Executive Insights

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The Three Ts of Successful M&A

In mature industries, M&A is often seen as a route to accelerated growth, and there are many examples of businesses successfully pursuing this as a growth strategy. But achieving the desired outcomes proves elusive for many. The question we ask in this edition of *Executive Insights* is, What are the factors that separate success from failure in European M&A?

To develop its analysis, L.E.K. Consulting quantified the share of European transactions across all industries that created value over a 10-year period, examined why they have beaten the odds and explained what can be learned from them.

L.E.K.'s research was based on 20 years of transactions (2,700 of them) conducted by European-listed companies between 1993 and 2013 for which pre- and post-deal valuation data was available. For each individual deal, we compared total shareholder returns (TSR) for the acquiring company shareholders over a period of two years that followed a transaction closing date (post-deal) with TSR over a period of two years that preceded the transaction (pre-deal). To ensure that the result would not be biased by the overall economic context, we have chosen a period of time that includes two full economic cycles and have adjusted all individual company returns against their respective industry index. All TSR figures quoted in this article are TSR above the respective MSCI index of the acquirer's industry.

The data shows that a (slight) majority of deals created rather than destroyed value (see Figure 1). A total of 33% of acquisitions resulted in value creation superior to pre-deal value (13% accelerated value creation and 20% reversed a prior trend of value destruction) and a further 19% created value post-deal, though at a lower value than before. This leaves just under 50% of transactions that destroyed value, either breaking a positive pre-deal trend or just continuing a prior value-destroying trajectory.

Our analysis revealed three key findings:

- Timing: The timing of the deal in the economic cycle has a major impact on performance
- Track record: Experience in conducting a number of transactions is a significant contributor to value creation
- Type: There is a discernible difference in value created from the acquisition of carve-outs compared with stand-alone companies, especially private companies

Timing is essential

A review of corporate M&A activity against stock market cycles shows almost perfect correlation between the number of deals closed in a given quarter and index performance. However, many deals are the victims of poor timing. Our analysis shows that it is best to close deals in a declining market; deals closed in an early decline of the equity index — just after the peak, as in the early 2000s and in 2008 — have achieved TSR above industry index almost six times greater than deals closed before the market peak. Early-decline deals have a 44% chance of achieving superior value

The Three Ts of Successful M&A was written by **Karin von Kienlin**, Partner and **Marc-Antoine Cousin**, a Senior Manager at L.E.K. Consulting. Karin and Marc-Antoine are based in Munich.

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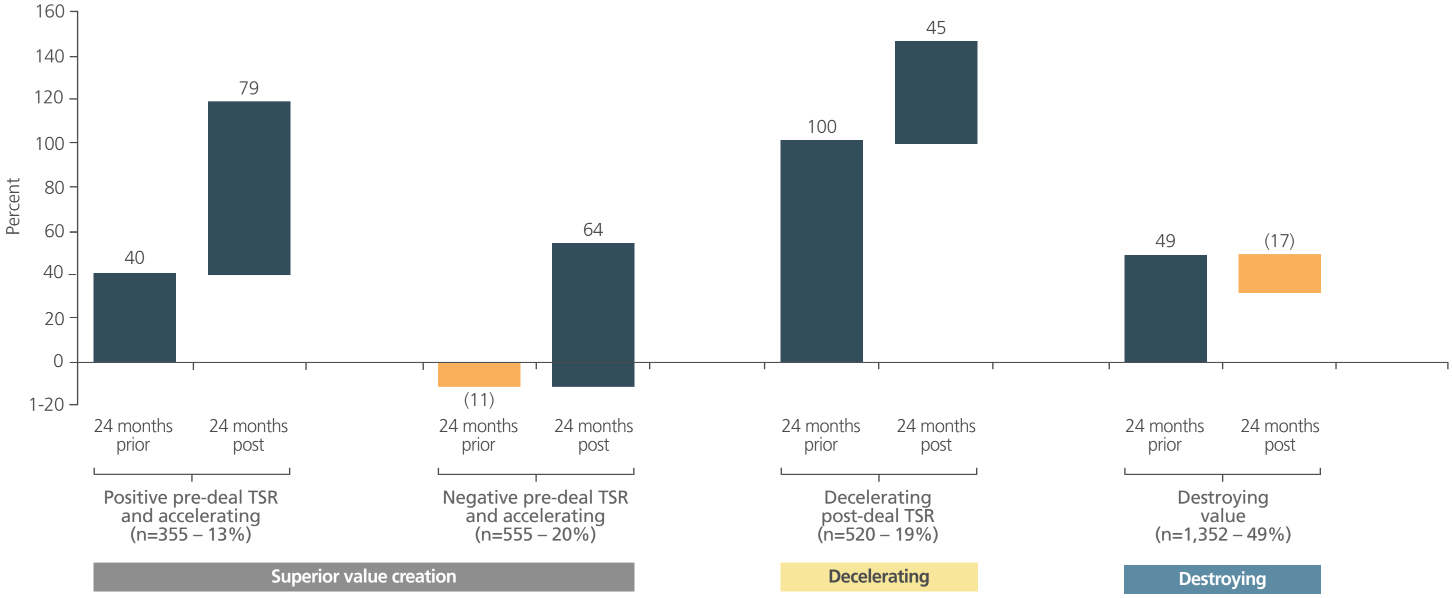
Figure 1
Cumulative shareholder return above industry index by performance class

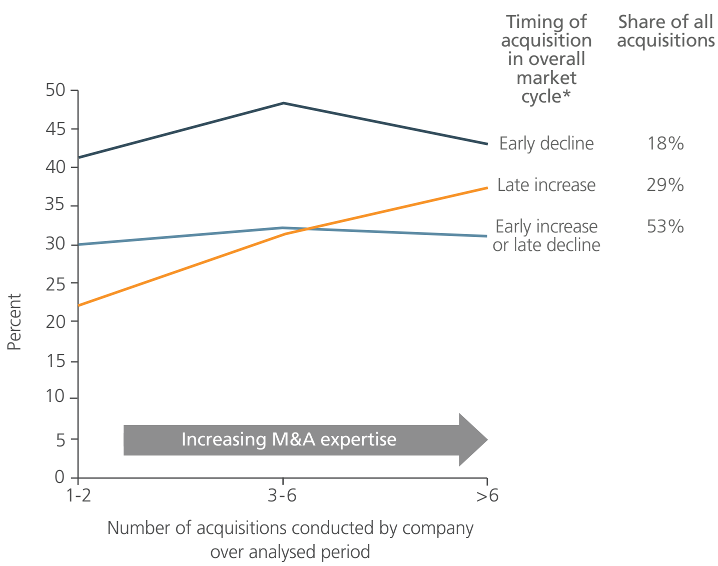


Source: Capital IQ; L.E.K. analysis

creation versus 30% at all other times. The most obvious factor here is the acquisition price, which decreases with deteriorating market expectations.

Acquisitions that take place in the later part of the industry uptrend are most likely to destroy shareholder value, and this is where the experience and expertise of the acquirer has the greatest impact. An experienced acquirer is 68% more likely than an inexperienced company to achieve superior TSR from a late-trend acquisition (see Figure 2).

Figure 2
Probability of achieving superior value creation by timing of the transaction and acquirer's experience (1995-2015)



Source: Capital IQ; L.E.K. Analysis

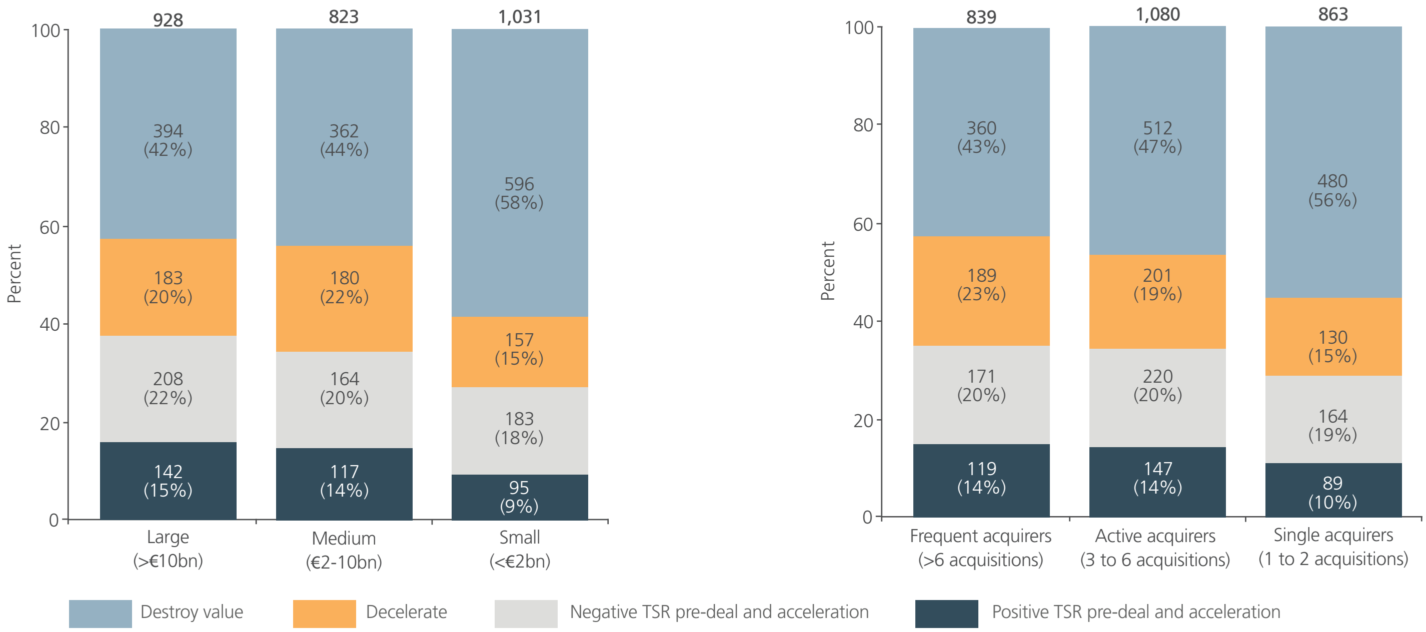
An example of a well-timed transaction was the acquisition in 2002 of Chicago Faucet Co., a U.S. manufacturer of faucets and plumbing fixtures, by Geberit AG, a Swiss manufacturer and supplier of sanitary parts and related systems. The acquisition at an EBITDA multiple of 6.5x was viewed positively by analysts as it enhanced Geberit's overall sales and its position in the fragmented U.S. market and gave it access to the commercial market in which Geberit had historically been weak. The acquisition took place near the bottom of the commercial property cycle in the U.S., while the residential property cycle was already in the uptrend. This gave Chicago Faucet Co. the ability to leverage growth in the residential sector by introducing Geberit's range into its distribution network and gave Geberit a cheap entry into the commercial sector.

Track record pays

Acquisitions made by companies with a market capitalization of more than €10 billion are 30% more likely to result in value creation both in absolute terms and versus their industry index (see Figure 3). Two principal factors can explain this: 1) a strategic approach to M&A, including M&A team resourcing and a high likelihood of investing in extensive due diligence; and 2) a higher experience level — larger companies tend to do more deals, which is a major factor of acquisition performance.

Figure 3

Proportion of transactions by acquirer market capitalization and by deal frequency (1995-2015) adjusted by index



Source: Capital IQ; L.E.K. analysis

Indeed, there is strong evidence that companies that acquire frequently — and this across all sizes — are better at it than sporadic or occasional acquirers.

Companies that acquire more often achieve significantly higher post-deal TSR performance than do companies that engage more sporadically in M&A activities. Our analysis shows that, from their third deal, companies increase by almost 20% their probability of achieving superior value creation. Statistically, this probability does not change significantly beyond three deals. However, the risk of failure is the dimension that most significantly improves as experience builds up: 56% for the first two deals, 47% from the third acquisition and 43% from the sixth acquisition.

Acquisitions that have taken place in the later part of the industry uptrend and are therefore more likely to destroy shareholder value is where the experience and expertise of the acquirer has the greatest impact. A case example of where acquisition experience paid off in spite of an unfavorable timing is the acquisition of two overland logistics companies — GL Kayser Spediteur and Cordes & Simon Group by Kuehne + Nagel in 2007 just before the 2008 financial crisis. These acquisitions, which followed several prior acquisitions including ACR almost two years before, enabled the logistics company to achieve scale in the European overland market and successfully face deteriorating market conditions and accelerate TSR by about 60%.

Carve-out acquisitions perform better than whole company acquisitions

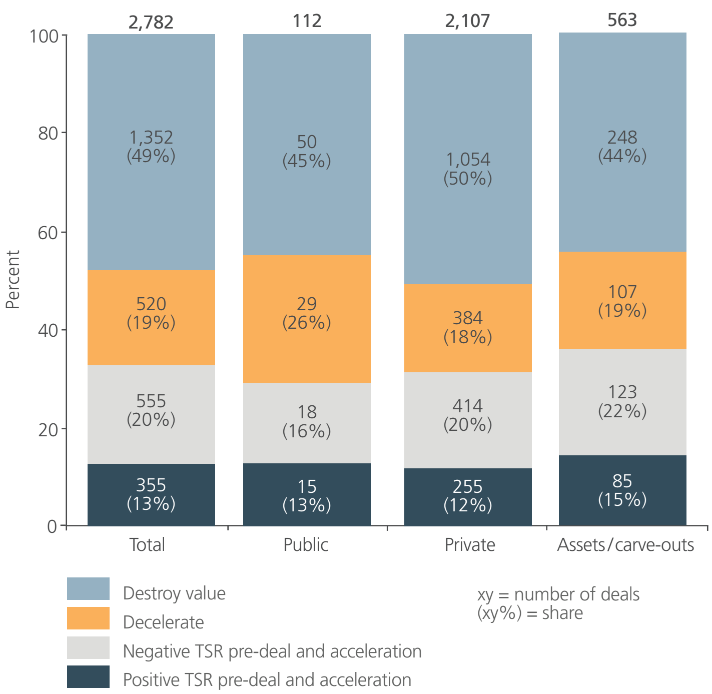
Acquiring a carved-out asset offers a number of advantages over whole company deals, resulting in improved outcomes. Our analysis shows that carve-out deals are 15% to 30% more likely to deliver positive returns than are whole company acquisitions (see Figure 4).

When approaching carve-outs, buyers are often able to target the exact part of the business that offers the greatest benefit to their existing operations, so the cost and distraction of managing rationalization is minimized and advantages can be realized more quickly. The specific suitability of an asset to the acquirer also means that competition is often less intense, resulting in more favorable transaction terms; this factor works in combination with the comparatively smaller deal sizes in relation to the acquirer's market capitalization, which results in a lower risk of M&A underperformance, making financing easier and reducing financial risk.

The nature of carve-outs is that they require the cooperation of the parent company to proceed, so they are always "friendly," and acquirers therefore have better access to due diligence information and management than would be the case in a hostile takeover. This enables more thorough due diligence, facilitates a more accurate assessment of asset value and supports the agreement of optimal transaction terms. This is consistent with on-average

Figure 4

Proportion of transactions by target ownership (1995-2015) adjusted by index



Source: Capital IQ; Edison Research; L.E.K. analysis

lower pricing of carve-outs relative to stand-alone public and private companies; in the 2005 to 2015 period, published valuation multiples for public and private companies were around 15x EBITDA compared with only 10x EBITDA for carve-outs.

A successful example of such carve-out acquisitions was the acquisition of the Connectors and Measurements Division of Expro Holdings U.K. by Siemens in 2012. Siemens saw strategic expansion opportunities in subsea power grids and distribution solutions for the oil and gas industries, addressing the need to achieve increasing efficiency from deep sea wells through deployment of pumps and compressors. This acquisition brought Siemens specific know-how and products, which strengthened its marine capabilities, and resulted in a 14% TSR acceleration. This was a great opportunity to acquire very specific capabilities and products without the need to simultaneously acquire off-strategy activities.

M&A as a route to growth

We have seen that acquisitions can generate superior shareholder value and that the experience and expertise of the acquiring company management is a critical factor in increasing the probability of success. It is no coincidence that larger companies with frequent deal experience typically do better, and "being too big to fail" is not the driver, as can be seen in some spectacular cases of value destruction with some larger deals.

For mid-cap companies, external advisors can add the value that larger companies generate in-house. Their contribution is in ensuring that the essential requirements of a good deal are in place: a sound and clear acquisition strategy, a realistic valuation of synergies, and a clear understanding of options created by the acquisition. Abstaining from making the wrong acquisition or acquiring at too high a price can save significant upfront costs and avoid years of missed budgets due to failed integration and improvement attempts.

Realizing value often relies on successful post-merger integration (PMI). When, through a rigorous PMI process supported by strong analytics, synergies in excess of those anticipated are uncovered and implemented, the payoff can be significant. Conversely, value can be destroyed through poor integration. Companies that have accumulated experience through multiple acquisitions are usually proficient at PMI, but this is not the case for infrequent acquirers, and we have seen that this can significantly decrease the odds of success, particularly for acquisitions made in the later part of an uptrend cycle. For those lacking deep experience in PMI, external specialists are a worthwhile investment.

As we head into 2018, M&A is going from strength to strength. Valuation and financing multiples are at an all-time high, and there is no sign of a decline despite material macroeconomic and political challenges. Corporate and financial sponsors have full war chests, and aggressive pricing and fast decision-making are needed to beat rival bidders. In this context, of the "three Ts" of successful M&A, "timing" presents the greatest risk, and brings into greater focus the question of what "type" of asset is most suitable. Those looking for acquisitions in this market should ensure they have the right expertise ("track record") on their team to make the right choices and deliver the best possible chance of success.

About the Authors:

Karin von Kienlin is Head of L.E.K. Consulting Germany and a Member of the European Regional Management and Global Investment Committees. Karin has more than 20 years' experience in mergers and acquisitions and strategy consulting across Europe, North America and Asia across various industries. She holds and MA from Oxford University.

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About L.E.K. Consulting

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