Wilson Perumal & Company's

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Avoiding the Pitfalls of being an Occasional Acquirer

How infrequent acquirers can learn from the Professionals to execute a successful M&A strategy

Even in the best of times, M&A is a controversial topic with research showing that more often than not, deals fail to create value. Yet despite all the evidence against doing acquisitions, almost 90% of large public companies engage in some level of M&A activity[1]. In fact, there has been a strong resurgence of M&A activity in recent months. What's going on here?

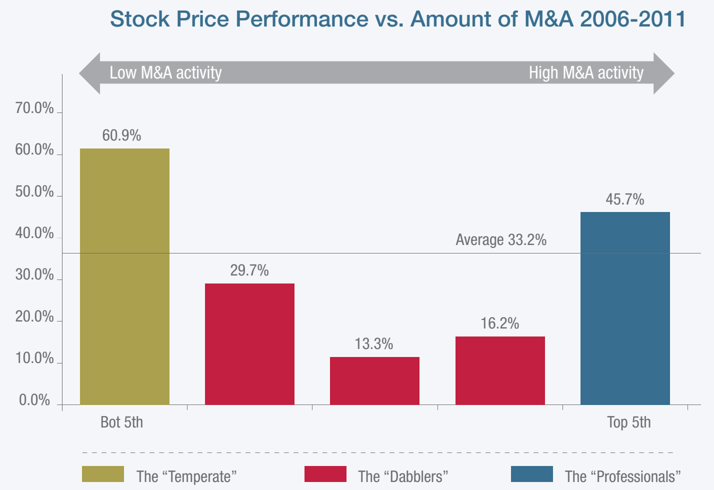
Perhaps everyone believes they are the exception to the rule—that this trip to the casino will be different. The analogy is perhaps not too far afield. In our experience, there are a few rare Professionals who consistently win. At the other end of the spectrum, there are the Temperate; they avoid the risk altogether. And then in the middle, there is everyone else: the Dabblers who quite often lose their shirts.

Fortunately, it doesn't have to be that way. If you understand why some companies are able to continually execute successful M&A strategies, you can tailor your approach to help you tilt the odds in your favor.

M&A activity and stock price performance

To better understand the situation, we first looked at the relationship between M&A activity[2] and stock price performance of large public companies from 2006 - 2011.

As you can see from the below chart, when



[1] Based upon large public companies studied during the time period 2006 – 2011 (n = 258)
[2] M&A activity = percentage of M&A spend relative to size of company (i.e. average amount spent on M&A / 2011 revenue)

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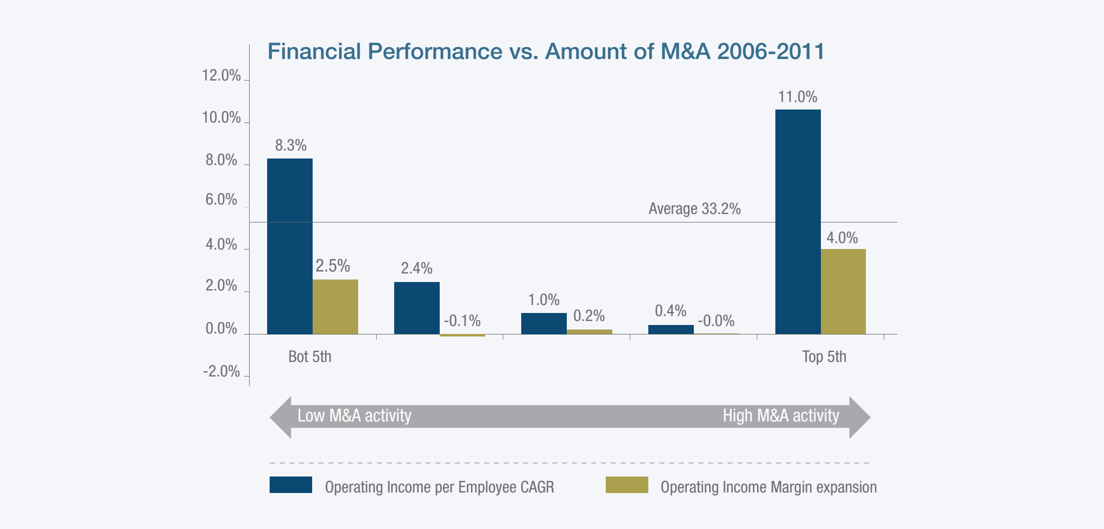
ranked by level of M&A activity from lowest to highest, companies in the bottom fifth (i.e. little-to-no M&A activity) saw the strongest average stock price appreciation. These are the **Temperate**—they generally abstain from the M&A game and walk away winners.

The top fifth are the most acquisitive companies and they also delivered strong stock price appreciation[3]. These are the **Professionals**—M&A is a pivotal part of their growth strategy and they have learned over time how to succeed.

Unfortunately, the majority of companies in the middle make an attempt at M&A but see significantly below average stock price appreciation. These are the **Dabblers**—they dabble in M&A and see sub-par results.

In general, we found that the Temperate and the Professionals displayed two key differences from the lagging Dabblers. First, they saw large improvements in their profit per employee ratio – an indication that they are becoming more efficient over time. Secondly, they were able to translate these efficiency gains into significant margin expansion (i.e. they are able to squeeze more profit from each dollar of revenue they received).

As you can see from the below chart, the highly acquisitive Professionals on the far right are able to significantly expand margins over time with an average of 400 basis points of



[3] Total stock price appreciation from 2006 – 2011

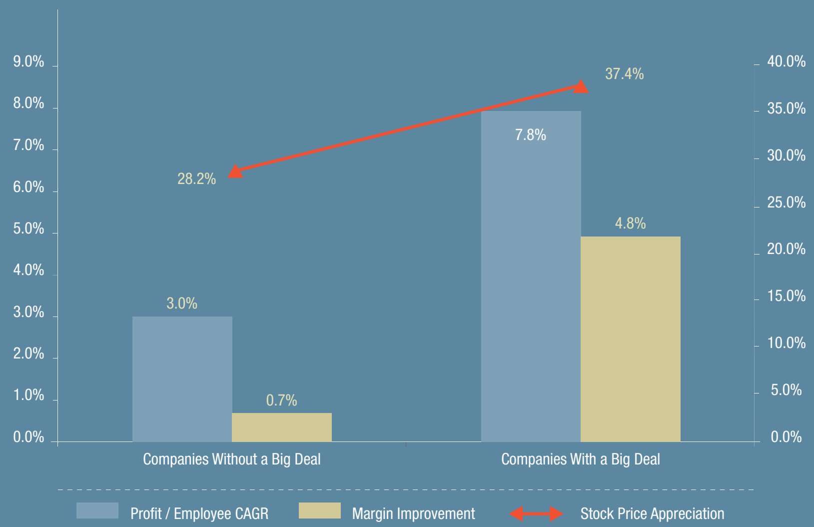
expansion. What is most striking is that despite the large amount of M&A activity they undertake (and the added complexity it brings), they actually see the highest improvement in their profit per employee ratio with an 11% compound annual growth rate (CAGR). In other words, they are becoming much more efficient over time—likely due to the synergies they are able to extract during the M&A integration process.

It's also interesting to note that as impressive as their performance is, the Professionals actually have lower stock price appreciation than the less acquisitive Temperate. Possibly because the large amount of capital (cash and stock) they must deploy in conjunction with an acquisition strategy partially offsets the return they get from synergies.

On the other end of the spectrum, the Temperate with little-to-no M&A activity (those on the far left) saw similar results, though not quite as strong. They delivered a respectable 250 basis points of margin expansion on average. They also saw very healthy improvements in their profit per employee ratio—likely from their ability to realize economies of scale as they grow rather than from M&A-related synergies. And, as mentioned above, the market rewards the Temperate with higher stock price appreciation,

Big deals also create value

"Big deals" are sometimes pointed to as the main culprits behind M&A deals not creating value. However, the results of this analysis show something different. Companies with "big deals" in any of the years studied outperformed those without by a factor of 5.1 with respect to margin improvement. Companies with big deals also saw 2.6 times greater improvements in profit per employee as well as higher stock price appreciation.



even though their financial performance is a bit lower than the Professionals.

Finally, we have the lagging middle section of the Dabblers which represent 60% of the data set. These companies engage in moderate amounts of M&A activity and actually posted strong revenue growth (5.5% revenue CAGR on average). Yet despite this growth, they significantly underperformed. Their margins were flat over the time period studied with many seeing their margins contract. Quite a few of these companies actually became less efficient as evidenced by their declining profit per employee ratio. And it goes without saying that they suffered significantly below-average stock price performance as a result.

Traits of the Professionals

Every industry, every company, and every situation is different. However, based upon this research, we can conclude that the Professionals share a few characteristics that differentiate them from their less acquisitive peers.

For one, they generate the highest level of efficiency improvement over time indicating that they are particularly good at integrating newly acquired companies. The goal of the M&A integration process is to develop and execute a plan that will achieve the highest level of synergies possible without damaging the newly acquired company. Whether from increasing revenue through cross-selling opportunities or eliminating redundant capabilities to lower costs, the end result is the same—increased output with the same or lower level of input.

The Temperate share the same (or greater) level of success as the Professionals but for different reasons—they leverage existing assets to grow rather than deploying capital to acquire new ones. However, the Temperate and the Professionals do share one trait in common. They are both very focused on their chosen growth strategies. The Temperate focus almost exclusively on organic growth, whereas the Professionals focus almost exclusively on inorganic growth (i.e. M&A).

Given all this, we can conclude that the following traits are required to successfully execute an M&A strategy:

- **Practice:** high levels of M&A activity affords Professionals the opportunity to get to advanced points on the learning curve—they practice, learn from their mistakes, and improve. M&A as a part-time hobby is nearly always a recipe for failure.
- **Focus:** Professionals benefit from their intense focus on the M&A process and their commitment to each stage of the deal is absolute. Senior management engages on every deal and they invest in dedicated M&A resources to support the entire deal process—from initial screening all the way through closing and integration.
- **Clarity of Strategy:** clarity is always critical. Emphasis on a clear growth strategy will pay off—whether organic or inorganic. A hybrid strategy may risk confusion, unless the rationale for the deal is explicitly stated and tied to strategic goals.

M&A best practices

Digging deeper, we took the results of our research and asked a variety of M&A professionals from corporations and private equity firms what best practices they've seen that could help the Dabblers improve their performance. Surprisingly, we found that even though the Dabblers may not have the same level of Practice, Focus, or Clarity of Strategy as the Professionals, there were many best practices that could be employed to mimic the behavior and financial results of the Professionals.

1. **It all starts with deal sourcing.** Everyone seems to agree that integration is a critical part of a successful M&A deal process. However, the importance of deal sourcing is often ignored. Companies with clear M&A strategies are able to proactively identify and approach M&A targets with the highest potential for success. And perhaps just as important, they are able to quickly pass on poor deals that don't fit their strategy. Companies without clear M&A strategies approach the deal process reactively and often waste time evaluating bad deals or worse—consummating a bad deal.

2. **Have dedicated M&A resources.** Many companies have dedicated in-house deal teams to help manage transactions, often referred to as Corporate Development. However, the Professionals go beyond that and have dedicated M&A resources in all functional areas (finance, accounting, HR, legal, etc). Follow the example of the Professionals and allow your entire M&A team to focus exclusively on M&A rather than staffing your diligence team as an additional duty. Given the size and scope of most deals, a relatively minor investment here will pay for itself many times over with just one successful acquisition.

3. **Build an M&A team with the right mix of skills.** Finding talented M&A personnel with experience in your industry is relatively easy. What is incredibly rare—but critical to find—is an experienced M&A professional with industry expertise who HAS PEOPLE SKILLS. By focusing on the number of deals a candidate has managed, companies often overlook people skills when hiring M&A professionals. However, M&A deals are a massive cross-business and cross-functional endeavor. If the person leading the charge doesn't have the necessary people skills then deals can, and will, fail.

4. **Be willing to change your company.** Most acquirers seek to impose their will on the newly acquired company and in some circumstances this can be a highly successful approach. However, there are times when this approach will break the newly acquired company. Not only that, there may be many lessons that can be learned from the new company—perhaps a new way to approach R&D or novel processes to keep employees engaged. Don't fall into the ego trap of thinking your company is perfect and that all target companies should be more like you. Be willing to change your company when the circumstances call for it.

Conclusion

So where does your company fit? Are you a Temperate, a Professional, or a Dabbler? Based on our data, there's a 60% chance you're a Dabbler. The good news is that by employing a clear-eyed view of your starting point and your goals, you can replicate the success of the Professionals without having to undergo a difficult–and expensive–learning curve.

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About Wilson Perumal & Company:

Wilson Perumal & Company is a premier management consulting firm and the leading advisor on how to manage and capitalize upon the complexity of today's world. To learn more, visit www.wilsonperumal.com.

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