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Consumer Packaged Goods Practice

The next wave of consumer M&A: Executing for value

New research on recent mergers shows that leading companies follow disciplined playbooks to extract maximum value.

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For many established consumer-goods companies, the struggle to achieve growth continues. Excluding M&A, industry revenues expanded by just 2.1 percent from 2013 to 2017, trailing global GDP growth. Large consumer-goods companies fared especially poorly, growing only 1.7 percent.[1] It's little wonder that consumer companies are increasingly looking to M&A for growth.

However, as our colleagues have demonstrated,[2] inorganic growth has become much more challenging in recent years, as valuations have soared. Larger transactions (more than $1 billion) have proved especially difficult. Companies whose M&A program centered on such deals did not generate any total shareholder returns (TSR) from 2013 to 2018.

Our new research focuses on the discipline of integrating two companies to create maximum value. We have examined the M&A activity of 119 large consumer-goods companies from 2013 to 2018, encompassing about 370 material transactions (with deal values exceeding $50 million).[3] On the whole, M&A produced only modest results, reflecting the difficulty of the current environment: median annual TSR was 4.3 percent. But within that muted median, some exciting potential exists. We categorized these companies by the dominant strategic intent of their M&A deals: to expand the portfolio with established brands, building scale and diversifying the portfolio; to snap up fast-growing companies in the company's core categories ("challengers") to accelerate growth; or to place a bet on finding growth in categories adjacent to the core.

Expanding the portfolio, the main archetype used by 74 percent of the 119 companies, produced modest annual TSR of 3.3 percent (Exhibit 1).[4] About half of the companies in this group exceeded the overall median of 4.3 percent. Snapping up challengers (the main archetype used by 18 percent of companies) produced the highest median annual TSR, about 6.3 percent. Two-thirds of the companies in this archetype exceeded the overall median. Betting on adjacencies (the main approach used by 8 percent of companies) generated the weakest outcomes—a negligible TSR of 0.4 percent per year. Over three-quarters of the companies pursing this approach lagged behind the overall median TSR.

In this article, we'll look closely at the recent history of the three archetypes and, within each, identify the characteristics of the M&A approach that leading companies use. Typically (though not always), that approach is programmatic.[5] In fact, companies deploying the programmatic approach performed better than those that used either the large-deal or selective approach, across all three archetypes (Exhibit 2).

Three deal types

As measured by deal count and volume, portfolio expansions not only are the most frequent deal type but also represent most of the value (about 80 percent) (Exhibit 3). Challenger acquisitions and adjacent moves represent about 10 percent each.

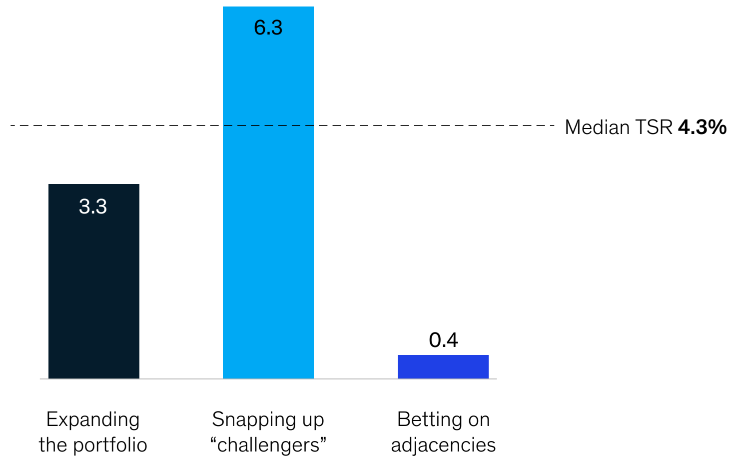
Over the period we studied, challenger and adjacency deals became more prevalent (Exhibit 4),

1 Updated figures for research originally published in Gregory Kelly, Udo Kopka, Jörn Küpper, and Jessica Moulton, "A The new model for consumer goods," April 2018, McKinsey.com.
2 Susan Nolen Foushee, Niall Murphy, Amaury Saint Olive, and Kandarp Shah, "The next wave of consumer goods M&A: Searching for growth," 2019, McKinsey.com.
3 Our colleagues have recently conducted an overview of global M&A, using a data set of 2,000 companies. See Jeff Rudnicki, Kate Siegel, and Andy West, "How lots of small deals add up to big value," *McKinsey Quarterly*, July 2019, McKinsey.com. Our research encompasses a larger number of branded consumer-products companies with market cap exceeding $300 million. It excludes companies in emerging Asia, as we have focused on M&A trends in developed markets. And given the meaningful changes in growth and customer behavior in the past five years, we have focused our analysis on 2013–18 results.
4 The "expanding the portfolio" approach focuses on acquisition of brands playing in the same categories, often from direct competitors—hence, it is largely a scale play. "Snapping up challengers" means an approach that favors the acquisition of up-and-coming brands with strong growth prospects that compete in the same space. "Betting on adjacencies" is an approach focused on expansion beyond core categories to access new consumers or product segments and bring diversification and growth.
5 Programmatic buyers did two or more small or midsize deals per year. Large-deal buyers made one or more acquisitions during the five years studied in which the purchase price represented 30 percent or more of their own market caps. Selective buyers did fewer than two deals per year.

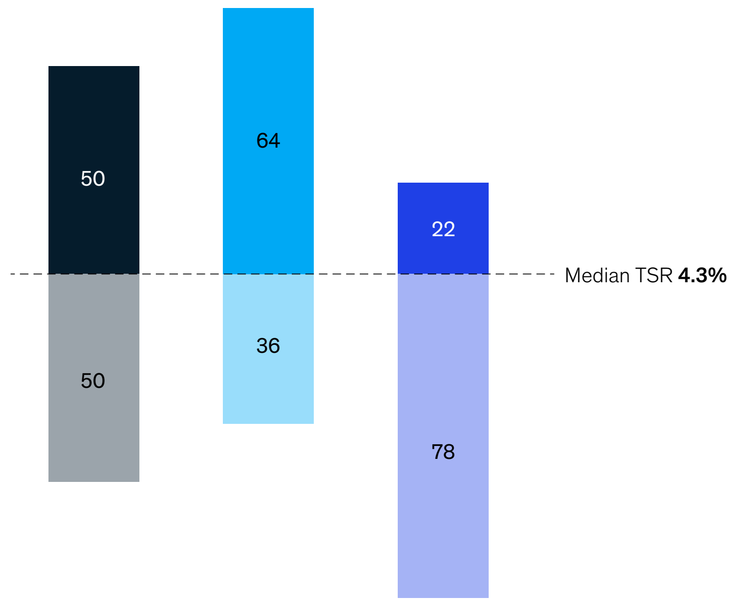
Exhibit 1

‘Snapping up challengers’ is correlated with the best shareholder returns.

Median TSR for consumer-goods acquirers in 2013–18, %[1]



Share of companies above and below median TSR, %
(n = 119 companies)



[1] TSR = total shareholder returns. TSR compound annual growth rate (CAGR) calculated from Dec 31, 2013, to Dec 31, 2018, with calculation adjusted if data were not available for full period. CAGR calculated based on US dollar value. Data from a sample of 119 consumer-goods companies across Australia, Europe, Japan, Latin America, North America, and South Korea; does not include retail, apparel, or durables.

likely because rising valuations and fewer targets in core categories sent acquirers further afield.

Expanding the portfolio

Looking more closely at each deal type, new insights emerge. Portfolio expansion is a traditional M&A-scale play focused on acquiring a brand portfolio, often from a direct competitor, for which the formula to extract value is largely known. This play is attractive for market leaders that remain profitable but, like most large consumer-goods companies, are seeing slower growth. The effects are typically immediate: larger deal size produces direct and material impact on the performance of the acquirer.

Exhibit 2

Programmatic acquisitions outperformed other M&A approaches for consumer-goods companies.

Median total shareholder returns for consumer-goods acquirers in 2013–18, %[1]

		Consumer archetype			
		Expanding the portfolio	Snapping up "challengers"	Betting on adjacencies	Overall
M&A approach[2]	Large deal	0.2	–10.3	1.3	0.2
	Programmatic	6.1	8.3	–7.8	6.4
	Selective	4.4	6.0	–0.4	4.5
	Overall	3.3	6.3	0.4	4.3

[1] Information based on deals announced and completed by 119 companies between 2013 and 2018. Categories with negative numbers all had <4 data points.
[2] Large deal: ≥1 deal/year in which target market cap was ≥30% of acquirer market cap. Programmatic: 1 or 2 small/midsize deals/year, with meaningful total market cap acquired. Selective: 1 or 2 deals/year in which cumulative value of deals was >2% of acquirer market cap.

Source: Dealogic; S&P Capital IQ; McKinsey analysis

In this deal type, most value is usually found on the cost side of the ledger: through synergies in the operations and general-and-administrative functions and through use of the increased scale and broader portfolio to negotiate with retailers, e-tailers, and suppliers from a position of strength. But in this new world of consumer goods, cost synergies and scale aren't enough. You can't cut your way to growth. The most successful acquirers look for targets that will bring them market-leading brands in faster-growing categories. Done well, this play unlocks growth while improving margins.

Several examples showed up in our research. Campbell Soup acquired Snyder's-Lance to expand its presence in snacks with market-leading brands, such as Kettle Foods and Cape Cod chips. Ferrero Group acquired Nestlé USA's confectionery business to gain access to strong legacy brands it could revitalize, and manufacturing and distribution in the United States. And Tyson Foods acquired Hillshire Brands to increase its presence in prepared foods.

Snapping up challengers

"Innovation in the garage" is no longer the sole province of high tech. In the past few years, young brands that ride consumer trends (such as "better for you," environmental sustainability, and social-media influence) have quickly secured shelf space and online sales. Traditional barriers to entry barely exist. Armed with a compelling idea and millennials' endorsement, these brands rapidly achieve above-market growth, as traditional categories (such as snacks, water, juice, coffee, yogurt, cosmetics, and even apparel) have seen.

While in-house innovation remains a pillar of success, acquiring an up-and-coming brand with strong prospects can make financial sense. The challenge to success lies in a legacy company bringing in such a cool, unconventional player and making it a key growth platform without crushing its unique value proposition and appeal—or scaring away its critical talent.

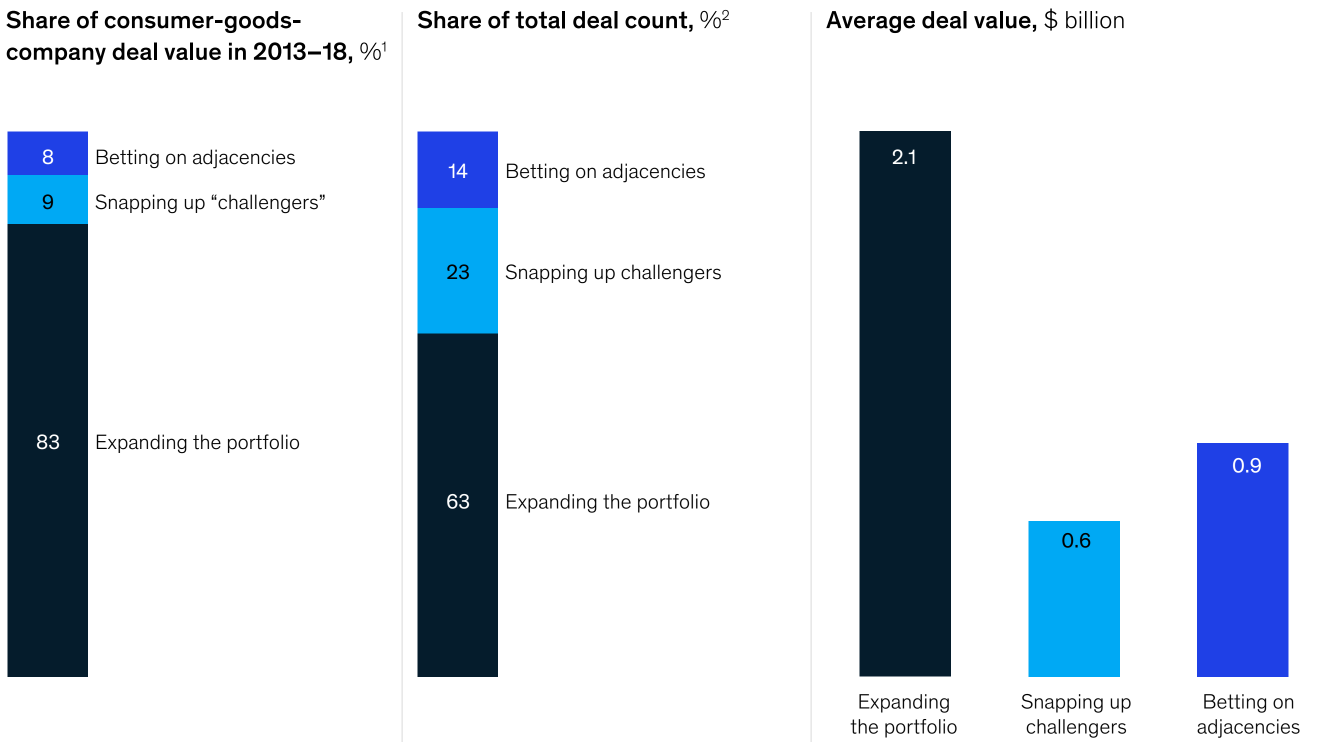
Several recent plays by big traditional players show that success is possible. Think of Kellogg's acquisition of Chicago Bar (maker of the RXBAR), General Mills's acquisition of Annie's Homegrown, and several others . The key to success lies in sustaining the challenger's secret sauce within the machinery of a 100-year-old company.

Betting on adjacencies

Several consumer-goods companies, under mounting pressure to drive growth, unable to

Exhibit 3

Portfolio expansions are the dominant deal type for consumer-goods companies.



[1] Includes 369 transactions of >$50 million from a sample of 119 consumer-goods companies across Australia, Europe, Japan, Latin America, North America, and South Korea; does not include retail, apparel, or durables. Total deal values of $489 billion, $54 billion, and $46 billion for expanding the portfolio, snapping up "challengers," and betting on adjacencies, respectively.

[2] Total deal counts of 231, 86, and 52 for expanding the portfolio, snapping up challengers, and betting on adjacencies, respectively.

Source: Dealogic

find attractively priced targets within their core categories, and often blessed with substantial cash reserves, have turned to adjacencies. The ideal target is similar enough to limit the risk involved but different enough to provide access to new consumers or product categories and bring diversification and growth. This play makes sense for a company that needs to diversify, is eyeing a category that offers real growth potential, and has the resources to make the acquisition.

But adjacencies typically face an uphill battle. Limited business overlap reduces the potential for cost synergies, and unfamiliarity with the new subsector hinders growth. Moreover, these plays often lack a straightforward deal thesis. Not surprisingly, as our research indicates, they fail more often than they succeed.

The greatest difficulty is realizing meaningful synergies, both cost and growth, in typically different businesses. Because the acquirer and the target focus on different consumer-goods categories, the possibility of capturing true combinational synergies is limited.

Recent adjacency bets that show success is possible include General Mills and J.M. Smucker entering the pet category by acquiring Blue Buffalo and Big Heart Pet Brands, respectively.

Playbooks for success

The fundamentals of successful integration in consumer goods still hold. Setting up a strong integration-management team, staffed with top talent, to go after value early; protecting the top line by not overcomplicating day one; and being sensitive to the cultural aspirations of a newly acquired company are all proven and effective techniques across integrations. But beyond that, each deal type has its own "get-rights" for integration success. In the following sections, we examine what sets winners apart.

Expanding the portfolio

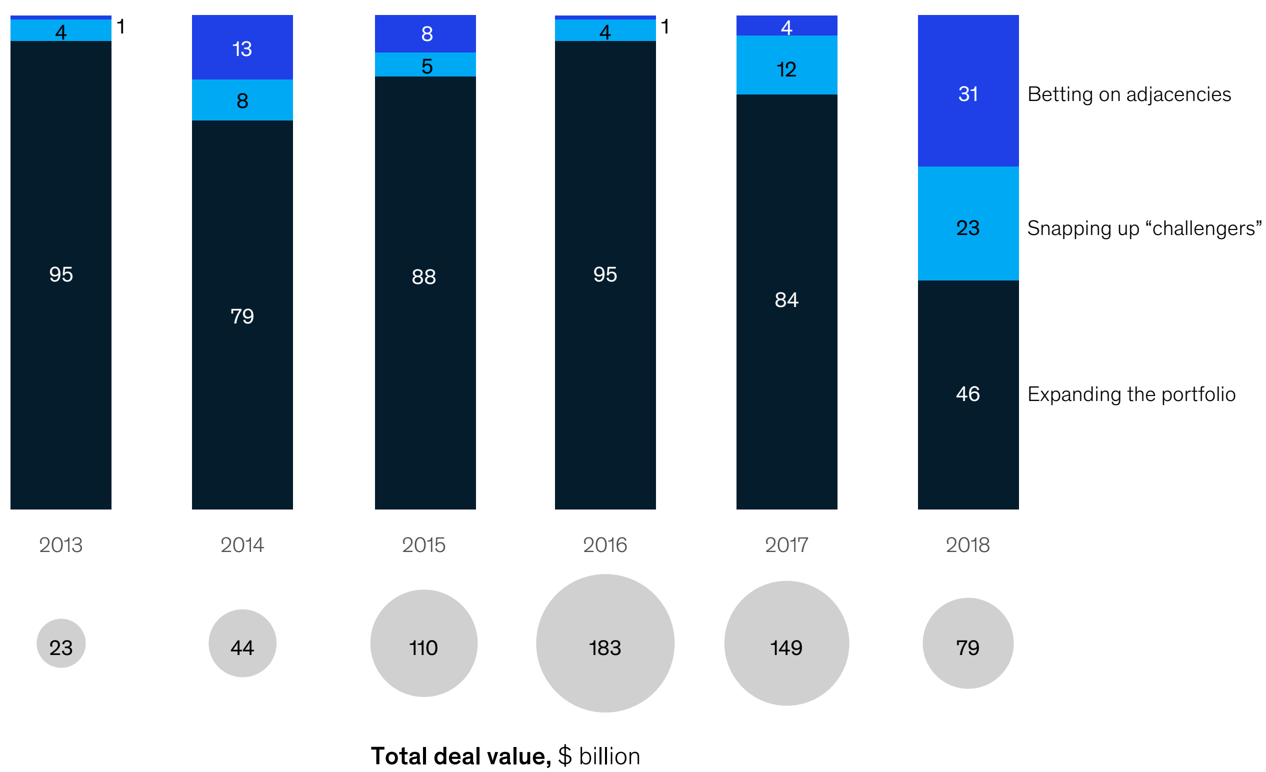
The portfolio-expansion play has four get-rights for integration success.

Integrate commercial organizations thoughtfully. While every merger invokes the mantra of "protect the top line and minimize disruption," most merged companies still experience top-line erosion. A primary cause is rapid consolidation of sales forces to achieve an early and material synergy through head-count reduction. Maintaining overlapping sales forces can feel burdensome. It's tempting to make cuts, especially since sales forces are typically large and the rationale of reducing duplication of customer and territory coverage is appealing. To be sure, companies can often consolidate their key-account-management teams and better coordinate other groups. But comprehensive sales-force consolidation immediately after the close can be disruptive—for example, it can uproot long-standing retailer

Exhibit 4

'Challenger' and adjacency deals are becoming more frequent in the consumer-goods sector.

Share of consumer-goods-company deal value in 2013–18, %[1]



[1] Figures may not sum to 100%, because of rounding. Includes 369 transactions of >$50 million from a sample of 119 consumer-goods companies across Australia, Europe, Japan, Latin America, North America, and South Korea; does not include retail, apparel, or durables. Total deal values of $489 billion, $54 billion, and $46 billion for expanding the portfolio, snapping up "challengers," and betting on adjacencies, respectively.

Source: Dealogic

relationships and send the best people streaming out the door once they sense that cuts are coming.

Instead, acquirers should prioritize stability and continuity of customer relationships. They can strengthen retailers' experience with the merger by communicating early and often and by taking steps to retain both sales forces and keep them working together in a well-organized way. Down the road, companies can usually find some reductions that won't prove disruptive.

For example, after acquiring a competitor in 2017, a large food-and-beverage company delayed integrating the commercial teams for almost a year after the close, to avoid the potential disruptions. The results: top-line stability and a solid platform for growth. While not every company can wait a year, a thoughtful stabilization period can provide time for a deeper, more thorough assessment of talent.

Capture cost synergies—but invest some of the savings in growth and capabilities. Realizing synergies from scale (in operations, overhead, and trade) is "table stakes" for this deal type. These synergies pay for the deal.

Operational efficiencies are critical. Operations typically account for two-thirds of the synergies in portfolio-expansion plays and determine their financial success. Companies can often achieve operational efficiencies faster than they think possible by applying two principles:

— **Act before completing the integration of all related IT systems.** Companies often assume that dealing with separate systems is a hard barrier to speedy integration. We recommend a cost–benefit analysis of developing temporary bridges that allow rapid execution of operational synergies. Postponing operational synergies until the integration of legacy systems is complete runs the risk that they will never materialize.

— **Abandon the traditional year-on-year approach to procurement.** Companies can use a deal as a chance to take a comprehensive view of procurement and locate opportunities to broaden procurement's scope, depth, and sourcing tactics. It's also a good time to build deeper capabilities in house.

After synergy realization, the question becomes what to do with the savings—return them to shareholders or invest some in sources of growth. Companies that invest in growth typically use the savings to strengthen brands, build new capabilities (such as innovation), or redesign the operating model to enhance agility or align better with market needs.

For example, a merger of two food companies looked far beyond simply harvesting synergies. The merged company used the opportunity to develop a new operating model and pump significant money into underinvested brands. The results: a lean, fit-for-purpose organization and rejuvenated brands driven by focused investments in faster growing categories.

In contrast, some recent large deals that primarily focused on returning savings to shareholders have seen sharply declining growth and balance-sheet write-downs. Plays to expand the portfolio need to complement cost synergies with growth.

Define roles within the brand portfolio as soon as possible. Early definition of roles for each brand, customer segments to target, and ways to target them provides focus and clarity. Choosing some brands to manage for growth and some to manage for profit aids the allocation of resources and investment—and helps retain talent, especially marketers. Too many companies spread their investments like peanut butter. A portfolio expansion is also the time to jettison or deprioritize brands that represent ongoing cost but have limited potential. Some caution is necessary, though: these decisions require careful customer management.

Early review of brands has proven important in recent cosmetics- and food-company deals. One leading deal maker methodically reviewed its brands early in integration planning, mapping them against consumer needs, customers, and company capabilities. This review quickly established where to invest, where to conduct business as usual, and where to cut the cord with brands that were subscale or had weak underlying category momentum.

Identify where the target is better. While easy to ignore in the rush to integrate, the target often does some things better than the acquirer. Failure to adopt the target's better approach can leave money on the table. The key to success is not to create endless hybrids and compromises but to choose the best approaches objectively. Benefits include improved processes (and even systems and tools); higher talent retention, often in critical areas (such as supply chain and marketing); and faster cultural integration. But a careful assessment of ways of working takes time and resources.

One programmatic acquirer in the beverage sector studied past acquisitions that had ignored the target's superior practices. It then developed a methodical approach to comparing practices in critical processes through a series of cross-functional working sessions and went on to adopt several of the target's practices. The results: significant value created by the company's acquisitions and higher TSR than its peer group.

Snapping up challengers

The challenger-acquisition play also has four get-rights for integration success.

It's not what you get—it's what you give. An acquirer must understand its value proposition to its target—what it offers the challenger, such as significant funds to invest, the ability to add and professionalize capabilities, and access to distribution. Companies must be very clear about the strategy to drive growth and know where to provide support and where to get out of the way.

In a recent deal, a consumer-goods giant successfully acquired several challenger brands by selecting targets in high-growth categories and flexing its distribution muscle to leapfrog to the desired scale, generating TSR of about 14 percent in the process. The acquirer gave the target considerable freedom to pursue growth and innovation while providing back-office infrastructure, marketing funds, and distribution for the target's brands.

Protect the brand. A challenger's brand story and its loyal customers are often the raisons d'être for the deal. A challenger brand often links tightly with founder identity, so the ongoing role of the founder and how that role ends are critical issues to address. Both employees and consumers may bolt if they perceive threats to the brand or the product. Even modest packaging changes or slight modifications to ingredients can damage value.

Ideally, the challenger brand also becomes a platform through which to sell a wider range of products. But the acquirer must balance speed of product proliferation with authenticity. Integrating the challenger brand into the portfolio too quickly risks destroying its appeal. Active brand communications with the loyal customer base and a tempered approach to expanding the portfolio are key to avoiding this risk. In the short term, the acquirer should seek to increase distribution (though even this comes with risks) without compromising the brand story.

Understand the 'innovation factory.' An acquirer must ask and answer several questions about the target's innovation process. Who drives it—the founder or others? Where do ideas come from? How can we protect those sources? Does the challenger have a core innovation group that we can tap for innovation in our broader portfolio?

Challengers usually take a fail-fast, iterative approach to innovation. This isn't an easy fit for most traditional consumer-goods companies committed to protecting a broader corporation. The acquirer must find ways to accommodate the challenger's modus operandi without sacrificing its own quality and safety standards.

A recent acquirer of a challenger brand took the time to understand where all the cool ideas came from. It turns out that the founder was a bit of a mad scientist, constantly experimenting and trying out new things. So, it was quite critical to retain the founder's services in the near term until the innovation process could mature and become more independent.

Approach employee integration and associated synergies carefully. Most companies acquire challengers for growth. The synergies in HR, finance, legal, and supply-chain functions are usually safe targets, but integrating the core business is harder. Employees in key areas, such as design, sales, and marketing, are critical to preserving and unlocking the value of a deal. Much of what makes a challenger special typically resides in a few dozen employees in such key functions.

In that regard, no one is more important than the founder. Many people loyal to the founder don't want to work for a big corporation; getting the right people in this cohort to stay is especially difficult. The effort requires a "stay story" that typically highlights the appeal of applying their skills on a much larger playing field and the potential of achieving growth far beyond the reach of the challenger.

Betting on adjacencies

Growth through acquiring adjacencies has three get-rights for integration success.

Be clear on where the value is. Since traditional synergies are hard to get in this play, acquiring companies need to think creatively about value creation.

For example, in General Mills's recent purchase of Blue Buffalo, it was betting on the growing natural-pet-food market and applying its strength and scale to drive premium brands across two segments. Recent performance has been positive, with double-digit growth for Blue Buffalo, propelled by an introduction to mass retail, an e-commerce push, and innovation (for example, in wet food).

But adjacency bets aren't usually this clear. The big challenge lies in determining how to realize meaningful synergies (cost and growth) by combining businesses with different value chains. The synergy potential of marketing and operations is typically limited. Brands have to remain independent, procurement and operations are often different and may offer only partial synergies, and only portions of the general-and-administrative function are addressable. So, the deal has to generate substantial value from growth synergies as well.

Think like both a strategic buyer and a private-equity firm. Any acquisition is a bet on a sector as well as a company. But that's even more true for adjacencies, for which the sector is less familiar. Since the synergy potential is limited, the deal has to make financial sense in other ways.

An acquirer must think strategically about its target's stand-alone growth profile. Put simply, moving into a sector in which the buyer has no experience makes sense only when the sector has more attractive economic fundamentals (such as growth, margins, and competitive landscape) than the buyer's home turf does, and the buyer is able to add enough value to justify a premium. The target ideally occupies a leadership position in its category. It's even better if the target is materially larger than its nearest competitor. In addition, the buyer needs to think about the investment and capabilities needed to stimulate the greatest growth for the target, assuming it hasn't yet reached its full potential. Bolstering household penetration through increased channel presence and a superior supply chain, faster and better innovation, and a robust marketing engine (including digital and e-commerce capabilities) are typical capabilities that can drive growth.

Lacking traditional direct-overlap synergies, this play requires an acquirer to ensure that its target can generate stand-alone cash flow (much needed, in the absence of synergies) by making transformational changes. Private-equity firms excel at this in their portfolio companies. Implementing a more rigorous approach to cost budgeting (such as zero-based budgeting), lean processes, and functional transformational improvements (all done judiciously, so as not to cripple growth) can produce such results.

But buyer beware. Traditional synergies, such as supply-chain optimization, can look great during due diligence but prove elusive after the deal closes. A large food company struggled to tame the complexity of its target's portfolio, which had many SKUs and a long tail of small brands, and found the expected efficiencies hard to realize. With a TSR of –2 percent per annum, the merger destroyed value.

Be patient. Value capture often takes longer to manifest than in a portfolio expansion and can require significant additional investment into a target. Since the value proposition for an adjacency deal is often fuzzy and evolving, would-be deal makers shouldn't evaluate potential deals against the traditional synergy timeline of 18 to 24 months. These plays take longer to cross the finish line.

Consumer-goods companies contemplating M&A should assess the current state of their businesses, evaluate their ability to execute, and have clear answers to the following questions:

— Is M&A a key driver to realizing our strategic growth aspirations? If yes, which M&A play could drive the most value and deliver on the growth ambition?

— What has been our record on M&A integration, and what are the lessons learned?

— Do we have the integration-execution capabilities required to undertake the selected M&A play?

— Do we currently have the resources, talent, and leadership required? Are we organizationally ready to absorb a new company?

— How can we best prepare the organization for the M&A journey ahead?

Honest answers to these questions can ensure that a company is ready to lead in the next wave of consumer M&A.

This article is a joint research effort with colleagues who studied recent deal selection, valuation, and due-diligence practices in consumer companies. See "The next wave of consumer M&A: Searching for growth" on McKinsey.com.

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