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A deal-making strategy for new CEOs

New CEOs typically raise the tempo of transactions at first, then the pace slows down. Is that costly?

by Michael Birshan, Thomas Meakin, and Andy West

More than half of new CEOs of S&P 500 companies launch some form of transaction during their first two years in office. Whether acquisition, merger, or divestiture, deal making is the second most likely strategic action for a new CEO to undertake, we've found. Few are able to maintain the pace of deals over the course of their tenure, though, and this appears to be a missed opportunity.

THE CASE FOR PROGRAMMATIC M&A

Our work has shown the strategic value of sustained transactions. We looked at different approaches to M&A activity and assessed the success of each in delivering shareholder returns. In "programmatic" deal making, for example, CEOs use M&A regularly (typically three to four deals per year) and meaningfully (with an average of 20 percent of companies' market capitalization acquired over ten years). That contrasts with a "large deal" approach, where companies transform themselves with one deal valued at more than 30 percent of their market capitalization. The research found that companies that pursue a programmatic M&A agenda outperformed their peers, achieving an average of 3 percent excess total returns to shareholders. "Large deal" strategies, on average, destroyed value.

AN EARLY BURST

How does CEO behavior stack up against the programmatic M&A model? Fairly well during the initial years of many CEOs, according to our research. A review of all mergers, acquisitions, and divestitures by the nearly 600 CEOs who left S&P 500 companies between 2004 and 2014 showed that CEOs conducted significantly more M&A activity early in their tenures. On average, the number of deals (regardless of deal size) completed by year two of their tenure was 50 percent higher than the average number of deals done in the five years before they took the helm (Exhibit 1).

This initial drive for action is broadly consistent across industries and time periods, and it's a testament to the pressures on CEOs to make their strategic and financial mark. Research by our McKinsey colleagues similarly found that the most successful CEOs front-load their reallocation of corporate resources during the first three years of their tenure.[1]

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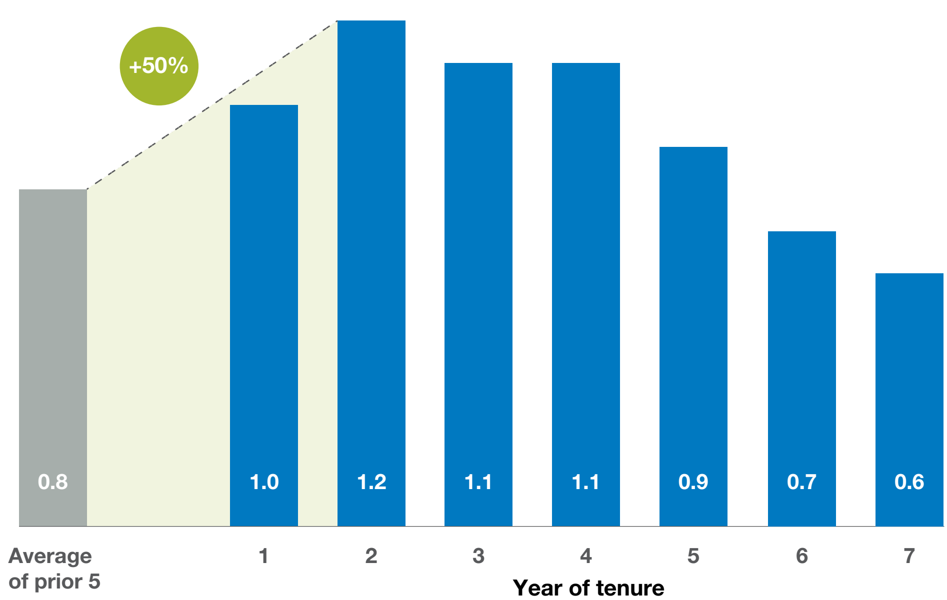
[1] See Stephen Hall and Conor Kehoe, "How quickly should a new CEO shift corporate resources?," *McKinsey Quarterly*, October 2013, McKinsey.com.

Exhibit 1

New CEOs are under pressure to move early and conduct more M&A deals sooner than later in their tenure.

Number of deals per year by year of tenure



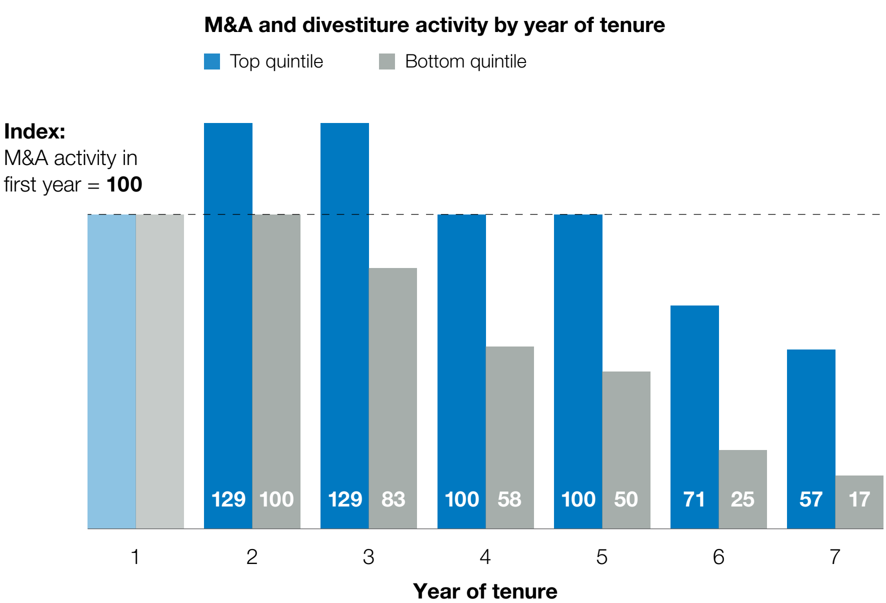
THE CHALLENGE OF STAYING THE COURSE

Our new research shows that transaction activity subsequently drops off, especially after year five of a CEO's tenure. By year seven, the CEOs in our data set were doing roughly one deal every two years. This was true both across the board and for the highest-performing CEOs (defined as those achieving top-quintile excess total returns to shareholders, where "excess" represents returns above the industry average). Those top-quintile CEOs typically were quite aggressive early on. By year two, they were doing nearly 30 percent more mergers, acquisitions, and divestitures than in year one (Exhibit 2). By year seven, though, the deal flow of the top-quintile companies was roughly half the level of year one. (For bottom-quintile CEOs, transactions were roughly one-quarter the levels of year one—an even sharper fall off.)

Like other strategic initiatives launched by incoming CEOs, transaction momentum tends to wane. After making big moves early on, CEOs tend to ride with the changes during the middle of their tenure. In part, that's to give the organization a break from the strains associated with integration and

Exhibit 2

Top-quintile CEOs are more aggressive early on and experience less of a drop-off in M&A activity over time.



change. Later on, however, it may reflect a penchant for conservatism and an unwillingness to take on additional risks toward the end of one's tenure. If not addressed, this creeping bias for inaction can hurt a company's performance as opportunities are missed and needed changes are not acted upon.

MAINTAINING MOMENTUM

Programmatic use of transaction activity demands a well-defined strategy supported by precise and analytical decision making by CEOs and their teams. Leaders throughout the organization first need to understand the role of transactions, as well as their relationship to organic-growth efforts, in achieving a vision (for more on organic growth and M&A, see "The value premium of organic growth," on McKinsey.com). Then it's valuable to maintain an ongoing commitment to rapid resource reallocation and to embrace frequent market scans and portfolio reviews that identify acquisition targets and divestiture opportunities. Sustaining an aggressive transaction tempo also demands a devotion to basic transaction blocking and tackling, with well-defined deal processes at ground level, along with strong supporting capabilities in deal sourcing, due diligence, and integration. Finally, boards have an important role to play. They should encourage their CEOs to view mergers, acquisitions, and divestitures as an ongoing tool, one that will help them maintain a strategic edge—and standing among shareholders. They should also understand that a CEO's appetite for doing deals (or not) is typically related to tenure, which can create a bias that they will need to identify and manage. Q

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