

Article
May 2017

The six types of successful acquisitions

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Companies advance myriad strategies for creating value with acquisitions—but only a handful are likely to do so.

There is no magic formula to make acquisitions successful. Like any other business process, they are not inherently good or bad, just as marketing and R&D aren't. Each deal must have its own strategic logic. In our experience, acquirers in the most successful deals have specific, well-articulated value creation ideas going in. For less successful deals, the strategic rationales—such as pursuing international scale, filling portfolio gaps, or building a third leg of the portfolio—tend to be vague.

Empirical analysis of specific acquisition strategies offers limited insight, largely because of the wide variety of types and sizes of acquisitions and the lack of an objective way to classify them by strategy. What's more, the stated strategy may not even be the real one: companies typically talk up all kinds of strategic benefits from acquisitions that are really entirely about cost cutting. In the absence of empirical research, our suggestions for strategies that create value reflect our acquisitions work with companies.

In our experience, the strategic rationale for an acquisition that creates value typically conforms to at least one of the following six archetypes: improving the performance of the target company, removing excess capacity from an industry, creating market access for

products, acquiring skills or technologies more quickly or at lower cost than they could be built in-house, exploiting a business's industry-specific scalability, and picking winners early and helping them develop their businesses.

Six archetypes

An acquisition's strategic rationale should be a specific articulation of one of these archetypes, not a vague concept like growth or strategic positioning, which may be important but must be translated into something more tangible. Furthermore, even if your acquisition is based on one of the archetypes below, it won't create value if you overpay.

Improve the target company's performance

Improving the performance of the target company is one of the most common value-creating acquisition strategies. 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. Among successful private-equity acquisitions in which a target company was bought, improved, and sold, with no additional acquisitions along the way, operating-profit margins increased by an average of about 2.5 percentage points more than those at peer companies during the same period.¹ This means that 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 returns on invested capital (ROIC) than that of a high-margin, high-ROIC company. Consider a target company with a 6 percent operating-profit margin. Reducing costs by three percentage points, to 91 percent of revenues, from 94 percent, increases the margin to 9 percent and could lead to a 50 percent increase in the company's value. In contrast, if the operating-profit margin of a company is 30 percent, increasing its 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 might not be reasonable to expect.

Consolidate to remove excess capacity from industry

As industries mature, they typically develop excess capacity. In chemicals, for example, companies are constantly looking for ways to get more production out of their plants, even as new competitors, such as Saudi Arabia in petrochemicals, continue to enter the industry.

The combination of higher production from existing capacity and new capacity from recent entrants often generates more supply than demand. It is in no individual competitor's interest to shut a plant, however. Companies often find it easier to shut plants across the larger combined entity resulting from an acquisition than to shut their least productive plants without one and end up with a smaller company.

Reducing excess in an industry can also extend to less tangible forms of capacity. Consolidation in the pharmaceutical industry, for example, has significantly reduced the capacity of the sales force as the product portfolios of merged companies change and they rethink how to interact with doctors. Pharmaceutical companies have also significantly reduced their R&D capacity as they 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, as in most M&A activity the bulk of the value 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 the target's (or buyer's) products

Often, relatively small companies with innovative products have difficulty reaching the entire potential market for their products. Small pharmaceutical companies, for example, typically lack the large sales forces required to cultivate relationships with the many doctors they need to promote their products. Bigger pharmaceutical companies sometimes purchase these smaller companies and use their own large-scale sales forces to accelerate the sales of the smaller companies' products.

IBM, for instance, has pursued this strategy in its software business. 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 more than 40 percent in the first two years after each acquisition.²

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, Gillette in others. Working together, they introduced their products into new markets much more quickly.

Get skills or technologies faster or at lower cost than they can be built

Many technology-based companies buy other companies that have the technologies they 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. More recently, in 2014, Apple purchased Novauris Technologies, a speech-recognition-technology company, to further enhance Siri's capabilities. In 2014, Apple also purchased Beats Electronics, which had recently launched a music-streaming service. One reason for the acquisition was to quickly offer its customers a music-streaming service, as the market was moving away from Apple's iTunes business model of purchasing and downloading music.

Cisco Systems, the network product and services company (with \$49 billion in revenue in 2013), 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. Cisco's sales increased from \$650 million in 1993 to \$22 billion in 2001, with nearly 40 percent of its 2001 revenue coming directly from these acquisitions. By 2009, Cisco had more than \$36 billion in revenues and a market cap of approximately \$150 billion.

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 are often already operating at scale. If two large companies are already operating that way, combining them will not likely lead to lower unit costs. Take United Parcel Service and FedEx, as a hypothetical 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 Volkswagen, Audi, and Porsche allows all three companies to share some platforms. For example, the VW Toureg, Audi Q7, and Porsche Cayenne are all based on the same underlying platform.

Some economies of scale are found in purchasing, especially when there are a small number of buyers in a market with differentiated products. An example is the market for television programming in the United States. Only a handful of cable companies, satellite-television companies, and telephone companies purchase all the television programming. As a result, the largest purchasers have substantial bargaining power and can achieve the lowest prices.

While economies of scale can be a significant source of acquisition value creation, rarely are generic economies of scale, like back-office savings, significant enough to justify an acquisition. Economies of scale must be unique to be large enough to justify an acquisition.

Pick winners early and help them develop their businesses

The final winning strategy involves making acquisitions early in the life cycle of a new industry or product line, long before most others recognize that it will grow significantly. Johnson & Johnson pursued this strategy in its early acquisitions of medical-device businesses. J&J purchased orthopedic-device manufacturer DePuy in 1998, when DePuy had \$900 million of revenues. By 2010, DePuy's revenues had grown to \$5.6 billion, an annual growth rate of about 17 percent. (In 2011, J&J purchased Synthes, another orthopedic-device manufacturer, so more recent revenue numbers are not comparable.) This acquisition strategy requires a disciplined approach by management in three dimensions. First, you must be willing to make investments early, long before your competitors and the market see the industry's or company's potential. Second, you need to make multiple bets and to expect that some will fail. Third, you need the skills and patience to nurture the acquired businesses.

Harder strategies

Beyond the six main acquisition strategies we've explored, a handful of others can create value, though in our experience they do so relatively rarely.

Roll-up strategy

Roll-up strategies consolidate highly fragmented markets where the current competitors are too small to achieve scale economies. Beginning in the 1960s, Service Corporation International, for instance, grew from a single funeral home in Houston to more than 1,400 funeral homes and cemeteries in 2008. Similarly, Clear Channel Communications rolled up the US market for radio stations, eventually owning more than 900.

This strategy works when businesses as a group can realize substantial cost savings or achieve higher revenues than individual businesses can. Service Corporation's funeral homes in a given city can share vehicles, purchasing, and back-office operations, for example. They can also coordinate advertising across a city to reduce costs and raise revenues.

Size is not what creates a successful roll-up; what matters is the right kind of size. For Service Corporation, multiple locations in individual cities have been more important than 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. Roll-up strategies are hard to disguise, so they invite copycats. As others tried to imitate 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 ROIC of the industry. The evidence shows, however, that unless it consolidates to just three or four companies and can keep out new entrants, pricing behavior doesn't change: smaller businesses or new entrants often have an incentive to gain share through lower prices. So in an industry with, say, ten companies, lots of deals must be done before the basis of competition changes.

Enter into a transformational merger

A commonly mentioned reason for an acquisition or merger is the desire to transform one or both companies. Transformational mergers are rare, however, because the circumstances have to be just right, and the management team needs to execute the strategy well.

Transformational mergers can best be described by example. One of the world's leading pharmaceutical companies, Switzerland's Novartis, was formed in 1996 by the \$30 billion merger of Ciba-Geigy and Sandoz. But this merger was much more than a simple combination of businesses: under the leadership of the new CEO, Daniel Vasella, Ciba-Geigy and Sandoz 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, strategy, portfolio, and organization, as well as all key processes, from research to sales. In every area, there was no automatic choice for either the Ciba or the Sandoz way of doing things; instead, the organization made a systematic effort to find the best way.

Novartis shifted its strategic focus to innovation in its life sciences business (pharmaceuticals, nutrition, and products for agriculture) and spun off the \$7 billion Ciba Specialty Chemicals business in 1997. Organizational changes included structuring R&D worldwide by therapeutic rather than geographic area, enabling Novartis to build a world-leading oncology franchise.

Across all departments and management layers, Novartis created a strong performance-oriented culture supported by shifting from a seniority- to a performance-based compensation system for managers.

Buy cheap

The final way to create value from an acquisition is to buy cheap—in other words, at a price below a company's intrinsic value. In our experience, however, such opportunities are rare and relatively small. Nonetheless, although market values revert to intrinsic values over longer periods, there can be brief moments when the two fall out of alignment. Markets, for example, sometimes overreact to negative news, such as a criminal investigation of an executive or the failure of a single product in a portfolio with many strong ones.

Such moments are less rare in cyclical industries, where assets are often undervalued at the bottom of a 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 their shareholder returns (relative to actual returns) if they acquired assets at the bottom of a cycle and sold at the top.³

While markets do throw up occasional opportunities for companies to buy targets at levels below their intrinsic value, we haven’t seen many cases. To gain control of a target, acquirers must pay its shareholders a premium over the current market value. Although premiums can vary widely, the average ones for corporate control have been fairly stable: almost 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 potential synergies, the pursuer that overestimates them most will offer the highest price. Since it is based on an overestimation of the value to be created, the winner pays too much—and is ultimately a loser.⁴ A related problem is hubris, or the tendency of the acquirer’s management to overstate its ability to capture performance improvements from the acquisition.⁵

Since market values can sometimes deviate from intrinsic ones, management must also beware the possibility that markets may be overvaluing a potential acquisition. Consider the stock market bubble during the late 1990s. Companies that merged with or acquired technology, media, or telecommunications businesses saw their share prices plummet when the market reverted to earlier levels. The possibility that a company might pay too much when the market is inflated deserves serious consideration, 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.

By focusing on the types of acquisition strategies that have created value for acquirers in the past, managers can make it more likely that their acquisitions will create value for their shareholders.

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