

# A simple M&A model for all seasons

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**A**cquisitions are a risky growth strategy, offering worse odds than a coin flip for most acquiring firms. Nonetheless, for many companies, the allure of deal making is irresistible – often because their alternative strategies for growth are even less promising. To mitigate the risk of failure, companies need to acquire prudently, following the best practices of successful dealmakers. The problem is, there's little consensus on what constitutes a proven acquisition model.

To discern patterns of success, Bain & Co. initially studied 724 US-based firms over a 15-year period from 1986 to 2001. The study was eventually expanded to include a total of 1,693 of the largest publicly held companies in the US, the UK, France, Germany, Italy and Japan. We asked, "What is it about a company's approach to deal making that engenders success?" and "Are winning strategies transferable?" The firms in our study each had at least \$500 million in revenues in 2000 and were all publicly owned in 1986. We compared the firms' acquisition behaviors across 11,049 deals with the excess return they delivered to shareholders over the 15 years to see whether there was any connection (excess return we defined as the total return to shareholders, including dividends, minus the cost of equity).

We found that the companies most successful at creating long-term shareholder value tend to be frequent, steady acquirers that maintain a constant program of transactions throughout both economic busts and boom times. These frequent buyers are able to outperform those that acquire episodically because they've learned from experience. Typically, the frequent acquirers cut their teeth on small, lower-risk deals before they tackle the big deals. They build an organizational capability and institutionalize M&A processes to help ensure that deal fever does not overwhelm rational decision making.

## Hone your game through practice

In our study, frequent acquirers outperformed all other companies. On average, the more deals a company did, the more value it delivered to shareholders. In fact, we found that frequent

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acquirers outperformed occasional buyers by a factor of 1.7 and non-buyers by a factor of almost 2 to 1 (see Exhibit 1.)

Consistent buying throughout economic cycles also appeared to make a difference. Frequent acquirers that bought constantly, through both economic slumps and expansions, were by far the most successful. They outperformed companies that bought primarily in growth periods by a factor of 2.3. The recession buyers did second best, outperforming the growth buyers by a factor of 1.4.

The logical conclusion: the most successful acquirers are always on the hunt for deals. They approach acquisitions in somewhat the same way that dollar cost averagers approach mutual fund investments. They buy low; they buy high. Above all, they buy systematically – winning both as a rising tide lifts stock prices or, even more so, by picking up assets in down markets at fire-sale prices.

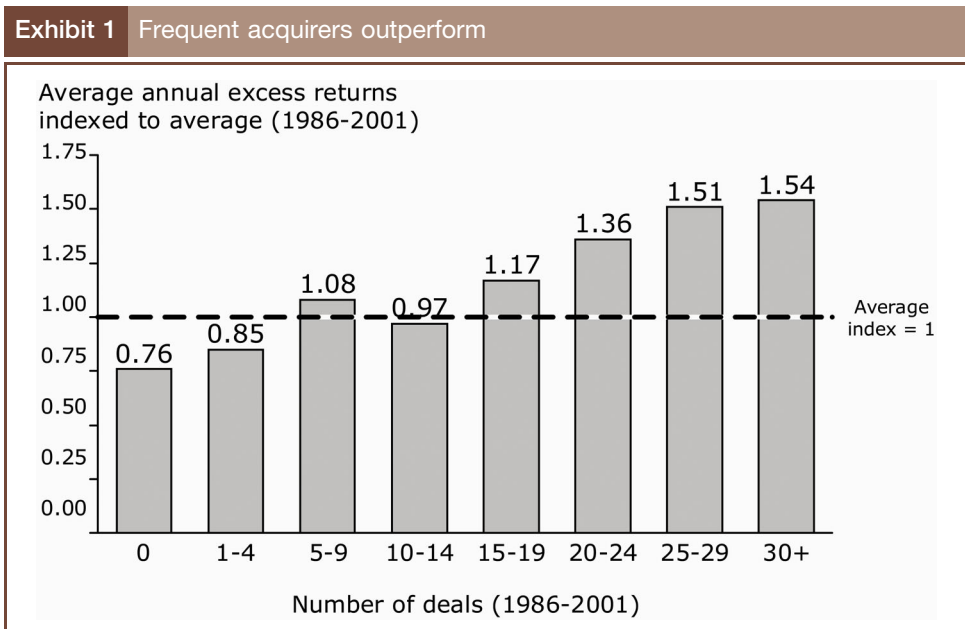
### Start small, then ramp up

There's another marked difference between the successful acquirers and the unsuccessful ones: the nature of their deal making. The companies that enjoyed the highest returns were those that focused on small deals, or targets that were less than 15 percent of their own size on average. Those acquirers outperformed the ones taking bigger bites by a factor of almost 6 to 1.

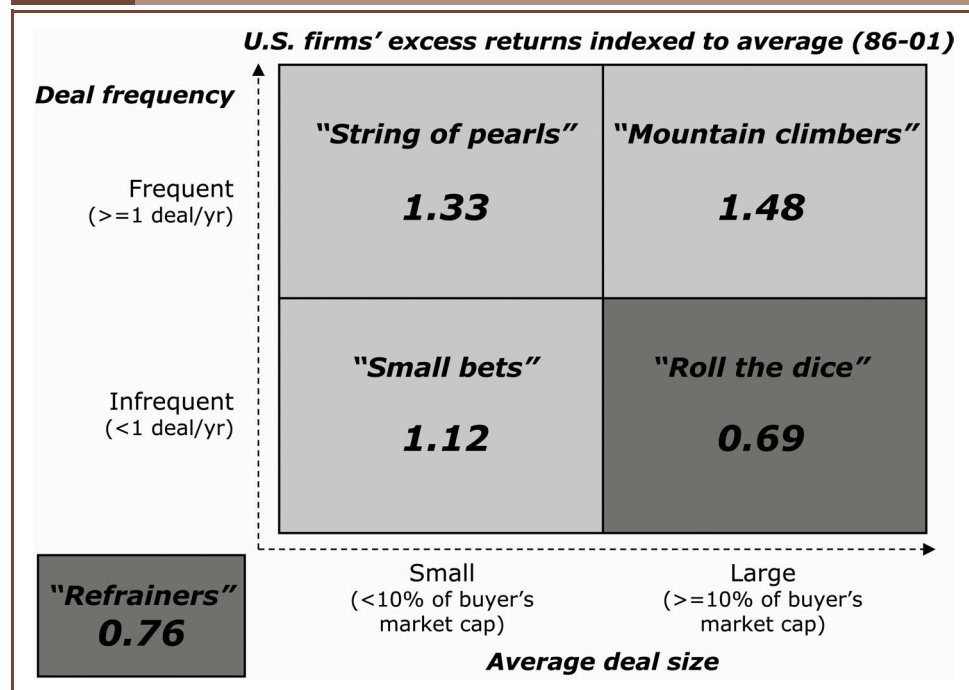
When you combine the two key deal-making criteria – frequency and deal size – five key strategic approaches to acquisitions emerge:

- (1) mountain climbing – making frequent acquisitions by starting with small deals and ramping up to larger ones;
- (2) stringing pearls – making frequent acquisitions that focus on small targets;
- (3) betting small – making infrequent acquisitions of small targets;
- (4) rolling the dice – making only a few big bets; and
- (5) refraining – not doing acquisitions at all.

The riskiest strategy, our research shows, is to make a couple of big bets (see Exhibit 2). Nonetheless, a handful of companies do actually make this approach work, and in highly consolidated, mature sectors, there may be no other option when an opportunity arises but to do a big deal to gain market share and economies of scale. The number of companies that have tried it and won, however, is small.



**Exhibit 2** The penalty is greatest for rolling the dice or sitting on the sidelines



One reason that infrequent buyers that do large deals post low returns is that the hurdles of merger integration are much harder for them to clear. The difficulty of integrating an acquired company rises almost exponentially with its size. The larger the target, the more likely a management team is to lose focus on both businesses, with attendant declines in share price or profitability or both. Frequent acquirers that work their way up from small deals to big deals, in contrast, build on their experience along the way and gradually learn to master the challenges of integration.

#### Avoid rookie mistakes

Infrequent acquirers tend to be more opportunistic, buying a business simply because it's available rather than because it fits their strategy. They're likely to lack the organization and processes needed to spot a deal's red flags and potential black holes or to measure revenue and cost synergies presented by the acquisition realistically. They may evaluate the deal without consulting the operations managers on the front line who are best positioned to assess the quality of the target and usually responsible for later integrating the acquisition. In sum, they make rookie mistakes.

Without a structured M&A process and experienced deal makers, infrequent buyers can succumb to "deal fever", getting so caught up in the excitement of making an acquisition, however misguided, that they just can't stop.

Veteran acquirers know better. They organize for opportunity. They set up a standing deal team and create a deal playbook, involve line managers early in the buying process, and put in place checks and balances to cool deal fever and maintain a rational, dispassionate approach.

#### Build a standing deal team

Successful acquirers build an experienced corporate deal team that gets involved in all acquisitions. Developing such core M&A expertise allows a company to pursue opportunities proactively or to strike rapidly when the right deal hits the block. The team establishes institutional M&A procedures, creating clear guidelines for the purchase and integration of acquisitions. It updates its codified guidelines at the conclusion of each deal by conducting a deal postmortem.

Clear Channel Communications Inc., which has spent more than \$40 billion since 1986 to build a leading market position in radio, outdoor-advertising displays, and live-entertainment venues, offers a good example of how to play the M&A game to win. The company started making acquisitions in the early 1970s, accumulating 43 radio stations and 16 TV stations by the time the US Congress deregulated the industry in 1996. When restrictions on radio ownership were lifted, Clear Channel had gained enough experience in buying stations, one at a time, to lead the ensuing industry consolidation. By 2003, Clear Channel had grown to about 1,200 radio and 40 TV stations in the US, five times more stations than its closest competitor, Viacom International Inc.

In addition, Clear Channel had accumulated equity in 240 international radio stations and had diversified into outdoor displays and live entertainment.

The financial results of Clear Channel's acquisition-driven growth strategy have been exceptional. Between 1986 and 2001, the company increased its revenues by 46 percent annually. It also generated a 36 percent average annual shareholder return, which was 21 percent higher than its cost of equity.

At Clear Channel, a central M&A team at company headquarters in Dallas drives the M&A process. However, the company also has local M&A teams in each of its three major divisions – radio, outdoor displays, and entertainment. At headquarters, the three-person M&A team is part of the finance function, reporting to CFO Randall Mays. The corporate M&A team examines any acquisition larger than \$100,000 and gets more involved on deals worth more than \$20 million. It always sets a “walk-away price” for each deal, above which it simply won't pursue the acquisition.

The central team imposes clear criteria for making any purchase. Acquisitions are weighed against one another, as well as against debt repayment and share buybacks, to ensure that any capital invested will earn the highest projected rate of return. Clear Channel's financial criteria for cash and stock deals are stringent, reflecting its cash-flow discipline. The central team also provides each division with its own standard, two-page due diligence checklist, which includes questions on how the acquisition fits into existing operations, its competitive positioning, its ratings (for radio), other potential acquirers, and, of course, financial projections.

Each of Clear Channel's three divisional M&A teams reports to the divisional finance chief, who reports to Mays. That's Clear Channel's way of making sure that acquisitions get incorporated into the division's long-term cash projections, which are generated and maintained by the finance groups.

#### Involve line managers early and often

Regardless of the core deal team structure, successful acquirers always bring line management into the M&A process at an early stage. In fact, they wouldn't make a deal without the approval of the operating personnel, the people who will later be running the acquired business.



Washington Mutual Inc., a frequent acquirer, understands that. Over the years it has grown from a small Seattle thrift into one of the nation's top consumer banks, with more than \$280 billion in assets. Washington Mutual is now the number one national player in mortgage servicing and a close number two to Wells Fargo in mortgage originations. From 1986 to 2001, a quiet but aggressive buying spree helped it boost revenues by 31 percent annually. The expansion has been good for shareholders. In that same period, Washington Mutual's average annual shareholder return was 24 percent, or 9 percent over its cost of equity. The company's success is even more striking when you consider how many banks and brokers have struggled to make acquisitions work.

As one of the main pillars of its success, Washington Mutual sees to it that line management gets involved early and frequently. Craig Tall, vice chair of corporate development and specialty finance, leads a six-member core deal team, internally referred to as “the quarterbacks of the transaction”, which

### About the research

This article is based on a global study of 1,693 of the largest publicly held companies in the US, Europe (the UK, France, Germany, Italy) and Japan, and the more than 11,000 acquisitions they made in the period from 1986 to 2001.

<i>Region</i>	<i>No. of firms</i>	<i>No. of transactions (1986 to 2001)</i>
US	724	7,476
Europe (UK, France, Germany, Italy)	293	2,879
Japan	676	694

In the first segment of the study, we compared the 724 American firms' acquisition behavior with the excess return delivered to shareholders. We followed up in 2002 with similar studies of European and Japanese firms.

As a result, we identified a score of acquirers that we could learn from, and conducted in-depth interviews with their executives, drawing out insights about their M&A approach. In doing so, we uncovered one of the major reasons why frequent acquirers outperform: they organize and institutionalize their M&A processes.

That insight and others discussed in this article were corroborated in a Bain survey of 250 executives active in deal making around the globe, conducted in December 2002. In the survey, we tried to determine what executives perceived as the root causes of success and failure in deals overall and in the various stages of the M&A process.

Finally, in early 2004, we shifted gears to study more specifically the success of deals, rather the performance of acquirers over the long term. In this study, excess return was defined as the total return to shareholders, including cash and stock dividends, minus the average total shareholder return for the acquirer's relevant sector index. Effectively, we compared an acquirer's stock performance with that of its peers, from one month before the announcement of a deal through to 12 or 24 months after the announcement. The study confirmed the dismal odds of deal success, with less than 30 percent of major deals creating significant shareholder value, defined as a 10 percent or greater increase in share price.

picks and analyzes acquisition prospects. Tall's team does not act alone but seeks advice and help from the business-unit leaders who know operations best. They join the team in evaluating targets, providing invaluable help during the due diligence process to make sure that the right decisions are made, and that the price is right. "You're asking the people who are going to inherit what you're buying to help assess what they're going to get", says Tall.

Early help from the front lines can also give acquirers a jump on integration. "We get early understanding and early buy-in from business units and the corporate people on who the targets are, why it makes sense, what kind of benefits we'll get, what kinds of hiccups they might be having", says Tall. "When an acquisition is consummated, they're already fully engaged, they've bought in, and they know what they're going to get. They have been asked to think about what they'd do with it if they were to get it".

#### Find ways to kill deal fever

Perhaps most important in the overall scheme of things, companies that beat the odds in M&A are prepared to walk away from a bad deal. They insist on high-level approval of deals and often use the compensation system to encourage executives to ward off ill-considered acquisitions. Like Clear Channel, they also set a walk-away price.

This last step is crucial. Consider a finding from a recent Bain survey of 250 executives. Respondents cited "allowing politics or emotions to interfere with decision-making" as the greatest due-diligence challenge. Successful corporate buyers excel at resisting risky deals.

Cintas, a Cincinnati-based uniform supplier, offers a compelling example. In the 1960s, Cintas Corp. began making acquisitions to expand its uniform-rental business in markets outside Cincinnati. It bought hundreds of companies, systematically, in boom times and bust. Those moves bumped Cintas up to leadership in its sector and lifted its stock price 20-fold in 15 years. Cintas vice chairman and former CEO Robert Kohlhepp says any deal, even a small one, needs

“ The five playbook secrets of successful acquirers are: get into the game in good times and bad; start small; create a core deal team; pull line management in early; and chill deal fever. ”

scrutiny from a cool, dispassionate executive who hasn't been swept up in the heat of negotiating the deal and the toil of due diligence. So every deal requires approval from one of three senior executives, including Kohlhepp, who have remained apart from the day-to-day acquisition process. On large deals, the board must give its blessing and set a price limit. If the acquisition is a new business, the CEO has to approve the deal. "We don't want people going off the beaten path without the top people in the company knowing what we're doing and why", says Kohlhepp.

Why does Cintas do it that way? "There were a few companies that we bought that in retrospect I said we should not have bought", said Kohlhepp. "When I looked at why we bought those companies, a lot of little things . . . were wrong". No single problem would have killed the deal, he noted. "But in aggregate, they should have caused us not to make the deal".

He continues: "The thing you have to guard against the most is that the M&A group and the operating people want to make deals. The M&A group gets their papers graded on how many deals they make. The operating people want to grow. The more they grow, the more they're responsible for, and the more their potential income. Therefore, you need discipline at a high level. You need somebody who's not right in the middle of the deal, who has an objective viewpoint, making sure we're not going ahead to make a deal just to make a deal".

Successful acquirers often use the compensation system to kill deal fever. These companies do not tie the compensation of any of the people involved in the acquisition to the completion of the deal. Instead, M&A teams and other deal participants usually get paid according to the financial performance of the firm. It's a powerful incentive to resist the temptation to buy expensive companies in the heat of the chase.

At Clear Channel, the line operators have to sign off "in blood", as Mays puts it, on the cash flows that the acquisitions will deliver. Their future compensation is tied to meeting the division's cash-flow projections, which include results from those acquisitions. The M&A teams' pay is also tied to the contribution that acquisitions make to the company's financial performance. At year's end, the M&A teams and division presidents meet Mays to study every acquisition they made in the previous three years and see if those deals delivered what they promised. And, at the same time, the M&A teams and Mays review compensation issues. As Mays puts it, "the deals they make are tied to them forever".

#### The bottom line

Though the history of M&A is littered with deals that destroyed shareholder value, the winners point the way to success. Our analysis of the companies that succeed at deal making and integration shows that they share some key characteristics, which can be boiled down to this simple playbook:

- (1) **Get into the game in good times and bad.** If you're not doing deals, your odds of outperforming go down relative to your competitors that buy steadily. Do not try to time the market.
- (2) **Start small.** Cut your teeth on smaller, lower-risk deals before you try the big ones. Build your team and your expertise in an environment where mistakes will have the least impact.
- (3) **Create a core deal team.** Set up a standing team that will keep gaining transactional experience and will not be subject to much turnover. It could be at the head office or in the field. It's critical that the same core team get involved in all deals. Buying companies is too risky to be done by rookies who are learning the process as they go. Devise clear guidelines

for the purchase and integration of acquisitions in advance. Institutionalize the processes and find ways to capture the knowledge learned from each acquisition.

- (4) **Pull the line in early.** Ensure that line managers buy into the deal and that they know what they're buying. After all, the operators are the ones who will have to integrate the acquisition and make it a success.
- (5) **Chill deal fever.** To cool down deal fever, insist on high-level approvals for deals or set up the compensation system to tie rewards to the long-term success of the business, rather than deal completion. Most important, set a walk-away price and be prepared to walk away from a deal that doesn't meet your high standards.

Companies that can master these techniques have a better chance to practice M&A as a strategy for profitable growth. The secret of success is to capture the knowledge gained from each deal and use it to make the next deal a bigger win.