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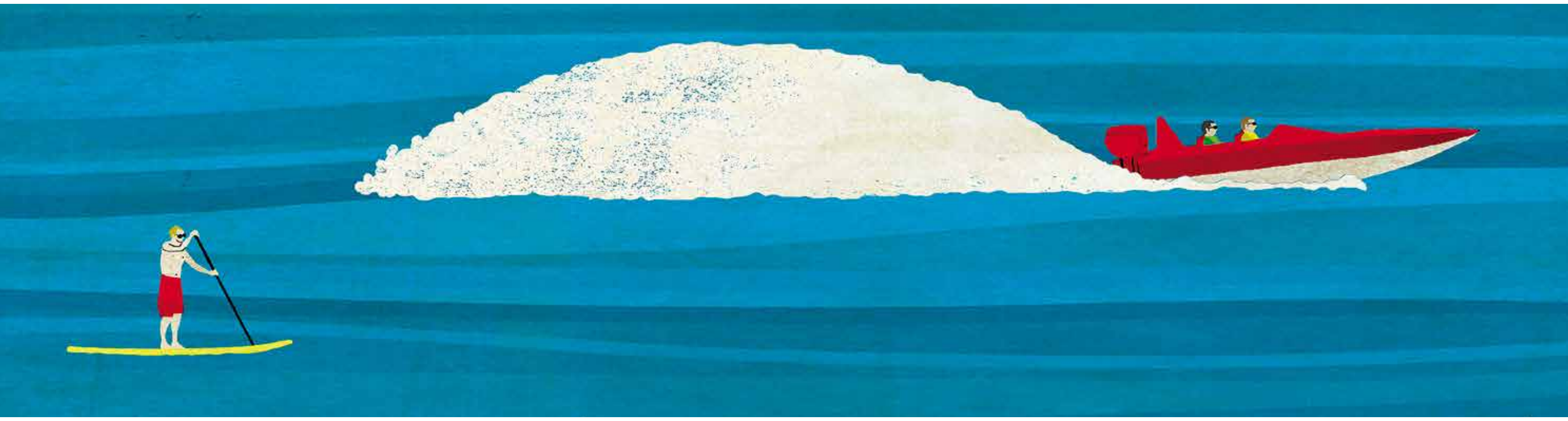

CORPORATE FINANCE PRACTICE

M&A as competitive advantage

Treating M&A as a strategic capability can give companies an edge that their peers will struggle to replicate.

Cristina Ferrer, Robert Uhlaner, and Andy West

Most companies approach deal making as an art rather than as a corporate capability deployed to support a strategy, and they see individual deals as discrete projects rather than integral parts of that strategy. Few have found a way to build and continuously improve, across businesses, an M&A capability that consistently creates value—and does so better than competitors. As a result, many lament how hard M&A is and worry about the statistics highlighting the failure rate of deals rather than how to build a capability that helps them win in the marketplace.

In our experience, 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.[1] This requires building four often-neglected institutional capabilities: engaging in M&A thematically, managing your reputation as an acquirer, confirming the strategic vision, and managing synergy targets across the M&A life cycle. The ability to approach M&A in this way elevates it from a tactical necessity focused on risk management to a strategic capability delivering a competitive advantage that others will struggle to replicate.

Engage in M&A thematically

At many companies, strategy provides only vague direction on where and where not to use M&A—and an unspecific idea of the expected source of value creation. We often find companies using M&A indiscriminately to purchase growth or an asset, without a thorough understanding of how to create value in a deal relative to others, a so-called “best owner” mind-set. Rarely is there an explicit link to organic investments or the business cases for broader growth initiatives, such as developing new products or building a sales force to deliver an acquired product. As a result, companies waste time and resources on targets that are ultimately unsuccessful and end up juggling a broad set of unfocused deals.

Successful companies instead develop a pipeline of potential acquisitions around two or three explicit M&A themes. 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 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, the M&A theme of one global retail company: to grow by entering into two emerging markets, 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 only achieve by aggressively entering emerging markets. A less disciplined company might have stopped there 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 synergies in companies with bloated operations—especially given the importance of economies of scale in the industry—and that local branding and catering to local preferences was critical. With their M&A theme defined so precisely, managers were able to narrow the list of potential candidates to a handful of companies. Well ahead of its five-year schedule, the company has successfully completed the acquisitions needed to enter its targeted emerging markets and has nearly achieved its revenue goals.

Manage your reputation as an acquirer

Few companies consider how they are perceived by targets or how their value proposition as an acquirer is better or worse than 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. As a result, they end up being overly dependent on targets proposed by outside sources or burdened by constant fire drills around potential targets. In many cases, they earn a reputation among potential targets as opportunistic, process heavy, and laden with overhead.

In our observation, companies that invest in their reputation as acquirers are perceived instead as bold, focused on collaboration, and able to provide real mentorship and distinctive capabilities. Even some of the largest and most complex organizations are 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 instead of on synergies or deal value. They let target-company managers see how they fit into a broader picture. They also have scalable functions and a predictable, transparent M&A process that targets can easily navigate. Finally, they are purposeful about how they present themselves, supporting executives with consistent and compelling materials that demonstrate the best of the organization. As a result, they are able to 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, decreasing search time, complexity of integration, and the chances of a bidding war.

A big part of developing a reputation is managing interactions and using them in a coordinated way. It's not unusual for companies to join conferences, partner with universities that control needed intellectual property, and talk to angel investors and venture capitalists. But most of them do so with no structure or understanding of how many relationships they're looking for with which kinds of partners possessing what specific attributes—and few of them do so to build their reputation in the ecosystem around potential targets.

To get it right, companies must be more purposeful. 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 a thoughtful 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 and old-fashioned jawboning 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. And when it came time to present integration plans and future investment models to targets, managers made sure they were consistent with the acquiring company's reputation.

Confirm the strategic vision

For many companies, the link between strategy and a transaction gets broken 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 do so, companies should bolster the usual financial due diligence with strategic due diligence, testing the conceptual 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 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. Advantaged buyers are typically better than others at applying their institutional skills to a target's operations, marketing and sales, product development, or even labor and management. They also employ their privileged assets or proprietary knowledge to build on things like a target's brand, intellectual property, financing, or industry insights. Naturally,

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they also turn to their special or unique relationships with customers, suppliers, and the community to improve performance, leading to synergies that in many cases go far beyond traditional scale synergies.

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 one large financial company that acquired an asset two years ago to expand its services to regional clients. 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.

Reassess synergy targets

Failing to update expectations on synergies as the buyer learns more about the target during integration is one of the most common but avoidable pitfalls in any transaction. Companies that treat M&A as a project typically build and get approval for a company's valuation only once, during due diligence, and then they build these targets into operating budgets. To drive speed, efficiency, and simplicity, they either have an overly rigid approach to integration, which fails to recognize the unique attributes and requirements of different deal types, or they are totally unstructured, ignoring established deal processes to rely instead on a key stakeholder or gatekeeper to make up his or her mind. There is rarely an opportunity to revisit value-creation targets with executives, board members, and other stakeholders.

The overly rigid or undefined nature of these processes makes it hard to reassess synergies and targets throughout the life cycle of a deal because valuation targets are set early on and are virtually locked in by the time integration starts. 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—overvaluing or undervaluing synergies more than 40 percent of the time, by our estimate. The reason is simple: financial due diligence is conducted with intentionally imperfect information, as each side does its best to negotiate favorable terms in short time frames, and it's typically focused on likely value instead of potential value. This is appropriate for managing the risk of overpaying, but it's not the way an operator would actually manage a business to maximize its potential.

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 approach to in-store promotions could be used to improve its base business. One pharmaceutical company raised its synergies by over 40 percent on 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, and throwing away initial assumptions. A few years later, it had captured those higher synergies.

Companies can employ a number of tactical activities to build a real capability at managing 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 synergy estimates are the lowest acceptable performance—and get managers used to setting their sights higher.

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M&A is complex, and it isn't the answer for every strategic goal. Companies that can achieve a strategic goal internally, with a sensible investment profile and within a desirable time frame, should do so and avoid the deal premium and integration risk of an acquisition. But those that can manage the complexity of M&A by building the capabilities and insights required to realize its full potential for growth can enjoy an enduring competitive advantage.

[1] Long-term returns vary significantly by deal pattern and by industry. Companies with the right capabilities can succeed with a pattern of smaller deals in most industries, but in large deals, industry structure plays as much of a role in success as the capabilities of a company and its leadership. See Werner Rehm, Robert Uhlaner, and Andy West, "Taking a longer-term look at M&A value creation," *McKinsey on Finance*, Number 42, Winter 2012, mckinsey.com, and Ankur Agrawal, Cristina Ferrer, and Andy West, "When big acquisitions pay off," *McKinsey on Finance*, Number 39, Spring 2011, mckinsey.com.

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