EXECUTIVE INSIGHTS

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Mergers & Acquisitions: What Winners Do to Beat the Odds

Flush with cash, bolstered by buoyant share prices, and facing slow prospects for organic growth in the currently moribund macroeconomic environment, many executives are on the hunt for acquisitions. Activity in M&A often comes in bursts; as of the second quarter of 2013, the scent is in the air.

But capturing value by creating a whole that is greater than the sum of its parts is a risky game. Recently, L.E.K. Consulting analyzed the performance of more than 2,500 M&A deals between 1993 and 2010 – a period that included two boom-and-bust economic cycles. The results were not encouraging. In the months leading up to the close of a deal, acquirers in our sample demonstrated healthy performance, generating a cumulative total shareholder return of about 15% above the relevant S&P sector index (returns were normalized to remove market effects). After the close of the deal, however, nearly 60% of companies destroyed shareholder value. Overall, on average, cumulative total shareholder returns dropped 10% in the two years following a deal close. In effect, most of the hard-fought gains leading up to a deal were squandered away.

Performance was poor across the board – in different industries, when viewed by the size of the deal, and when analyzed by deals involving bigger companies acquiring smaller ones and mega-mergers between giants. Performance was even mixed among more frequent acquirers – although relatively better compared to deals involving companies that pursue M&A less frequently. The M&A learning curve is steeper than most companies like to admit (See Figure 1).

What's happening here? In essence, mergers that destroy value do so because acquirers pay too much for the target because they overestimate the value gained from the acquisition; they fail to realize the gains they had predicted because of poor post-merger execution of the integration; or they do both. Yet we know that M&A *can* create value; approximately 40% of the deals we analyzed involved two companies that turned out to be more valuable together than apart. What do winners do differently? How can executives overcome common pitfalls to beat the long odds of creating value through mergers and acquisitions? Based on our experience working with companies across industries and in various types of deals, we believe that winning acquirers share some universal approaches to the M&A process. From identifying the right target to synergy valuation to post-merger integration, winners have shown that with the right approach, value through M&A can be found and captured.

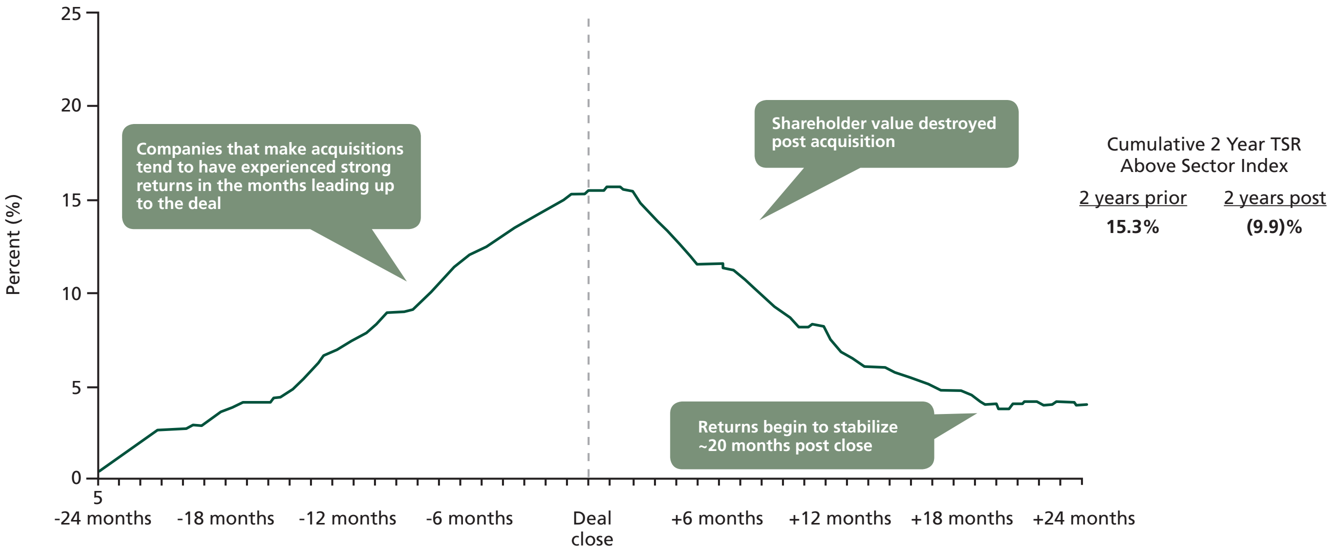
Winning Acquirers Clearly Define Their M&A Strategy

An acquiring company that wishes to succeed in M&A must first clearly identify the problem it wishes to solve through an acquisition. That is not as simple as it sounds. Consider lagging revenue growth, a problem that companies often attempt to solve inorganically. Acquiring companies in your market to build share, or entering into a new market via an acquisition, are not sufficiently focused strategies to revitalize revenue streams. The acquiring company must first identify the *specific* market segments it wishes to target, and determine whether that segment

Mergers & Acquisitions: What Winners Do to Beat the Odds was written by **Michael Connerty**, Managing Director in L.E.K. Consulting's Chicago office. Associate Consultant **Grayden Webb** and **Sidney McNabb**, Director of U.S. Information Centers, contributed to this whitepaper.

Figure 1

Acquirers' Cumulative Total Shareholder Return



Source: CAPIQ data, L.E.K. analysis

Methodology Notes: All deals greater than $50M in transaction value, 100% control transactions, and completed during the 1993-2010 period by public acquirers; U.S. primary location of the acquirer and target; acquirers' total shareholder returns were compared against S&P 500 sector and composite indices to normalize for market-related performance (S&P 500 composite index was used in the earlier sample years prior to when sector indices were created); excludes REITs

can best be reached by acquiring another firm. Who are the customers? Where are they? What products or service will they buy? L.E.K. Consulting has written extensively about "Strategic Market Position" (SMP) – the need to target the specific market segments where abundant value hides rather than clumsily chasing market share for its own sake.[1] Winning acquirers challenge their internal understanding of their targeted segments and expectations for segment growth compared to internal growth expectations. A pre-requisite for all successful M&A efforts is clear, thesis-driven deal criteria, aligned with the company's broader strategic plan and objectives.

Once a company has determined its M&A strategy and deal criteria, it faces the temptation to head straight out on the hunt. Winning acquirers don't do this. They make sure to prepare their organization for the upcoming journey by outlining in advance a clear deal process that delineates roles and responsibilities for staff. Early planning is paramount. Performing this vital task on the fly once due diligence has been initiated often results in confusion and missed diligence opportunities. Winning acquirers define roles, responsibilities, governance and decision-making for those likely to be involved in the deal process well before due diligence is underway. They assemble diligence teams from business units, as well as division and functional leaders. These are the leaders who will ultimately be accountable for delivering synergy opportunities, so their early involvement is essential. Star performers and subject-matter experts are assigned to the teams; their participation entails extra work beyond their normal responsibilities, so attractive incentives that include the prospect of career development through M&A are often required to keep staff focused and motivated. This is no sacrifice on the part of the company: M&A situations are great development opportunities for aspiring managers, and should be communicated as such. Some of the less experienced, but successful acquirers that recognize their limitations often look for external support to supplement a taxed management team and help avoid some of the mistakes others tend to make.

Once the team is in place, it can draw up an M&A playbook that guides due diligence and integration teams in areas that commonly need to be addressed such as sales and marketing, supply chain or back-office functions. The playbook includes the acquiring company's baseline financial and operational performance in areas that are tied to the deal thesis and potential synergy opportunities with the target company. In most cases, a company will not have time to quantify a baseline

[1] Stuart Jackson, *Where Value Hides: A New Way to Uncover Profitable Growth for Your Business* (Hoboken: John Wiley and Sons, 2007).

performance during the short due diligence period, so this analysis must be completed well in advance. Accurately estimating revenue synergy – which is often the most difficult type of synergy to realize – requires particularly detailed assessments down to the account level. That can be a daunting task in the pressure-packed pre-close period, which is another reason why involving the right team early is essential. (For more on capturing revenue synergies, see sidebar on page 5).

The playbook can be amended through the M&A process, and through various deals over time. Eventually, it should be treated as an asset of the company – a key tool to institutionalize learning for future acquisitions.

Winning Acquirers Get the Price Right

With a clearly defined M&A strategy and a well-prepared organization, acquirers are in a much stronger position to avoid overpaying for their target. Almost all mergers today attempt to create value through some mix of revenue and cost synergies between companies. Determining the right price for a deal rests upon a company's ability to develop estimates that are grounded in the market and operations of the businesses, and overcome internal biases that may wrongly influence such estimates.

As an example, L.E.K. recently helped a client in the global industrial equipment and services business to identify revenue synergies for an acquisition target. The client wished to test its assumptions about how well the target company was positioned in various market and geographic segments in order to estimate to what extent products and services could be pulled through the client's sales force and channel partners. The client came to L.E.K. with very optimistic predictions about post-merger growth.

L.E.K. scrutinized the client's assumptions that customers were interested in a combined product and service portfolio of the two companies. Using data-driven analysis, including input from customers and other market participants, we found that revenue synergy existed, but not likely at the magnitude our client had predicted. Armed with this insight, the client recalibrated and ultimately negotiated a purchase price that was roughly 15% lower than it originally estimated it should pay.

As the above example illustrates, investigative research and analysis can improve the accuracy of synergy estimates by testing assumptions of a potential combined company's products and services against market, customer and competitor realities. Revenue dis-synergies from the elimination of some products, pricing adjustments in the combined portfolio or customer share of wallet limits can be quantified and layered into estimates. Broad-brush or gut-feel assumptions can be put under scrutiny, and eventually rooted out.

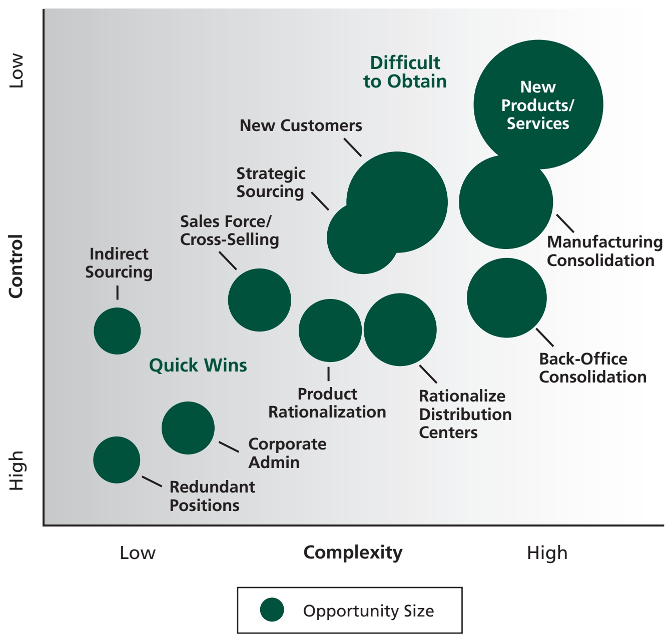
Successful acquirers take a similar approach to estimating cost synergies. They avoid generalized assumptions (e.g., "we think we can save 5% on costs."). Instead, they focus on defining the right operating model and linking cost drivers, operating practices and performance between acquirer and target. Identifying upfront the preferred operating model for a given functional area for the combined company makes it much easier for the diligence team to develop detailed cost synergies. Major business processes and the costs to generate corresponding outputs can then be mapped between the acquirer and target company to help estimate cost differentials and potential synergy opportunities. Migrating to the acquirer's back-office model, outsourcing a particular process, or consolidating production and distribution locations are all examples of early operating model decisions that give the right focus on assessing cost synergies. Understandably, the typical deal timeline and limitations on sharing competitively sensitive information can create challenges to this process. Successful acquirers leverage their own advance preparations, consult service providers such as outsourcing partners, and use consultants to staff third-party "clean teams" to maximize accuracy in the face of tight deadlines and limited access to information.

Of all the value drivers, revenue synergy is often the most difficult to realize.

Underestimating the time and cost to achieve synergies is a classic M&A mistake that the best companies carefully avoid. Not all synergies are created equal; some are more difficult to realize than others. Successful acquirers focus on the most impactful synergy opportunities first to understand what they can control to ensure success and what they have less control over that requires a different set of tactics. Additionally, they carefully gauge the level of complexity associated with a given opportunity. As Figure 2 shows, there are a wide variety of potential synergy opportunities that have different profiles along the dimensions of control and complexity.

Figure 2

M&A Synergies – Control vs. Complexity



Source: L.E.K. research and experience

High control/low complexity synergy opportunities are typical "quick win" candidates. Indirect procurement savings opportunities are a common example – they are easy to identify, the tactical steps to realize them are straightforward and control is typically high as vendors often anticipate these efforts following mergers and are eager to maintain or win new business with the combined company. Successful acquirers then focus their due diligence efforts on identifying specific spend categories that can be sourced – sizing the opportunity and defining the integration plans to realize the savings.

At the other end of the complexity/control spectrum is new product and service growth opportunities. Entering new markets, developing new products and services, growing share in a channel – these are complex undertakings and may involve some combination of developing new products or services, market research and testing, prototyping and running pilots, sales and customer service preparations, distributor and channel negotiations, and scaling up production or service delivery, to name only a few. Such opportunities are hard to realize even in organic situations let alone in mergers and acquisitions when a company is simultaneously undergoing profound organizational changes. Complicating the task even further still, control in these situations is low given the ultimate measure of success is determined by the level of acceptance by customers and sales growth.

For these opportunities, successful acquirers plan differently. With a clear understanding of what problems they are trying to solve with an acquisition, they know their internal performance, what customers think of them and what they need, what opportunities exist in the market and how the target company will help solve the problem. Significant time and energy is put into understanding the integration and operational requirements to follow through on the opportunity, the costs to achieve potential synergy benefits, the risks that need to be proactively managed and the organizational barriers that must be overcome. These factors are incorporated into target company valuations and negotiations as the time and costs to achieve high-potential, complex/low control synergy opportunities are easy to underestimate.

Winning Acquirers Use a Structured Approach to Post-Merger Integration

We believe the best acquirers are also methodical in their approach to post-merger integration (PMI). There can be no single recipe book for an undertaking as complex as combining two companies. In our experience, however, we have noticed that successful companies fulfill six requirements during the integration process:

- **Strong Senior Leadership and Broad Organizational Buy-In:** As a first priority, successful acquirers set the senior leadership team quickly for the combined organization. Roles, accountability and reporting structures are clearly delineated before a long-term structure is established. Senior leaders remain visible and open throughout the process; they work tirelessly to ensure the organization understands the vision, rationale and plan for the combined company. Commitments are gained pre-close and reaffirmed post-close to see the integration through and realize the expected benefits.

- **Disciplined Focus on Value Drivers:** The key value drivers behind a deal are always front and center for executives and the integration team (and are often tied to incentives). Discrete work streams are organized around the value drivers and key enabling functions of those value drivers. Metrics are identified to quantify how each specific value driver will be achieved and linked to integration plans (i.e., the 'leading indicators' of synergy realization).

Realizing Elusive Revenue Synergies

Of all the value drivers that underpin mergers, revenue synergies can be the most difficult to realize. This is because companies too often make assumptions about revenue enhancements following a deal without grounding them in market or operational realities, or clearly understanding how the synergies will be achieved. For instance, a common revenue synergy tactic is to cross-sell products and services of both the acquirer and target post-merger. But a company must first be sure that customers who buy products from Company A will also be interested in purchasing the wares of Company B. Then it must be sure that customers have the ability to do so: sales teams from both companies must be quickly trained to sell the other's products and services, and rewarded sufficiently for doing so. In the very short term, the order-to-cash process may need to be "band-aided" to ensure any customer can call the customer service center they have used in the past, or go on a website to place an order for any product in the combined portfolio.

Long-term integration and optimization of customer service centers and ERP and CRM systems can wait; winners develop a work around quickly to ensure customers get what they want. In fact, some successful acquirers launch promotions to stimulate short-term demand during the early post-close period to help ensure revenue synergies materialize and to keep competitors from poaching. These promotions, combined with a ready-to-go sales team, can be a powerful combination in the crucial first few months following an acquisition.

Often, the key strategic imperative is speed. For example, we recently worked with a medical products company to estimate potential synergies between its sizable distribution and sales capacities and a target company that was about to release a next generation product that had very high growth expectations. The key to realizing the synergy was maximizing the speed at which the acquirer could absorb the new product and get out in front of competitors before they were able to introduce their own next generation products. We worked closely with our client to map out the fastest route to market upon close of a deal. Operational barriers were identified and steps were planned to overcome them with short-term workarounds. Data and systems were bridged to support customer interfaces. Frequent, cross-functional planning sessions aligned dependencies and sequenced the critical steps. Thanks to the advance preparation, the new product hit the market within several weeks of the deal closing, and customers were excited to get their hands on it. The success all tied back to the pre-close effort to understand what it would take to operationalize the revenue opportunity, and realize its full value.

- **Dedicated Integration Teams:** Dedicated integration teams are critical to meeting integration milestones. As noted earlier, successful acquirers begin integration planning well before close. Additional team members are brought in once operating model decisions are made and clear guidance can be provided to further define the integration plans. An Integration Management Office is established to oversee the development and execution of integration plans, challenge the teams to meet their objectives and push the pace of integration.

- **Robust Implementation Plans:** Detailed integration plans are put in place before close, and validated post-close, to ensure continuity of day-to-day operations while addressing immediate needs (e.g., supporting customers and employees). Clear, definable objectives are set for Day One, the first 100 days and the first year. Attention to detail – sequencing and identifying interdependencies and risks across functional and organizational boundaries – is crucial when laying out these objectives.

- **A Strong Talent Retention Program:** The best acquirers view acquisitions as an opportunity to topgrade their overall talent pool – employees from both legacy companies compete for important positions. Flight risks in key functions are identified early and retention plans are put in place. Money is not always the answer; often new career development opportunities and fresh leadership can inspire people to stay and perform well. Nonetheless, contingency plans are put in place should key employees leave unexpectedly.

- **An 'Overcommunication' Strategy:** Winning companies address stakeholder concerns and interest early and often. Questions are proactively addressed by developing consistent messaging and communication that is tailored for key stakeholders (e.g., employees, customers, partners, etc.). For employees, basic questions are addressed first: Do I still have a job? What do I stand to gain from this merger? Companies often undercommunicate key integration milestones and don't provide the message repetition that is required to help distracted audiences understand the value of the deal, and what it means for them. A well-structured communication plan is instrumental in supporting the organization as it moves through various stages of integration to achieve its goals.

Beating the Odds

Our research into M&A performance shows that creating value through M&A is a daunting prospect. But our experience working with clients suggests otherwise. We've helped scores of companies identify and capture value through acquisitions. Success starts with building a focused M&A strategy, establishing deal criteria and identifying targets. Synergy assumptions must then be put under intense analytical scrutiny and grounded in market, customer, competitor and operational realities to arrive at the right price. After that, it all comes down to realizing the gains identified on paper – successful post-merger integration. Integrations are typically a complex undertaking, but the best acquirers employ a structured approach to manage organizational changes, create shareholder value and beat the odds.

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For further information contact:

Boston
75 State Street
19th Floor
Boston, MA 02109
Telephone: 617.951.9500
Facsimile: 617.951.9392

Chicago
One North Wacker Drive
39th Floor
Chicago, IL 60606
Telephone: 312.913.6400
Facsimile: 312.782.4583

Los Angeles
1100 Glendon Avenue
21st Floor
Los Angeles, CA 90024
Telephone: 310.209.9800
Facsimile: 310.209.9125

New York
1133 Sixth Avenue
29th Floor
New York, NY 10036
Telephone: 646.652.1900
Facsimile: 212.582.8505

San Francisco
100 Pine Street
Suite 2000
San Francisco, CA 94111
Telephone: 415.676.5500
Facsimile: 415.627.9071

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