

Demystifying deal making: Lessons from M&A veterans

Two longtime experts in mergers and acquisitions describe what works—and what doesn't—in corporate deal making, including how to approach the role of activist investors.

In mergers and acquisitions (M&A), nothing quite beats experience. This is particularly true of so-called programmatic M&A, a systematic approach to finding and transacting a steady stream of deals over time along a common theme.¹ To help demystify the deal-making process—including what works and what doesn't—we asked two seasoned executives: Michael Carr, the coleader of global mergers and acquisitions at Goldman Sachs; and Russell Fradin, an operating partner at private-equity firm Clayton, Dubilier & Rice and former CEO and chairman of Aon Hewitt Corporation (and a McKinsey alumnus). Carr and Fradin spoke with McKinsey's

¹ See Chris Bradley, Martin Hirt, Sven Smit, and Andy West, "Research shows that smaller M&A deals work out better," *Harvard Business Review*, May 9, 2018, hbr.org.

Robert Uhlener at a panel discussion at McKinsey's Global Business Leaders Forum in New York earlier this year. The following is an edited version of their conversation.

The Quarterly: *What practical steps can business leaders take to make M&A more effective?*

Michael Carr: There's often a sense of mysticism about M&A, and the [pressures of M&A] can lead people to throw everything they've learned out the window. So first, lay out the rationale: Why are we doing this, and how does it fit within our business and our team? Next, lay out the steps, because there's always going to be disruption in the process, and it often comes from external forces like competition from other buyers, so you need to be ready to respond. Most importantly, make sure your people are prepared, that they know their roles and what the delivery is supposed to look like. Once you have that, more than half the battle is taken care of. After all, these are just companies, and companies are full of people and processes.

Russell Fradin: In terms of programmatic M&A, you have to answer the question "What's the program?" And the program is you're either trying to do more of what you already do, or you're trying to buy a new product that you can leverage with your sales force or distribution, or you're trying to buy distribution in new geographies. Then you need a strategy that says, "In terms of our category, here are the targets that would constitute a doubling down, here are the targets or products that we'd like to have, and here are the targets for the distribution we want." Go about it in a systematic way.

Two other reasons to do M&A are diversification and capability building. [In my experience,] those two are likely to fail. Today, a lot of companies want to buy digital capabilities, and I'd be careful. I don't want to insult anyone, but do you really think the hottest AI [artificial intelligence] start-ups are looking to become part of [a hundred-year-old company]? In other words, are you really going to get the best of the bunch? If you're a strategic buyer, and capability building is the rationale, you need the people to stick around [after the deal], because what you're really buying is people—it's a mass-hiring situation. And then you get into questions like "Do I need retention bonuses? How do I teach them about the company?" Typically, if you're buying like for like, or a product that's in your industry, there is a greater likelihood of the cultures being a match. [Some companies are] just looking to cash out. I don't want to say it's never a good idea to buy capabilities, but, in general, if you're looking at the latest blockchain start-up or the latest AI company or the best analytics company—you need those people to stay. If you're looking at a company that just wants to cash out, it's a good time to run for the hills.

Finally, I've found that having M&A strategy and business development reporting to the CFO is a bad idea. The CEO shouldn't have that input filtered. I always kept the business-development function reporting directly to me. The CFO also had a key vote, but you don't want all the good ideas killed before they get to you.

The Quarterly: *How important is it for targets or potential targets to perceive a company as a good acquirer? And what, to your minds, does “good” look like?*

Michael Carr: In the M&A world, everybody develops a reputation, and unfortunately the reputation usually is built on the last bad transaction that they’ve executed or failed to do. As investment bankers, we spend a lot of time making sure the target knows what they’re getting into. This will sound like a cliché, but what is the acquirer’s ethos? Why are they who they are, and how do they operate? Are they honest people? Is this an organization that has a genuine culture? Of course, a lot of M&A is about earnings-per-share growth and other understandable and observable factors, but these ephemeral topics, the human element, [also are critical].

The Quarterly: *What are some ways that successful management teams create value from deals?*

Russell Fradin: First, a lot of what the market values is organic growth, so be careful not to think that M&A is going to solve all your problems. But M&A can accelerate organic growth if you do it right.

You have to have a clear strategy and be very well networked in your industry—and I don’t mean just the CEO, but the entire management team. I used to include in all my regional managers’ bonus plans that they had to raise [M&A] ideas, because the best ideas often come from the field.

The Quarterly: *How would you describe the impact of activist investors on M&A velocity and decision making?*

Russell Fradin: Having come from the management side, my answer will probably surprise you. And that is: more often than not, the activists are right, and management doesn’t want to face it. When I recently joined the board of a public company, I asked them if they’ve looked at how an activist would attack them. If a company hasn’t, that tells me it’s not on their minds. What do you think the activists would be picking on? If management is not open to that alternative viewpoint, it’s not a good thing. The CEO of one company where I’m a director simply published the cash [allocation] on their website—how much would go to stock buybacks, how much to dividends, how much to growth. An activist would look at that and say, “There’s nothing to do here. They’ve already said they’ll return the bulk of their cash to shareholders.” But don’t underestimate how smart these folks are. It’s always the 20 percent where activists are wrong that management will pick on, not the 80 percent where the activists are right.

Michael Carr: Everybody tends to forget that shareholder activism has been around for a long time. Carl Icahn is over 80 years old! Shareholder activism, like it or not, is just part of a very complex market; it’s a part of how markets function.

But activism has changed a lot, and activism defense has changed a lot. We measure this very carefully. When the [US Securities and Exchange Commission filings] that list shareholder positions—including activist positions—are published, we see a series of activist cases develop. And within 40 to 50 days after the positions are published, there will be either a settlement—and that settlement usually entails changes at the board level—or a proxy fight starts. Over the past several years, 85 percent of companies that have encountered activist investors chose to settle, because shareholders don't like proxy fights; [they] are very expensive and time consuming.

Many shareholder activists make a living out of criticizing companies' portfolios of businesses, and there are times when they're absolutely right. It's extremely disruptive to your organization when you sell a business, but everybody has to make those hard decisions. The best CEOs have the guts and the ability to sell businesses that aren't earning their cost of capital. The private-equity model is interesting because they have the luxury to choose when to sell, and the best investors are those who have the discipline to sell. Companies often don't have that luxury, and they also have to address the perceived stigma of selling a business.

However, if you feel that your business is starting to degrade, or the market in which it operates has some structural challenges, you will need to act. You need to be your own activist. Get ahead of it, because otherwise you won't have enough time to put together the necessary effort to beat the clock. Q

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