



## Beating the Odds

How companies can improve value through M&A

### Executive Summary

Board members and executives at Fortune 500 companies in the Consumer and Industrial Products (C&IP) industry generally accept the “rule of thumb” that 40 percent of Mergers & Acquisitions (M&A) transactions fail to provide the value anticipated.<sup>1</sup> And why shouldn’t they? The figures are widely reported and legitimized by academic research, cited by industry peers, and reinforced by well-reputed consulting firms.

It is logical to assume — rule of thumb or no — that a portion of M&A transactions do add value. Pragmatism suggests that companies should not remain bystanders in the M&A game simply because accepted odds appear to favor inaction. In fact, when viewed

against the odds of delivering value via other strategies (e.g., investing in innovation to develop a new product or deploying resources to build “greenfield” capabilities in a new market), pursuing M&A may be a better bet. Therefore, an important question for executives and boards with fiduciary duties to shareholders may be: When should companies put money on the table and how should they “beat the odds” so an M&A transaction may pay off?

In response to recurring queries from clients, Deloitte undertook an extensive research effort to help determine how to beat the odds and improve value through M&A. As part of its study, Deloitte analyzed the interplay among the four variables that

were found to be statistically significant to the odds of addressing company’s requirements in M&A. The study concludes with suggestions to address these recurring questions raised by Deloitte C&IP clients and their boards.

The study’s findings suggest that M&A should be an integral part of growth-oriented strategies; and that deal-making is not like games of chance where you play the hand dealt. Rather, Boards of Directors and executive teams should pursue M&A in a judicious manner, looking for an observable set of conditions that might tilt the table in their favor and improve the odds of winning in M&A. Deloitte’s reasoning takes the day-to-day realities of M&A into account:

<sup>1</sup> Bruner, Robert F. Deals from Hell, John Wiley and Sons, 2005

opportunities rarely arise when the 'perfect' set of circumstance exist. An acquisition target may become available after years of concerted efforts by the company's business development group; or an unexpected industry shift may occur that creates an opportunity to acquire for scale or market access. Companies should capitalize on these opportunities and control for the risks that may arise due to timing, funding and/or experience gaps.

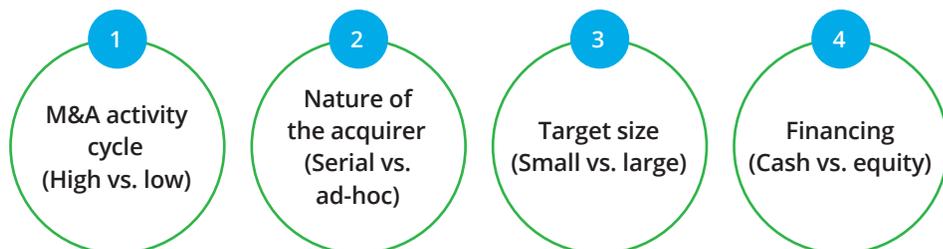
**Leading drivers of value generation in M&A**

This paper analyzes a body of research that explores the long-term M&A behavior of acquirers in the C&IP industry and identifies conditions (Figure 1) that may impact likelihood of M&A effectiveness. In brief, the study found four conditions that can make for better bets in the high-stakes M&A game:

- Acquiring at the correct time (M&A Activity Cycle)
- Applying accumulated experience (Nature of the Acquirer)
- Pursuing deals of an appropriate size relative to the acquirer (Size of the Target)
- Funding transactions with equity or a mix of equity and cash (Financing)

As noted, numerous M&A studies explore overall effectiveness based on the performance of individual transactions. However, Deloitte proposes that overall effectiveness should be measured more broadly; e.g., cumulatively for all transactions done by an acquirer. Therefore, Deloitte selected Total Shareholder Return (TSR) measured over a period of 15 years as the more pertinent benchmark to evaluate M&A strategies and effectiveness rates in the C&IP industry.

Deloitte's study included more than 280 companies, ranging from industry leaders to smaller firms with at least a 0.5 percent market share in their respective sectors. The study's fact base contained more than 1,400 M&A transactions and supporting financial data for the last 15 years (1997–2011).



**Are there good deals and bad deals?**

Deloitte's study asserts that there are no "good" or "bad" M&A deals, just conditions and decisions that make deals more or less risky (Figure 2).

Deloitte categorized the acquisitive companies based on a set of four deal characteristics — M&A activity cycle, nature of the acquirer, target size, and financing — and compared value generation across acquirers who consistently made similar decisions corresponding to these deal characteristics.

When considering the nature of the acquirer and how that impacts total shareholder

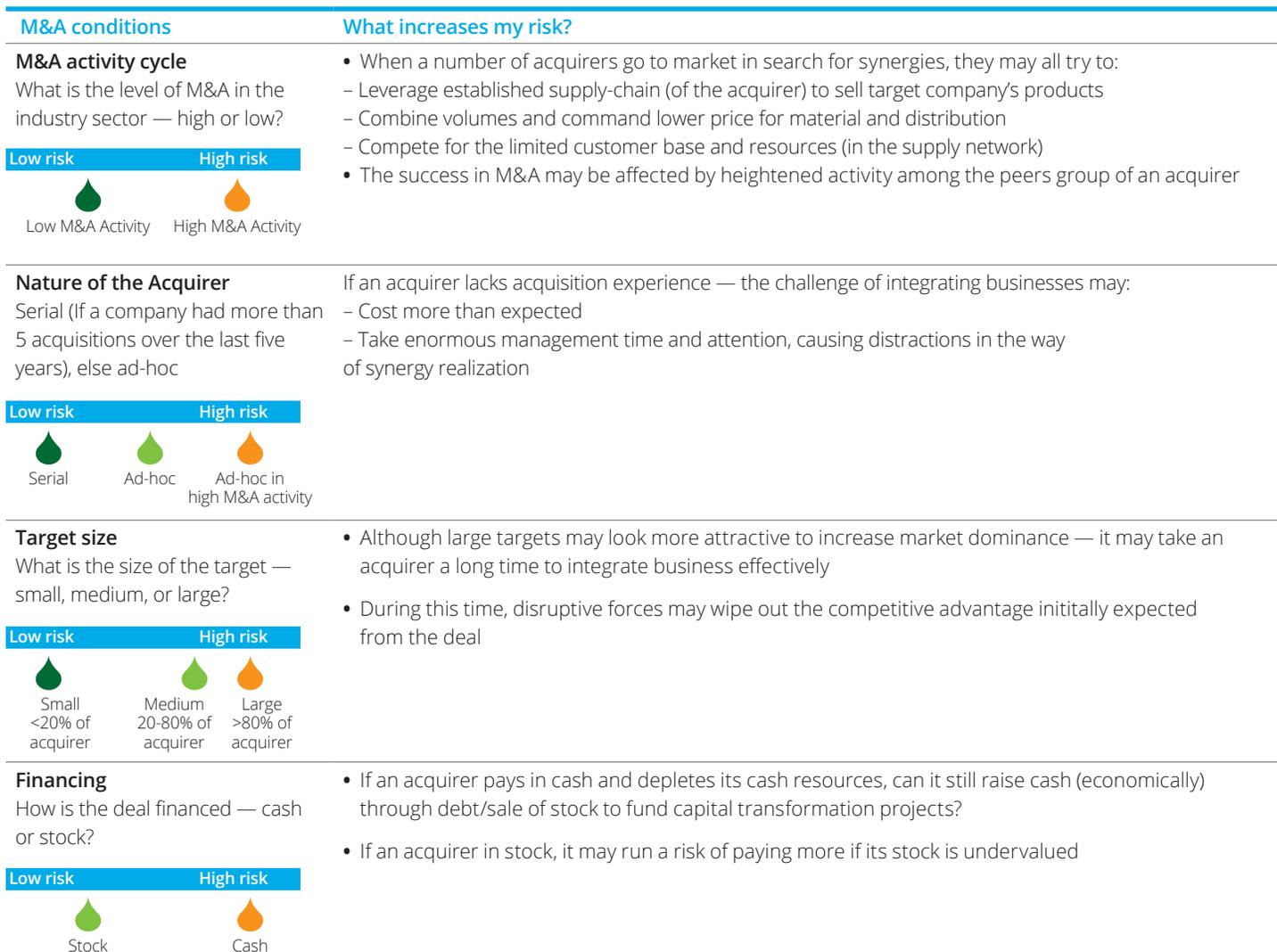
return (TSR), serial acquirers (those with more than five transactions during the study's time period) generated approximately two times as much value as ad hoc acquirers.

When evaluating impacts on TSR based on the level of M&A activity in the C&IP industry sector, companies which acquired only during periods of low M&A activity produced approximately two times as much value as companies which acquired only in periods of high M&A activity. Also, over 85 percent of the companies which acquired during periods of high M&A activity were ad hoc acquirers. When examining the size of the acquisition target and its impact on TSR, the study

showed that C&IP companies which acquired smaller targets (<20 percent of the acquirer's size) produced over three times as much value as companies which acquired larger targets. Of note, approximately 80 percent of the serial acquirers in the dataset preferred smaller targets.

Finally, when analyzing the acquirer's payment method (cash or equity) and the impact on TSR, the study showed that C&IP companies which paid for a considerable portion of their deals in stock produced approximately 70 percent more value than those which paid in cash.

Figure 2: Conditions that can influence risk levels in M&A



Number of deals are greater than the average number of deals per year during the period 1997-2011

**Internal survey and interview results**

In addition to its study of C&IP acquisitions over the past 15 years, Deloitte conducted a survey within the M&A practices across its network of member firms to attain practitioners' perspectives on the qualitative factors that may influence M&A effectiveness. The study represents responses from over 6,000 practitioners who work in over 100 countries. Among survey results:

Figure 3: Survey responses identifying conditions with favorable & unfavorable impacts on M&A

**Responses identifying factors with favorable impact on M&A Effectiveness**

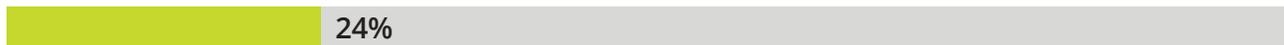
Acquirer is experienced (more than 5 transactions over 5 year period)



Size of the target is small (<20% of acquirer)



Transactions paid for primarily in equity



**Responses identifying factors with favorable impact on M&A Effectiveness**

Size of target is equal to that of the acquirer



Size of the target is large (<50% of acquirer)



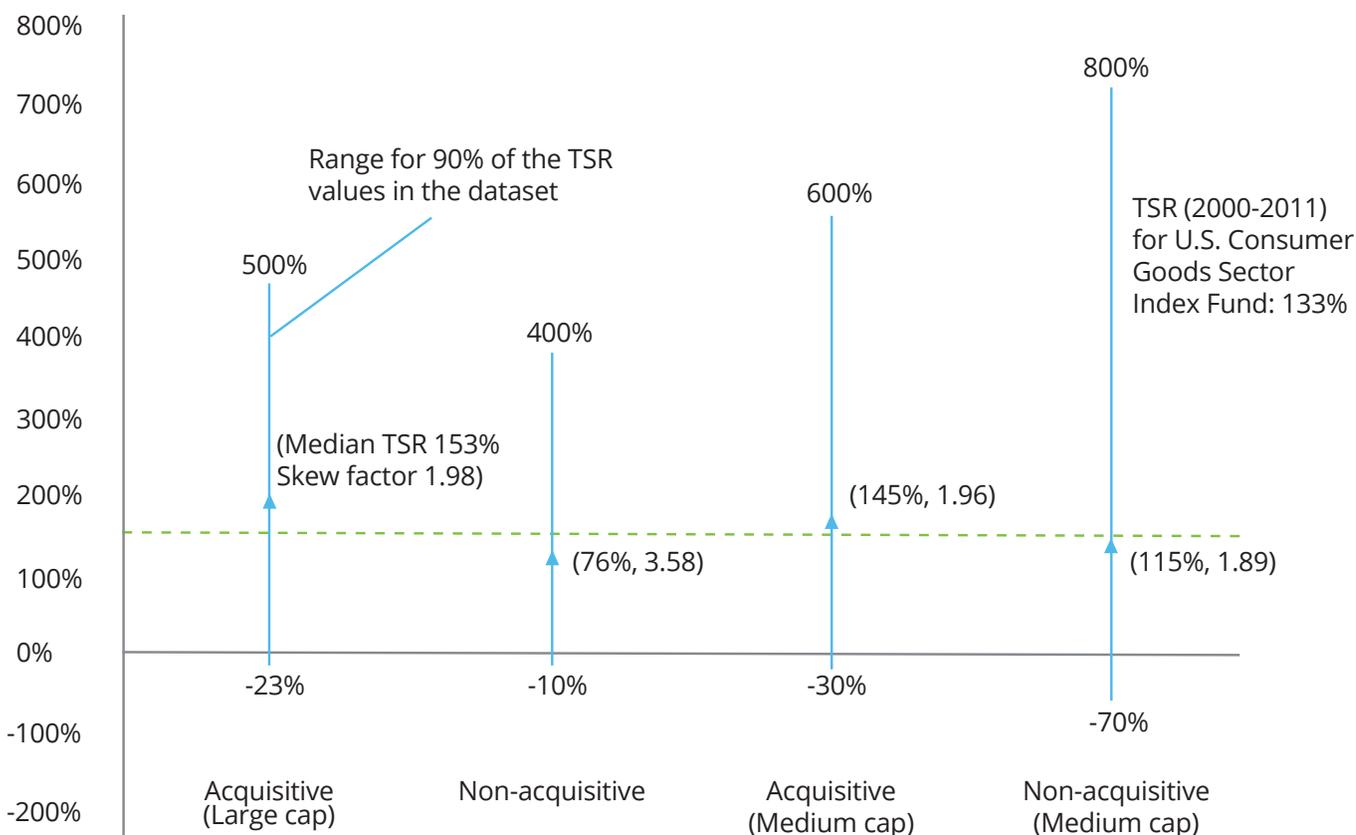
Transactions paid for primarily in cash



**Does M&A or organic growth provide better value generation for C&IP companies**

The study indicates that M&A-driven growth generates higher and more definitive value for large-cap and medium-cap C&IP organizations than organic growth does (Figure 4). Results were not conclusive for small-cap companies due to small sample size and data volatility.

Figure 4: Value generation for acquisitive and non-acquisitive C&IP companies (based on 15-year TSR)<sup>2</sup>



**Large-cap companies** (market cap of the acquirer > \$10B)

- Median TSR for companies in the acquisitive group is two times the median TSR in the non-acquisitive group.
- Over 80 percent of companies in the non-acquisitive group generated lower TSR than the average return observed in the acquisitive group.
- TSR in the non-acquisitive group is 1.5 times more volatile than in the acquisitive group.

**Medium-cap companies** (market cap of the acquirer between \$1B and \$10B)

- Median TSR in the acquisitive group is 25 percent higher than the median TSR in the non-acquisitive group.
- The TSR in the acquisitive and non-acquisitive groups have similar levels of volatility.

<sup>2</sup> US Consumer Goods Index Fund data from iShares by BlackRock

Drawing from the population of companies in Deloitte’s database, the following case studies compare TSR performance of two companies that performed M&A under considerably different conditions:

**Multinational Fresh Foods Manufacturer (MFF):** TSR -4.16% (Market Cap ~ \$300 M, Revenue ~ \$3B)<sup>3</sup>

**U.S. Based Egg Producer (USEP):** TSR 1279.34% (Market Cap ~\$1B, Revenue ~\$1B)<sup>4</sup>

**M&A Profile At a Glance**

- Two deals
- Ad hoc acquirer
- Two cash deals
- One large deal (~\$900 M in cash)
- Two deals in high M&A activity conditions

**M&A Profile At a Glance**

- 12 deals
- Serial acquirer
- Six cash deals
- Seven small deals
- Five deals in high M&A activity conditions, seven in low M&A activity conditions

MFF acquired under unfavorable M&A conditions. MFF’s stock price in 2011 dropped 50% as compared to its 2005 stock price, when the company announced its large cash deal.

USEP is a serial acquirer that acquired under largely favorable M&A conditions. Its carefully executed M&A strategy has helped USEP generate high shareholder returns, with stock price rising by over 10 times between 2003 and 2013.



<sup>3</sup> M&A Deal information for the case studies was accessed from <http://seekingalpha.com> on March 7, 2013

<sup>4</sup> Revenue and Market Cap data is for Financial Year 2011 as reported by Yahoo Finance and AFG View

### Game-changing strategies

Sometimes business reasons drive the need to do an M&A deal under “unfavorable” conditions. Therefore, it is important that acquirers proactively assess and understand the risk profile of a deal before undertaking an M&A transaction; this may help to reduce the impact of unfavorable conditions.

The favorable or unfavorable conditions associated with the four M&A deal characteristics depend, in part, on company type, present economic conditions, and certain conscious decisions. When working with Boards of Directors and executives teams, Deloitte suggests that C&IP companies which embark on an M&A journey under unfavorable conditions employ certain strategies and tactics during each phase of planning to help overcome those conditions and facilitate value generation (Figure 5).

Figure 5: Strategies to offset M&A risks due to unfavorable conditions

	High M&A activity	Ad-hoc acquirer	Large target size	Cash financing
<b>Deal identification</b>	Avoid dilution of value due to competitive action by choosing a target that provides differentiated advantage over its (target's) peers.	Develop a program for quick and private target scanning; this can reduce the need to participate in auctions, which generally is a more reactive M&A strategy.	Develop strategic objectives; assess the attractiveness of those objectives during critical decision-making points during the deal process.	Evaluate economics of the deal and expected value generation by assessing financing options for the transaction and mid- / long-range plan.
<b>Deal process</b>	Know your “walk-away” price; prepare alternative strategies if the deal can't go through.	Be a buyer that the seller can trust despite lack of M&A experience (e.g., by engaging advisors).	Set realistic timelines with the “seller”; avoid a long and convoluted deal process.	Secure funding for the transaction and mid-range plans.
<b>Due diligence</b>	Be objective; stay true to your strategy — be ready to walk away from the deal if there are red flags.	Before you jump into due diligence with both feet, spend some time framing the investment opportunity.	Analyze the points of failure (e.g., loss of specific suppliers, employees, technology/process/ cultural differences) and assess if mitigation is possible.	Understand the degree of leverage you have from a negotiations point of view; use it to arrange favorable financing conditions.
<b>Pre-close planning</b>	Create flexible and agile strategies to achieve performance objectives in a changing market/ industry environment (e.g., accelerated go-to-market timing based on competitor response)	Complete integration planning before close.	Complete integration planning before close; know the integration challenges and plan for mitigation ahead of time.	Establish a proactive cash-flow monitoring and management process.

If M&A is part of a C&IP company's growth strategy, whether conditions are favorable or unfavorable should not reduce confidence or determine outcomes. Rather, companies should take control of the situation, develop appropriate strategies, and carefully execute them to improve shareholder value.



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