 percent of the time, pre-closing estimates failed to provide an adequate road map for fully identifying improvement opportunities.[22]

We find that companies do a much better job of realizing cost savings than revenue improvements. McKinsey's Merger Management Practice analyzed 90 acquisitions and found that 86 percent of the acquirers were able to capture at least 70 percent of the estimated cost savings.[23] In contrast, almost half of the acquirers realized *less* than 70 percent of the targeted revenue improvements, and in almost one-quarter of the observed acquisitions, the acquirer realized less than 30 percent of the targeted revenue improvements.

Estimating Cost and Capital Savings

Too often, managers estimate cost savings simply by calculating the difference in financial performance between the bidder and the target. Having an earnings before interest, taxes, and amortization (EBITA) margin 200 basis points higher than the target, however, will not necessarily translate into better performance for the target. There are no easy rules of thumb in estimating cost and capital savings. The best estimates are based on detailed analysis. Cost and capital reduction should follow a systematic process: estimating a baseline, estimating savings for each category, and testing the results against benchmarks.

Begin with a detailed baseline for cost and capital as if the two companies remained independent across the different parts of the companies' cost structures. The purpose of the baseline is to ensure that all costs of both the acquirer and target are accounted for and that you don't run the risk of double-counting when you estimate savings. Make sure the baseline costs and capital requirements are consistent with the intrinsic valuations.

Now you can systematically estimate the potential cost and capital savings for each cost category of both the acquirer and the target. While there are some typical types of savings, as Exhibit 31.6 shows, you should ensure that the cost categories and savings ideas are tailored to the company and industry. For an accurate estimate of potential savings, tie the savings explicitly to operational activities in the business. For example, what is the equivalent head count reduction responsible for the cost savings in selling, general, and administrative (SG&A) expense? What is the resulting revenue per head count? How much will distribution costs fall when trucks are fully loaded, rather than partially loaded? Are revenues sufficient to guarantee fully loaded trucks?

When tying savings to operational drivers, involve experienced line managers in the process. An integrated team that includes both financial analysts and experienced line managers is more likely to be accurate than a pure finance team is. In addition, experienced line managers often will already know details about the target. If so, you will generate insights on capacity, quality issues, and unit sales not easily found in the public domain.

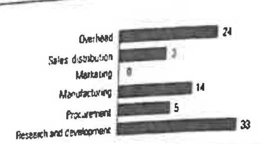
[22] O. Engert and R. Rosiello, "Opening the Aperture 1: A McKinsey Perspective on Value Creation and Synergies" (working paper, McKinsey & Company, June 2010), www.mckinsey.com.
[23] S. A. Christofferson, R. S. McNish, and D. L. Sias, "Where Mergers Go Wrong," *McKinsey Quarterly*, no. 2 (2004): 93–99.

EXHIBIT 31.6 Sample Framework for Estimating Cost Savings

Function	Example Savings
Research and development	• Stopping redundant projects • Eliminating overlap in research personnel • Developing new products through transferred technology
Procurement	• Pooled purchasing • Standardizing products
Manufacturing	• Eliminating overcapacity • Transferring best operating practices
Sales and marketing	• Cross selling products • Using common channels • Transferring best practices • Lowering combined marketing budget
Distribution	• Consolidating warehouses and truck routes
Administration	• Exploiting economies of scale in finance, accounting, and other back office functions • Consolidating strategy and leadership functions

EXHIBIT 31.7 **Automotive Merger: Estimated Cost Savings**

% of original costs



Consider an acquisition where the head of operations took the lead in estimating the savings from rationalizing manufacturing capacity, distribution networks, and suppliers.[24] His in-depth knowledge about the unusual manufacturing requirements for a key product line and looming investment needs at the target's main plant substantially improved savings estimates. In addition, this manager conducted a due-diligence interview with the target's head of operations, learning that the target did not have an enterprise resource planning (ERP) system. Each of these facts improved negotiations and deal structuring, for example, by permitting management to promise that the target's main European location would be retained while maintaining flexibility about the target's main U.S. facility. Moreover, the involvement of the operations manager ensured that the company was prepared to act quickly and decisively to capture savings following the deal's closure.

After you complete the assessment, always compare the aggregate results for the combined companies with industry benchmarks for operating margins and capital efficiency. Ask whether the resulting ROIC and growth projections make sense, given the overall expected economics of the industry. Only a fully developed integrated income statement and balance sheet will ensure that savings estimates are in line with economic reality. In particular, ensure that the ROIC for the new combination lands at the right level for the continuing value and is in line with the underlying competitive structure of the industry. The more difficult it is to sustain a competitive advantage, the more you need to scale down the performance improvements over the longer term.

You'll also find that the potential cost savings vary widely by cost category. Exhibit 31.7 presents the cost savings by category for an automotive-industry acquisition. While the overall estimated cost savings for the automotive acquisition were about 10 percent of total combined costs, the savings varied considerably across category. For example, although procurement costs are the single largest cost category for automotive manufacturers, most companies already have the necessary scale to negotiate favorable contracts. Therefore, savings from procurement were estimated at only 5 percent. In contrast,

[24] This and other examples can be found in Christofferson et al., "Where Mergers Go Wrong."

research and development reductions were estimated at 33 percent, as the two companies consolidated new-product development, paring down the number of expected offerings. This reduction also had a follow-on effect in manufacturing, as product designs would move toward a common platform, lowering overall manufacturing costs. Finally, while sales and distribution expenses could be lowered, management decided to preserve the combined company's marketing budget.

Estimating Revenue Improvements

Although it is tempting to assume that revenues for the newly combined company will equal stand-alone sales plus new cross-selling, the reality is often quite different. First, the merger often disrupts existing customer relationships, leading to a loss of business. Also, smart competitors use mergers as a prime opportunity to recruit star salespeople and product specialists. Some customers may have used the acquirer and target as dual sources, so they will move part of their business to another company to maintain a minimum of two suppliers. Finally, customers who decide to stay during the merger will not be shy in asking for price and other concessions that salespeople will be eager to offer, for fear of losing the business.

Make sure to develop estimates of pricing power and market share that are consistent with market growth and competitive reality. As in the process for estimating cost savings, calibrate the pro forma assumptions against the realities of the marketplace. One global financial company estimated that an acquisition would net €1 billion in sales improvements within the next five years, including double-digit profit growth in the first year. However, overall market growth was limited, so the only way to achieve these sales goals was to lower prices. Actual profit growth was a mere 2 percent.

When estimating revenue improvements, be explicit about where any growth in revenues beyond base case assessments is expected to originate. Revenue improvements will typically come from one or more of four sources:

1. Increasing each product's peak sales level
2. Reaching the increased peak sales faster
3. Extending each product's life
4. Adding new products (or features) that could not have been developed if the two companies had remained independent

Alternatively, revenue increases could come from higher prices, achievable because the acquisition reduces competition. However, antitrust regulations are in place precisely to prevent companies from using this lever, which would transfer value from customers to shareholders. Instead, any increase in price must be directly attributable to an increase in value to the customer and not to reduced choice.

We also suggest you project revenue improvements in absolute amounts per year or as a percentage of stand-alone revenues, rather than as an increase in the revenue growth rate. With the growth rate approach, you can easily overestimate the true impact of revenue improvements.

Implementation Costs, Requirements, and Timing

Although performance improvements often result from doing more with less, making a change or combining systems always involves some costs. Some are obvious, such as the costs to decommission a plant and the severance that must be paid to employees being let go. Others are more subtle, such as rebranding campaigns when the name of the target is changed, integration costs for different information technology (IT) systems, and the retraining of employees. But these costs, often forgotten, must also be identified and estimated. It is not unusual for total implementation costs to be equivalent to a full year of cost savings or more.

Bear in mind that acquirers often make overly optimistic assumptions about how long it will take to capture improvements. Reality intervenes in many ways: ensuring stable supplies to customers while closing a plant can be more complicated than the acquirer expects, disparate customer lists from multiple sources can be tricky to integrate, and examining thousands of line items in the purchasing database almost always takes more hours than estimated, just to name a few possibilities.

Moreover, timing problems can affect whether the improvements are captured at all. Our experience suggests that improvements not captured within the first full budget year after consolidation may never be captured, as the drive to capture them is overtaken by subsequent events. Persistent management attention matters.

Neglecting the "use by" date of certain savings can be equally problematic. Many potential savings do not stay on the table forever. For example, one source of cost savings is eliminating cyclical excess capacity in a growing industry. But in these circumstances, the excess capacity will eventually be eliminated through natural growth. Thus, reducing capacity can achieve *incremental* savings only if the reduction comes during the expected duration of any capacity overhang.

HOW TO PAY: WITH CASH OR STOCK?

Should the acquiring company pay in cash or in shares? Research shows that, on average, an acquirer's stock returns surrounding the acquisition announcement are higher when the acquirer offers cash than when it offers shares. We hesitate, however, to draw a conclusion based solely on aggregate statistics; after all, even companies that offer cash can pay too much.

EXHIBIT 31.8 Paying with Cash vs. Stock: Impact on Value

Value to shareholders after transaction, $ million

Market value before deal	
Acquirer	1,000
Target	500
Price paid (30% premium)	650
Ownership ratio (stock deal)	39.4%/60.6%

	Downside scenario (Synergies = 100)	Upside scenario (Synergies = 200)
Consideration in cash		
Combined value	1,600	1,700
Price paid	(650)	(650)
Value of acquirer postdeal	950	1,050
Target value created (destroyed)	150	150
Value of acquirer predeal	(1,000)	(1,000)
Acquirer value created (destroyed)	(50)	50
Consideration in stock		
Combined value	1,600	1,700
Target's share (39.4%)	(630)	(670)
Value of acquirer postdeal	970	1,030
Target value created (destroyed)	130	170
Value of acquirer predeal	(1,000)	(1,000)
Acquirer value created (destroyed)	(30)	30

Assuming that the acquirer is not capital constrained, the real issue is whether the risks and rewards of the deal should be shared with the target's shareholders. When the acquiring company pays in cash, its shareholders carry the entire risk of capturing synergies and paying too much. If the companies exchange shares, the target's shareholders assume a portion of the risk.

To show the impact on value of paying in cash rather than shares, Exhibit 31.8 outlines a hypothetical transaction. Assume that the acquirer and the target have a market capitalization of $1 billion and $500 million, respectively. The acquirer pays a total price of $650 million, including a premium of 30 percent. We calculate the estimated discounted-cash-flow (DCF) values after the transaction under two scenarios: (1) a downside scenario in which the value of operating improvements is $50 million lower than the premium paid, and (2) an upside scenario in which the value of these improvements is $50 million higher than the premium. (To simplify, we assume that market value equals intrinsic value for both the target and the acquirer.)

If the payment is entirely in cash, the target's shareholders get $650 million, regardless of whether the improvements are high enough to justify the premium. These shareholders do not share in the implementation risk. The acquirer's shareholders see the value of their stake increase by $50 million in the upside case and decrease by the same amount in the downside case. They carry the full risk.

Next, consider the same transaction paid for in shares. The target's shareholders participate in the implementation risk by virtue of being shareholders in the new combined entity.[25] In the upside case, their payout from the acquisition increases as improvements increase: they receive $670 million in value, as opposed to $650 million. Effectively, even more value has been transferred from the acquirer's shareholders to the target's shareholders. The acquirer's shareholders are willing to allow this form of payment, however, because they are protected if implementation goes poorly. If the deal destroys value, the target's shareholders now get less than before, but still a nice premium, since their portion of the combined company is worth $630 million, compared with the $500 million market value before the deal.

From this perspective, two key issues should influence your choice of payment. First, do you think the target, and/or your company, is overvalued or undervalued? During a bubble, you will be more inclined to pay in shares, as everybody will then share the burden of the market correction. In such a scenario, develop a perspective on relative overvaluation of the two businesses. If you believe your shares are more overvalued than the target's, they are valuable in their own right as transaction currency.[26] Second, how confident are you in the ability of the deal to create value overall? The more confident you are, the more you should be inclined to pay in cash.

When weighing whether to pay in cash or in shares, you should also consider what your optimal capital structure will be. Can your company raise enough cash through a debt offering to pay for the target entirely in cash? Overextending credit lines to acquire a company can devastate the borrower. One company, an automotive supplier, borrowed cash to pay for a string of acquisitions. Operating improvements did not materialize as originally expected (partly because execution of the post-merger plan was not rigorous), and the company ended up with a debt burden that it could not bear, leading to bankruptcy.

If the capital structure of the combined entity cannot accommodate any extra debt incurred by paying cash for the acquisition, then you need to consider paying partially or fully in shares, regardless of any desire to share risk among the shareholders of the new entity.

FOCUS ON VALUE CREATION, NOT ACCOUNTING

Many managers focus on the accretion and dilution of earnings brought about by an acquisition, rather than the value it could create. They do so despite numerous studies showing that stock markets pay no attention to the effects of an acquisition on accounting numbers but react only to the value that the deal is estimated to create. Focusing on accounting measures is therefore dangerous and can easily lead to poor decisions.

[25] Target shareholders with small stakes can sell their shares in the public market to avoid implementation risk. Influential shareholders with large stakes, such as company founders and senior executives, will often agree not to sell shares for a specified period. In this case, they share the risk of implementation.

[26] The signaling effect of share consideration is similar to that of share issuance. The capital markets will use this new information (that the shares might be overvalued) when pricing the shares.

EXHIBIT 31.9 **EPS Accretion with Value Destruction**

Assumptions	Acquirer	Target
Net income, $ million	80.0	30.0
Shares outstanding, million	40.0	10.0
EPS, $	2.0	3.0
Preannouncement share price, $	40.0	40.0
Price-to-earnings ratio	20.0	13.3
Market value, $ million	1,600.0	400.0
Price paid, $ million	–	500.0

Impact on EPS	Cash deal	Stock deal
Net income, $ million		
Net income from acquirer	80.0	80.0
Net income from target	30.0	30.0
Additional interest[1]	(19.5)	–
Net income after acquisition	90.5	110.0
Number of shares, million		
Original shares	40.0	40.0
New shares	–	12.5
Number of shares	40.0	52.5
Earnings per share, $		
EPS before acquisition	2.00	2.00
EPS accretion	0.26	0.10
EPS after acquisition	2.26	2.10

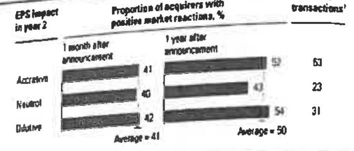
[1] Pretax cost of debt at 6%, tax rate of 35%.

For example, in 2005, both International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (GAAP) eliminated amortization of goodwill. Overnight, most acquisitions that would have been dilutive to earnings per share (EPS) were now accretive. In cash deals, the only dilution is from additional interest expense, which after taxes is typically less than 4 percent of the deal value. In the case of share deals, the deal is accretive if the acquirer's P/E is higher than the target's.

But changing accounting doesn't change the economics of the deals. Many acquisitions are earnings accretive but destroy value. Consider the hypothetical deal in Exhibit 31.9. You are deciding whether to purchase a company currently priced in the market at $400 million for $500 million in cash. Your company, the acquirer, is worth $1.6 billion and has a net income of $80 million. For simplicity, assume there are no operating improvements to come from the deal. You decide to finance this deal by raising debt at a pretax interest rate of 6 percent. This deal destroys value: you overpay by $100 million (remember, no improvements). Even so, next year's earnings and earnings per share actually increase because the after-tax earnings from the acquired company ($30 million) exceed the after-tax interest required for the new debt ($19.5 million).

How can a deal increase earnings yet destroy value? The acquirer is borrowing 100 percent of the deal value based on the combined cash flows of both companies. But the acquired business could not sustain this level of debt on its own. Since the acquirer puts an increased debt burden on the existing shareholders without properly compensating them for the additional risk, it is destroying value. Only when the ROIC (calculated as target profits plus improvements

EXHIBIT 31.10 Market Reaction to EPS Impact of Acquisitions



Note: The difference in returns between accretive and dilutive is not statistically significant. Returns were risk adjusted using the capital asset pricing model (CAPM).
¹ The sample set included 117 transactions greater than $3 billion by U.S. companies between January 1999 and December 2000.
Source: Thomson analyst reports, Compustat.

divided by the total purchase price) is greater than the weighted average cost of capital are shareholders appropriately compensated. In our hypothetical deal, the investment is $500 million, and the after-tax profit is $30 million—a mere 6 percent return on invested capital. While this is above the 3.9 percent after-tax cost of financing the debt, it is below the weighted average cost of capital.

Now suppose the same target is acquired through an exchange of shares. The acquirer would need to issue 12.5 million new shares to provide the 25 percent acquisition premium that the target company's shareholders demand.[27] After the deal, the combined company would have 52.5 million shares outstanding and earnings of $110 million. The earnings per share for the new company rise to $2.10, so the deal is again accretive without having created any underlying value. The increase is a result of mathematics rather than value created by the deal.

Conversely, companies sometimes pass up acquisitions that can create value just because they are earnings dilutive in the first several years. Suppose you spend $100 million to buy a fast-growing company in an attractive market, with a P/E of 30 times. Before performance improvements, the earnings from the acquisition will be $3.3 million. If you borrow at 4 percent after taxes, interest expense will be $4.0 million, leading to earnings dilution of $0.7 million. However, if you are able to accelerate the target's growth rate to 20 percent for the next five years and the target earns a 25 percent return on capital, it will probably create value for shareholders, even though the earnings and ROIC will be depressed for a couple of years.

Financial markets understand the difference between creating real value and increasing EPS. In a study of 117 U.S. transactions larger than $3 billion, our colleagues found that earnings accretion or dilution resulting from the deals was not a factor in the market's reaction to the deals (see Exhibit 31.10).

[27] The exchange ratio in this hypothetical deal is 1.25 shares of the acquiring company for each share of the target company. We assume that the capital market does not penalize the acquirer and that the exchange ratio can be set in relation to the preannouncement share price plus the 25 percent acquisition premium.

Regardless of whether the expected EPS was greater, smaller, or the same two years after the deal, the market's reaction was similar (within the bounds of statistical significance) at one month after the announcement and one year after the announcement.

CHARACTERISTICS OF BETTER ACQUIRERS

This chapter ends with some observations about the characteristics of companies that are better acquirers. Companies are more successful at M&A when they apply the same focus, consistency, and professionalism to it as they do to other critical disciplines.[28] This requires building four often-neglected institutional capabilities: engaging in M&A thematically, managing their reputation as an acquirer, confirming their strategic vision, and managing performance improvement targets across the M&A life cycle.

Engaging in M&A Thematically

Successful companies develop a pipeline of potential acquisitions around two or three explicit M&A themes that support the corporate strategy. These themes are effectively business plans that utilize both M&A and organic investments to meet a specific objective while explicitly considering an organization's capabilities and its characteristics as the best owner of a business. Priority themes are those where the company needs M&A to deliver its strategy and to have the ability to add value to targets. They are also highly detailed, and their effect is measurable in market share, customer segment, or product development goals.

Consider, for example, a global retail company's M&A theme: to grow through entry into two emerging markets by acquiring only local companies that are unprofitable yet in the top three of their market. That's a level of specificity few companies approach. To get there, managers started with the company's strategic goal: to become the third-largest player in its sector within five years, something it could achieve only by aggressively entering emerging markets. A less disciplined company might have accepted the strategic goal as its M&A objective and moved on to a broad scan for targets. But managers at the retail company refined their M&A goals further. They concluded that trying to enter too many markets at once was impractical, due to constraints on management time and the complexities of entering new geographies, so they limited their search to the two most promising regions. They also knew their lean operations would offer cost performance improvements in companies with bloated operations—especially given the

[28] Adapted from C. Ferrer, R. Uhlaner, and A. West, "M&A as a Competitive Advantage," *McKinsey on Finance*, no. 47 (Summer 2013): 2–5.

importance of economies of scale in the industry—and that local branding and catering to local preferences were critical. With their M&A theme defined so precisely, managers were able to narrow the list of potential candidates to a handful of companies.

Managing Reputation as an Acquirer

Few companies consider how they are perceived by targets or how their value proposition as an acquirer compares with that of their competitors. Many are too slow and reactive at identifying potential acquisition targets, too timid in courting and building relationships with them, or too tactical when initiating conversations. They may have such broad goals that they can't proactively approach a list of potential targets.

In our observation, companies that invest in their reputation as acquirers are perceived as bold, focused on collaboration, and able to provide real mentorship and distinctive capabilities for the target. Even some of the largest and most complex organizations can be perceived as attractive buyers by small and nimble targets, largely due to the way they present themselves and manage M&A. The best among them tend to lead with deep industry insight and a business case that is practical and focused on winning in a marketplace, rather than via synergies or deal value. They let target-company managers see how they can be successful in the new organization, typically by enabling the aggressive growth vision of the smaller company. They also have scalable functions and a predictable, transparent M&A process that targets can easily navigate. As a result, they can use their position in the market to succeed in dimensions that go beyond price—and are often approached by targets that aren't even yet for sale. This is a real competitive advantage, as the best assets migrate to the companies they perceive will add value, and this decreases search time, complexity of integration, and the chances of a bidding war.

At one high-tech company, for example, these concepts came together around the theme of enabling innovation. The company's investment in its reputation as an acquirer started with an external marketing campaign but quickly made its way deep into the M&A process. In discussions at conferences and in engineering communities, managers used testimonials from acquired employees to underscore their track record at buying companies and providing them with the expertise and resources they need to accelerate their product pipelines. They developed useful personal relationships with target-company executives by discussing ways to work together even beyond the context of a deal (or instead of a deal). And when it came time to present integration plans and future investment models to targets, managers made sure the proposals were consistent with the acquiring company's reputation.

Confirming the Strategic Vision

For many companies, the link between strategy and a transaction breaks down during due diligence. By focusing strictly on financial, legal, tax, and operations issues, the typical due diligence fails to bring in data critical to testing whether the strategic vision for the deal is valid.

To underpin the strategic impulse behind the deal, companies should bolster the usual financial due diligence with strategic due diligence. This entails testing the value creation rationale for a deal against the more detailed information available to them after signing the letter of intent, as well as seeing whether their vision of the future operating model is actually achievable. A strategic due diligence should explicitly confirm the assets, capabilities, and relationships that make a buyer the best owner of a specific target company. It should bolster an executive team's confidence that they are truly an advantaged buyer of an asset.

It is critical for executives to be honest and thorough when assessing their advantages. Ideally, they develop a fact-based point of view on their beliefs—testing them with anyone responsible for delivering value from the deal, including salespeople, R&D engineers, and their human resources and finance departments. Such an approach would have helped a large financial company whose due diligence for the deal focused on auditing existing operations rather than testing the viability of the future operating models. The advantaged-buyer criteria assumed by the company focused on being one of the most effective operators in the industry, supported by strong IT systems and processes. Executives proceeded with the deal without ever learning that the IT team had a different picture of the eventual end state, and they learned only after close that the two companies' IT systems could not be integrated.

Reassessing Performance Improvement Targets

One of the most common but avoidable pitfalls in any transaction is failing to update expectations on performance improvements as the buyer learns more about the target during integration. Companies that treat M&A as a project typically build and secure approval for a company's valuation only once, during due diligence, and then build these targets into operating budgets. This forces the organization's aspirations down to the lowest common denominator by freezing expectations at a time when information is uncertain and rarely correlated with the real potential of a deal.

Managing this challenge can be complex but worthwhile. One consumer packaged-goods company boosted run-rate synergies by 75 percent after managers recognized that the target's superior approach to in-store promotions could be used to improve its base business. A pharmaceutical company raised its synergies by over 40 percent in a very large transaction by actively revisiting estimates immediately after the deal closed, creating a risk-free environment for managers to come up with new ideas. A few years later, it had captured those higher synergies.

Companies can employ various tactics to build a real capability at realizing synergies. They might, for example, bring stakeholders together in so-called value creation summits that mimic the intensity and focus of a due-diligence effort but change the incentives to focus on the upside. And we've seen experienced acquirers take a blank-sheet approach to foster creativity, rather than anchor the exercise in a financial due-diligence model, which often leads to incremental synergies. These and similar activities allow companies to reinforce the idea that due-diligence estimates of performance improvements are the lowest acceptable performance, and they get managers used to setting their sights higher.

CLOSING THOUGHTS

Acquisitions are good for the economy when they allocate resources more efficiently between owners. However, most acquisitions create more value for the shareholders of the target company than for those of the buyer, and many destroy value for the buyer's shareholders. This is perhaps not surprising when we recall that acquisitions can create value for acquirers only if the target company's performance improves by more than the value of the premium over the target's intrinsic value that the acquirer had to offer for the target in order to persuade its shareholders to part with it.

Managers can help to ensure that their acquisitions are among those that create value for their shareholders by choosing one of the limited number of acquisition archetypes that have created value for acquirers in the past. Success also depends critically on making realistic estimates of the cost and revenue improvements that the target company can realize under new ownership, taking into account the often-substantial cost of implementing those improvements.

Managers should bear in mind that stock markets are interested only in the impact of acquisitions on the intrinsic value of the combined company. Whether an acquisition will increase or decrease earnings per share in the short term has no effect on the direction and extent of movements in the buyer's share price following the acquisition announcement.

Finally, the best acquirers build systematic institutional skills in defining their M&A strategy, managing their reputation as an acquirer, and consistently looking for performance improvement opportunities beyond those estimated before the deal was complete.