McKinsey&Company

McKinsey on Finance

Number 39,
Spring 2011

Perspectives on Corporate Finance and Strategy

When big acquisitions pay off

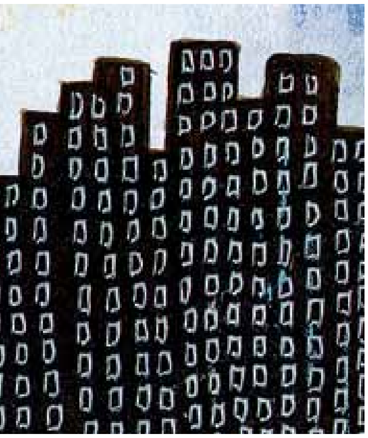
Some are quietly creating value that doesn't make the headlines. Here's how.

Ankur Agrawal, Cristina Ferrer, and Andy West

Big mergers and acquisitions make for splashy headlines, but do they make financial and strategic sense? Executives, board members, and investors are wise to be skeptical. Such deals—worth 30 percent or more of the acquirer's market capitalization—are extremely complex. And as high-profile failures have demonstrated, big deals can destroy significant value for shareholders.

Big deals can create significant value for the acquirer, however, even if success takes time to unfold. Indeed, in our analysis of such deals over the past decade, half had created excess returns to shareholders when measured two years after the deal's completion.[1] In one-third, returns were significantly higher relative to the industry average.

The difference between success and failure often comes down to strategy. Only a few situations give companies a clear, compelling reason to take on a big deal's risks and integration complexity. Companies with few options for organic growth, for example, can use a large deal to enter a new sector or market quickly. Those in consolidated industries, such as oil and gas or mining, can find success in big deals when other options are limited and major economies of scale exist. And on the rare occasion when a large target company is a very clear strategic fit with the prospective buyer, a big deal can improve an acquirer's growth and performance rapidly.



But a successful deal also results from strong execution. In case studies of nine of the best-performing deals and six of the worst in our dataset, we found that successful acquirers employ several approaches to execution and integration that are different from those used by unsuccessful ones—and different from those typically used by acquirers in smaller deals. Successful acquirers set performance targets higher than due-diligence estimates of a merger's value. They reject the common idea that an acquisition represents an opportunity to adopt the best of two companies' cultures. Finally, their CEOs focus their involvement on a few most critical areas.

Aiming higher than due diligence

In the hectic pace of integration after a deal closes, many integration managers adopt the synergy estimates calculated by the pre-deal due-diligence team as performance targets. Yet how much a company pays for a deal isn't necessarily the same as it's worth. Even the best due-diligence efforts can be only so good. They're often constrained by time and access to data. They typically focus on whether expected cost synergies alone can justify a deal, placing more emphasis on how much could be saved by eliminating redundant functions, facilities, people, or products and much less on how much can be gained through growth. To compound the error, as individual managers weigh the uncertainty of due-diligence estimates against their own performance risk, they often translate synergy estimates into even more conservative—and easily achievable—cost and revenue targets.

Yet, as our case studies suggest, companies that reassess their synergy targets after a deal closes seem to achieve higher synergies than those that don't. These more ambitious companies use pre-deal estimates of synergies not as performance targets but as a performance baseline—the minimum they expect. In fact, in a survey on corporate transformations that included mergers and acquisitions, executives managing deals in which baseline aspirations were reset by a number of robust facts after a deal was reached were four times more likely to characterize those deals as very or extremely successful than executives whose baseline aspirations were not reset.[2]

The successful acquirers in our case studies reset their aspirations by identifying opportunities to transform the business and then building a fact base to support those opportunities. Sometimes they came from fundamental changes to operations or from providing customers with new products or services that hadn't come up in due diligence—or weren't investigated, as a result of limited time or information access.

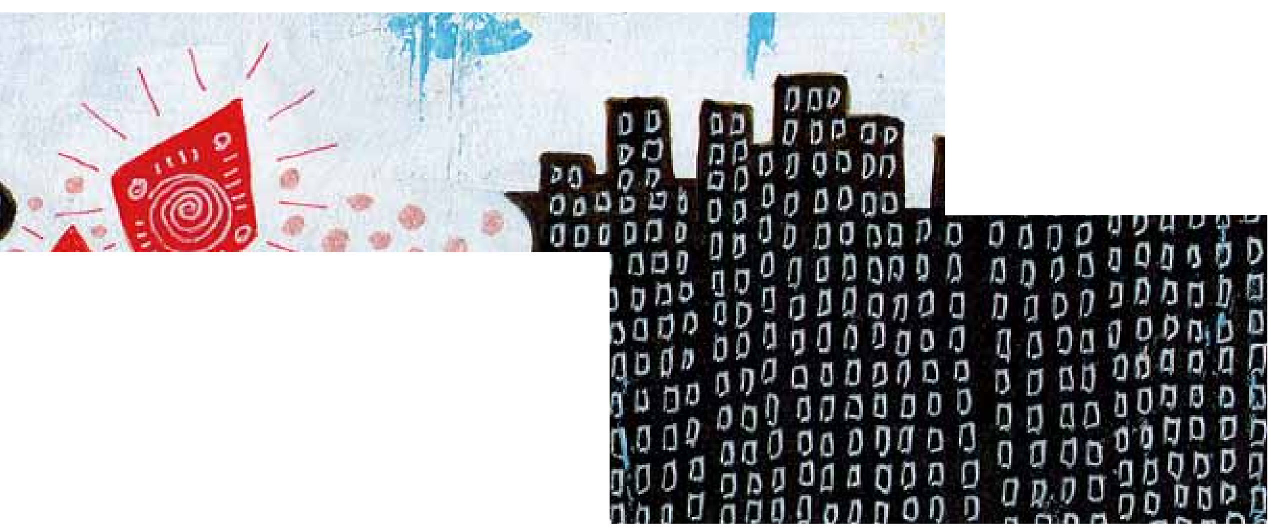
After a merger between two global mining companies, for example, the acquirer had more access to details on the overlap between its own and the target's customer base and suppliers. Previously confidential information on the terms and conditions of sales agreements—and the needs and expectations of customers—led to unexpectedly high levels of cross-selling and bundling between the target's and acquirer's products, as well as unexpectedly lower input costs, thanks to improved supply chain management. While these considerations were not a large part of the original investment thesis, they were a major part of the deal's success, improving the combined company's earnings before interest, taxes, depreciation, and amortization (EBITDA) by more than 20 percent.

Similarly, when a North American packaged-goods company reviewed its synergy targets after a deal's close, managers learned that the target company's marketing strategy was better than its own. Importing those and other best practices helped the company realize synergies 75 percent above due-diligence estimates.

Setting such aggressive target estimates requires individual leaders to leave their comfort zones and share aspirations. Workshops encouraging the joint exploration of opportunities can help. Senior managers of one large deal in the pharma industry, for example, summoned teams from different backgrounds to a three-day off-site event. It started with an idea generation session where each team compiled a list of growth-related opportunities. The group then assessed each of the opportunities, ranking them by size and priority, and eventually developed a high-level implementation plan. In three days, the group did not discuss the due-diligence model or its synergy estimates. In the end, the acquirer uncovered more than 40 percent more synergies and rebalanced its synergy expectations significantly across teams. In addition, the teams were motivated by their targets and believed they were achievable—a much better outcome than being allocated a target based on a brief due-diligence period.

Higher performance targets have their challenges, of course, and to meet those targets companies must have the right kind of managers. In a broad-based survey on organizational health,[3] managers at the most successful acquirers reported having a higher-than-average sense of accountability, as well as inspirational and authoritative leadership. Developing those traits requires companies to create an environment that encourages managers to take calculated risks and gives them confidence to aim beyond the original size and scope of the synergy targets. Such an environment includes clearly defined managerial roles, strong links between individual performance and consequences (positive and negative), and attractive incentives for high performers.

In one case study, for example, a global bank in a large acquisition actively encouraged managers to develop ambitious business plans and provided the resources to pursue them. Managers were generously rewarded for meeting their goals but also faced consequences if they failed: those



In our case studies, the leaders of successful big deals typically focused in a meaningful way on only one or two areas where their involvement mattered most.

who missed agreed-upon targets for a third time were let go. All of these attributes can—and, if possible, *should*—be developed long before a large deal is under way. In fact, in our transformations survey, respondents in companies that focused on building capabilities before an acquisition were twice as likely to describe it as successful.

Asserting cultural control

It's not uncommon for an acquiring company to assert control over the culture of the acquired one—if it is small. But many executives have been reluctant to do so with really large deals, taking instead a merger-of-equals posture or one purporting to adopt the best of each company's culture. That approach, we find, typically leads to confusion and reduces accountability, hindering integration and lengthening the time needed to get past integration and on with running the business. In fact, in our case studies' examination of culture, the biggest difference between successful and unsuccessful large deals was the recognition in the former that one culture inevitably tends to dominate. Unsuccessful acquirers typically discovered that the emerging dominant culture wasn't always the best fit for the deal's strategic intent.

In successful deals, companies acted more purposefully. They started by building a fact base to identify cultural differences, focusing on extremely targeted improvements to the acquiring company's culture, if needed. Then they spent the majority of their time explaining the differences and helping acquired employees understand what they needed to do to migrate to the culture of the new organization. Finally, they aggressively managed that migration. This sounds intuitive but is quite different than what happened in many of our unsuccessful case studies, where promises of "best of both cultures" resulted in high aspirations supported with little transitional support and, ultimately, an unfair playing field for acquired employees.

Managers of a large international media deal, for instance, started with a survey of cultural performance, management practices, and outcomes. The survey identified nine dimensions of culture, and the data it generated gave managers a benchmark of each company's position on performance. These managers then used that data to inform discussions with the integration leaders, so that everyone understood the differences between the cultures, and then to identify very targeted improvements and shape the language and messaging to the merged company. Finally, they created an "on-boarding" program that helped acquired employees understand what to expect and how to succeed. The topics included how the acquiring company conducted performance reviews and financial planning, set and communicated goals, and enforced accountability. At some levels, the program even included getting people comfortable with little things that would "feel" very different, such as the reimbursement of expenses, laptop policies, and time and expense reports.

There are exceptions when an acquirer wants to leave cultural gaps in specific areas or to protect a specific capability by creating a distinct culture in parts of the business. An acquirer that relies on top-down innovation, for example, may want to retain the entrepreneurial culture of a target's R&D department. But this approach should be restricted to cases when the uniqueness of the target's culture creates value—and the acquirer makes the needed investment to keep a culture separate by forming clear organizational and operational boundaries.

When one North American high-tech company acquired a target with a potentially disruptive new technology, for instance, it found that the investment required to protect the target's culture was at least equal to the cost of integrating it. The effort, which lasted five years, required a senior executive to manage all interactions full time, changes to the parent company's HR policies and systems to meet the target's needs, flexible financial reporting and budgeting that fit the target's operating model, and forgoing almost all cost synergies from redundant operations. Yet the investment proved to be very worthwhile; the asset flourished under new ownership and significantly exceeded expectations.

Balancing CEO involvement

Demands on the CEO's time can be overwhelming after a large deal because of the magnitude, complexity, and risk of integrating a large company, typically of comparable size. The CEO's involvement is critical for the deal team to maintain focus and energy; transformation survey respondents were six times more likely to describe deals as successful when the CEO was significantly involved. Yet not every decision or risk demands the CEO's attention, and in a large deal the CEO cannot spend adequate time on every issue that might merit his or her attention in a smaller deal.

The degree of focus may be surprising: in our case studies, the leaders of successful big deals typically focused in a meaningful way on only one or two areas where their involvement mattered most. Everything else, they delegated to an empowered group of senior leaders. The CEOs could therefore focus on protecting the base business even as they pushed the organization to realize the deal's full potential. In one global oil-and-gas merger, for instance, the CEO met with his acquired top team—the target company's CFO and the CEO—for several hours every few weeks, with explicit instructions that they bring only the most challenging issues to the table. All other integration updates and process-related issues fell to the integration leader, who escalated them only if necessary.

Delegating this much authority and responsibility requires CEOs to encourage others to think and act imaginatively without explicit CEO input. This approach is critical to uncovering transformational synergies. CEOs should thus create risk-free environments for generating and evaluating ideas and bring in outside experts (including academics, private-equity partners, and consultants) who can foster creativity. In the organizational-health survey, successful acquirers scored 1.5 times higher than average ones in the frequency with which they used external ideas or outsourced expertise.

The CEO's intervention is critical to overcome biases in performance evaluation systems, often structured toward short-term, organic goals. To help organizations pursue higher aspirations, CEOs should review their top-management incentive systems to make sure they reward people who aim to realize long-term transformational synergies that frequently require otherwise-avoidable short-term investments.

[1] We looked at all 197 deals, from 2000 to 2009, completed by the largest 1,000 companies as of 2009 by market cap where the value of the deal exceeded 50 percent of the acquirer's value. We then excluded deals for which financial data were incomplete and deals done in the financial, energy, or mining industries, where valuations were excessively volatile. In selecting case studies, we expanded the analysis to include five deals worth 30 to 50 percent of the acquirer's value.

[2] The online survey was in the field from January 19, 2010, to January 29, 2010. It elicited responses from 2,512 executives representing the full range of regions, industries, functional specialties, and seniority. The survey's initial results were published in "What successful transformations share: McKinsey Global Survey results," mckinseyquarterly.com, March 2010. Our analysis looked only at the responses from executives working for companies whose transformations involved a merger.

[3] This survey was completed by more than 600,000 employees of 500 organizations globally between 2003 and 2010; our analysis focused on the nearly 4,000 respondents in companies that had completed a large acquisition. Complete results will appear in Scott Keller and Colin Price, *Beyond Performance: How Organizational Health Delivers Ultimate Competitive Advantage*, Hoboken, NJ: Wiley & Sons, June 2011.

The authors wish to acknowledge the contribution of Theresa Lorriman to the development of this article.

Ankur Agrawal (Ankur_Agrawal@McKinsey.com) and **Cristina Ferrer** (Cristina_Ferrer@McKinsey.com) are consultants in McKinsey's New York office, and **Andy West** (Andy_West@McKinsey.com) is a partner in the Boston office.