

Value Creating - Acquisition Strategies

Abstract

One hundred and four tender offers between 1962 and 1979 were analyzed to develop a conceptual framework to determine the connection between economic value and diversification strategies in acquisitions, as well as to determine whether different acquisition methods are connected with varying degrees of value creation. Research results indicate that different sources of value creation are likely to develop in various types of acquisitions. Research results also indicate that value creation is dependent on the mixture of characteristics of two merging companies, not the separate characteristics of each firm. Additionally, research results indicate that differences in performance between unrelated and related diversification methods is dependent upon categorizing firms as following one method or the other.

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Introduction

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 five archetypes: improving the performance of the target company, removing excess



Srusti Management Review

Vol.- IV, Issue-I, Jan-2011

pp. 55-60

ISSN 0974 - 4274

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, and picking winners early and helping them develop their businesses. If an acquisition does not fit one or more of these archetypes, it's unlikely to create value. Executives, of course, often justify acquisitions by choosing from a much broader menu of strategies, including roll-ups, consolidating to improve competitive behavior, transformational mergers, and buying cheap. While these strategies can create value, we find that they seldom do. Value-minded executives should view them with a gimlet eye.

Five 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, while new competitors continue to enter the industry. For example, Saudi Basic Industries Corporation (SABIC), which began production in the mid-1980s, grew from 6.3 million metric tons of value-added commodities—such as chemicals, polymers, and fertilizers—in 1985 to 56 million tons in 2008. Now one of the world's largest petrochemicals concerns, SABIC expects continued growth, estimating its annual production to reach 135 million tons by 2020.

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.

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. From 2002 to 2009, it acquired 70 companies for about \$14 billion. By pushing their products through a global sales force, IBM estimates it increased their revenues by almost 50 percent in the first two years after each acquisition and an average of more than 10 percent in the next three years.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

Cisco Systems has used acquisitions to close gaps in its technologies, allowing it to assemble a broad line of networking products and to grow very quickly from a company with a single product line into the key player in Internet equipment. 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.

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. When J&J bought device manufacturer Cordis, in 1996, Cordis had \$500 million in revenues. By 2007, its revenues had increased to \$3.8 billion, reflecting a 20 percent annual growth rate. J&J purchased orthopedic-device manufacturer DePuy in 1998, when DePuy had \$900 million in revenues. By 2007, they had grown to \$4.6 billion, also at an annual growth rate of 20 percent.

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 five 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 per se 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 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, though 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.

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

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. Premiums for private deals tend to be smaller, although comprehensive evidence is difficult to collect because publicly available data are scarce. Private acquisitions often stem from the seller's desire to get out rather than the buyer's desire for a purchase.

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.

Conclusions

There are probably a lot of companies out there doing what you do or providing the same service that you do. Don't take any of your customers for granted – they could choose any day to go to one of your competitors if they are creating a better value, deepening a relationship or being served in a more effective way. It is going to be more work for you – we are all working a little harder these days to do a good job or keep a job.

In order to find and keep great customers you need to provide great customer service and offerings that are going to make your customers want to seek you out. My providing value, deepening relationships and servicing your customers you are going to create a customer acquisition program that is going to be very successful. Make sure that with this uncertain economy you aren't taking your customers or their money for granted because they are going to be looking for the company and service that provides them with the best bang for their buck today and in the future. By cross-selling and keeping the value relevant you are going discover great ways to keep your customers happy.

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