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Brian Dinneen,
Eric Kutcher,
Mitra Mahdavian,
and Kara Sprague

Grow fast or die slow: The double-edged sword of M&A

High Tech October 2015

Our latest research on growth in software and online-services companies has some surprising findings about the benefits and risks of buying growth.

Acquisitions, done well, can be a powerful tool to accelerate revenue growth. And pushing for gains is vital in software and online services, where the rate of growth typically determines whether a company thrives, survives, or dies. While 20 percent revenue growth is enviable in most industries, companies in software and online services are expected to deliver numbers that are markedly higher. In fact, we've found that software and online-services companies with revenue that grows by more than 60 percent annually when they hit $100 million in sales are eight times more likely to eventually pass $1 billion in annual revenue than players with revenue that grows by less than 20 percent annually.[1]

However, acquisitions, done episodically, can also stifle growth. Our research shows that acquiring companies infrequently may actually disrupt organic growth and slow overall revenue gains. We examined the acquisition activity of 578 software and online-services companies that surpassed $100 million in annual revenue[2] and identified three lessons:

- *Low-volume acquisition programs disrupt growth; high-volume programs accelerate growth.* The software and online-services companies whose revenue grew most rapidly had high-volume acquisition programs.

- *Successful acquisition programs complement organic growth.* Among software and online-services companies that reached $1 billion in annual revenue, acquisition efforts preserved or accelerated organic growth. These companies completed more deals, squeezed more growth out of each deal, and managed to preserve high organic growth while investing energy in finding and incorporating acquisitions.

- *Successful acquisitions align with growth strategy.* Companies that accelerate revenue growth through acquisitions don't treat deals as an opportunistic event to capture cost synergies. They use several different deal archetypes—all linked to their fundamental growth strategy.

[1] For more, see Eric Kutcher, Olivia Nottebohm, and Kara Sprague, "Grow fast or die slow," April 2014, mckinsey.com; and Rishi Kant, Eric Kutcher, Mitra Mahdavian, and Kara Sprague, "Grow fast or die slow: Pivoting beyond the core," April 2015, mckinsey.com.

[2] The data set includes companies that first surpassed $100 million in revenue after 1995 and that provided multiple years of public data while earning revenue of $100 million to $1 billion.

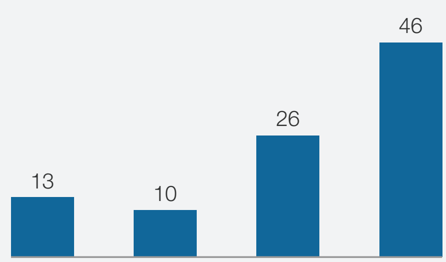
Low-volume acquisition programs disrupt growth; high-volume programs accelerate growth

Some software companies rocket past $1 billion in annual revenue on organic growth alone. Yet for those that seek to supplement everyday growth with acquisitions, it's not enough to check the box with a deal here and there. Our research found that companies making less than one acquisition per year on average have worse revenue growth than those that did no deals. By contrast, companies undertaking one to two deals a year had double the revenue growth of those doing no deals, and companies acquiring two or more companies a year averaged significantly higher growth (Exhibit 1).

Exhibit 1

Companies that make more acquisitions grow revenue faster.

Average revenue growth, compound annual growth rate, %[1]



Deals per year	0	0–1	1–2	>2
Number of companies	**76**	**369**	**87**	**46**

[1]n = 578 companies; sample includes companies that first surpassed $100 million in revenue after 1995 and that provided multiple years of data while earning revenue of $100 million–$1 billion.

McKinsey&Company | Source: S&P Capital IQ; McKinsey analysis

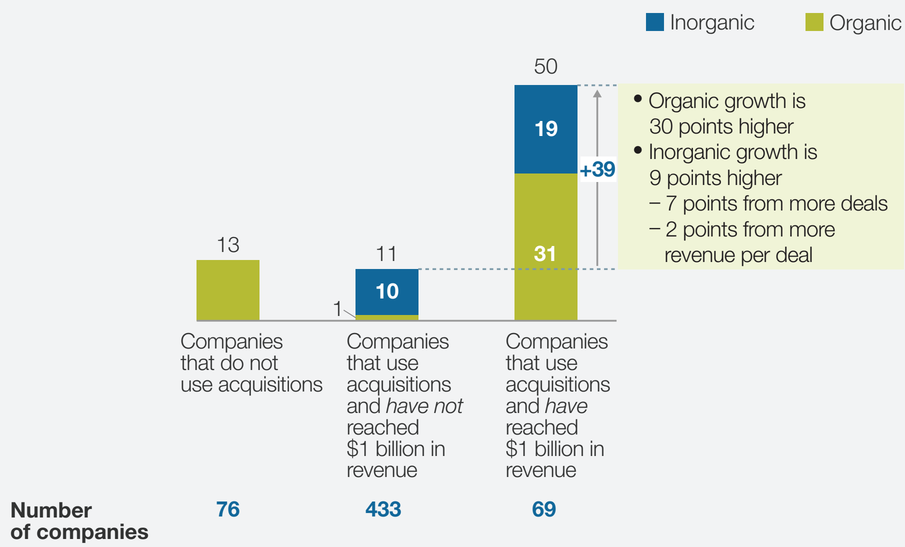
Successful acquisition programs complement organic growth

The acquisition programs of companies that achieved $1 billion in annual revenue delivered organic growth superior to that of companies falling short of the $1 billion mark. As Exhibit 2 shows, companies that reached $1 billion in revenue had nearly twice as much growth from acquisitions as companies that did not, but they saw 31 times the organic-growth contribution. Successful companies drove results in three areas: preserving or enhancing business momentum (or organic growth), executing more deals, and translating each deal into more revenue growth.

Exhibit 2

Successful acquisition programs also promote organic growth.

Average organic and inorganic growth in revenue, compound annual growth rate, %[1]



[1]n = 578 companies; sample includes companies that first surpassed $100 million in revenue after 1995 and that provided multiple years of data while earning revenue of $100 million–$1 billion.

McKinsey&Company | Source: S&P Capital IQ; McKinsey analysis

Let's look at each element. First, and most important, *a company needs to preserve its business momentum*. Software and online-services companies that used acquisitions and successfully moved from $100 million in annual revenue to $1 billion were able to maintain rapid organic-revenue growth (31 percent a year); companies that did not reach the $1 billion mark achieved just 1 percent organic-revenue growth each year. Acquisition activity can distract management and direct resources away from the existing business, or it can preserve and even enhance growth in the core business. Successful companies achieve the latter.

Second, companies that reached $1 billion in annual revenue *undertook more deals each year* (1.5 deals on average) than those that did not (0.9 deals). We found that executing more deals delivered an additional seven percentage points of revenue growth annually. The bottom line is that executing a successful acquisition program is not as simple as buying more companies. It requires a systematic, disciplined approach to deal discovery and execution that is improved over time. Trying to jam more deals through a broken process will only compromise organic growth and the chance of success.[3]

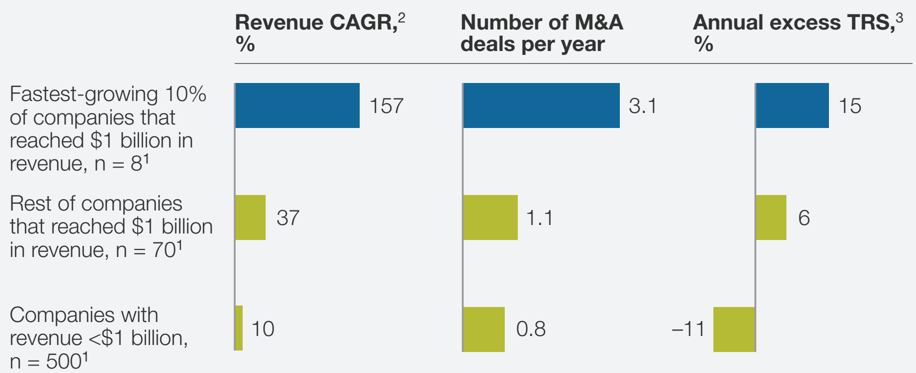
Third, companies that get to $1 billion in annual revenue can *achieve more growth per deal*—a compound annual growth rate of 13 percent, compared with 11 percent for companies that do not reach this threshold. Although a difference of two percentage points is small, the ability to capture more growth from deals adds up when combined with a greater deal volume. This means the acquisition programs of successful companies deliver annual revenue growth of 19 percent on average, almost twice the 10 percent of companies that are unable to reach the $1 billion level.

[3]For more, see Werner Rehm, Robert Uhlaner, and Andy West, "Taking a longer-term look at M&A value creation," *McKinsey Quarterly*, January 2012, mckinsey.com.

So do the fastest-growing software and online-services companies use acquisitions? Yes. When we examined the fastest-growing 10 percent of companies, we found that they all used acquisitions—and that they all had high-volume acquisition programs, delivered the greatest average excess total return to shareholders,[4] and achieved annual revenue growth of more than 100 percent (Exhibit 3).

Exhibit 3

The fastest-growing software and online-services companies use acquisitions and outperform in several areas.



[1]Sample includes companies that earned more than $100 million in revenue after 1995 and that provided multiple years of data while earning revenue of $100 million–$1 billion.
[2]Compound annual growth rate.
[3]Total return to shareholders.

McKinsey&Company | Source: S&P Capital IQ; McKinsey analysis

Our conclusion is that acquisition programs should be robust, and they must build on the core business. It's the combination of organic and inorganic growth that allows companies to survive and delivers excess total return to shareholders.

Successful acquisitions align with growth strategy

It is no surprise that most deals in software and online services appear to be aligned with growth rather than costs. Yet this does not mean that all deals are the same. We identified four common deal archetypes and rationales aligned with accelerating growth:

- *Audience expansion or consolidation.* Once a company has established a successful offering, growth can be supplemented by acquiring a target with an applicable audience or customer base. This can improve the scale of the offering, allow the company to reach new geographies, enhance the credibility of a product or service, and improve the value

[4] Total return to shareholders (TRS) measures the return to shareholders in all forms (for example, dividends and price increases). It is the return if all dividends were reinvested in the stock. We define excess TRS as the annualized return above the average TRS of the sample. It is calculated by comparing TRS with a weighted index composed of the entire sample.

proposition for products that benefit from greater market share. One example of this is the combination of several audiences for travel websites (Expedia, Hotels.com, Hotwire, and TripAdvisor) under the umbrella of IAC. However, executing acquisitions poorly may drive away acquired customers and yield diminishing returns. In such transactions, it's important to pay attention to both existing customers and new customer opportunities.

- *Gap fills.* A company may use acquisitions to fill gaps in its core product or service offering. For example, Salesforce.com's acquisition of Jigsaw allowed it to automate the way it acquired and maintained business-contact data and to improve the value proposition of its core customer-relationship-management offering. A deep technical understanding is critical to ensure that the gap is successfully addressed by the target's offering or intellectual property and that the target can be successfully integrated with the acquirer's existing solutions.

- *Speed to adjacency.* Companies looking beyond their core offering for growth typically pursue opportunities in adjacent markets. In the fast-paced realm of software and online services, organic entry may be too slow. In such cases, companies often use acquisitions to speed their entry. Synopsys, for example, acquired Coverity to expand into the software-testing market. Adobe, Oracle, and SAP are serial adjacency acquirers. The risk of this type of acquisition is that the adjacent market or target company is not as attractive as expected, or that the company does not have what it takes to win in the new market after the acquisition. To address this, companies need to understand their core differentiators and where they have the familiarity to succeed.[5]

- *Acqui-hire.* These deals are focused on securing distinctive talent that can enhance the acquirer's core offering, and the offerings of the target usually are discontinued. When Facebook bought FriendFeed, for instance, the deal brought on board several talented employees, including Bret Taylor, who went on to become Facebook's chief technology officer. The central risks with this type of acquisition are not surprising: the inability to retain employees of the company that has been acquired, and the potential for the acquiring company to overestimate the individual capabilities of the acquired company.[6]

These archetypes illustrate the ways that acquisitions can accelerate revenue growth. Moreover, they show how opportunities could align with an acquirer's growth strategy rather than emanating from a target's current market price, a shared industry, or the opportunity to reduce overhead.

Putting it all together

Software and online-services companies thinking of doing one acquisition per year are actually better served doing no deals. To drive the type of growth required to thrive in the software and online-services sector, acquisitions must be done regularly and treated as a capability that fuels

[5] See Rishi Kant, Eric Kutcher, Mitra Mahdavian, and Kara Sprague, "Grow fast or die slow: Pivoting beyond the core," April 2015, mckinsey.com.

[6] For more on this topic, see Reid Hoffman, "Acquiring proven entrepreneurs is a smart way to innovate," *Financial Times*, May 26, 2015, ft.com.

both organic and inorganic growth. Companies that successfully accelerate from $100 million to $1 billion in annual revenue typically undertake more than two deals per year, use acquisitions to accelerate their core organic growth, and deliberately align the deal rationale with their most pressing growth challenges. In short, what matters is not whether you do acquisitions. What counts is *how* you do them. □

The authors wish to thank Yubing Ji, Rishi Kant, and Robert Uhlaner for their contributions to this article.

Brian Dinneen is a consultant in McKinsey's Boston office; **Eric Kutcher** is a director in the Silicon Valley office, where **Mitra Mahdavian** an associate principal; **Kara Sprague** is a principal in the San Francisco office.