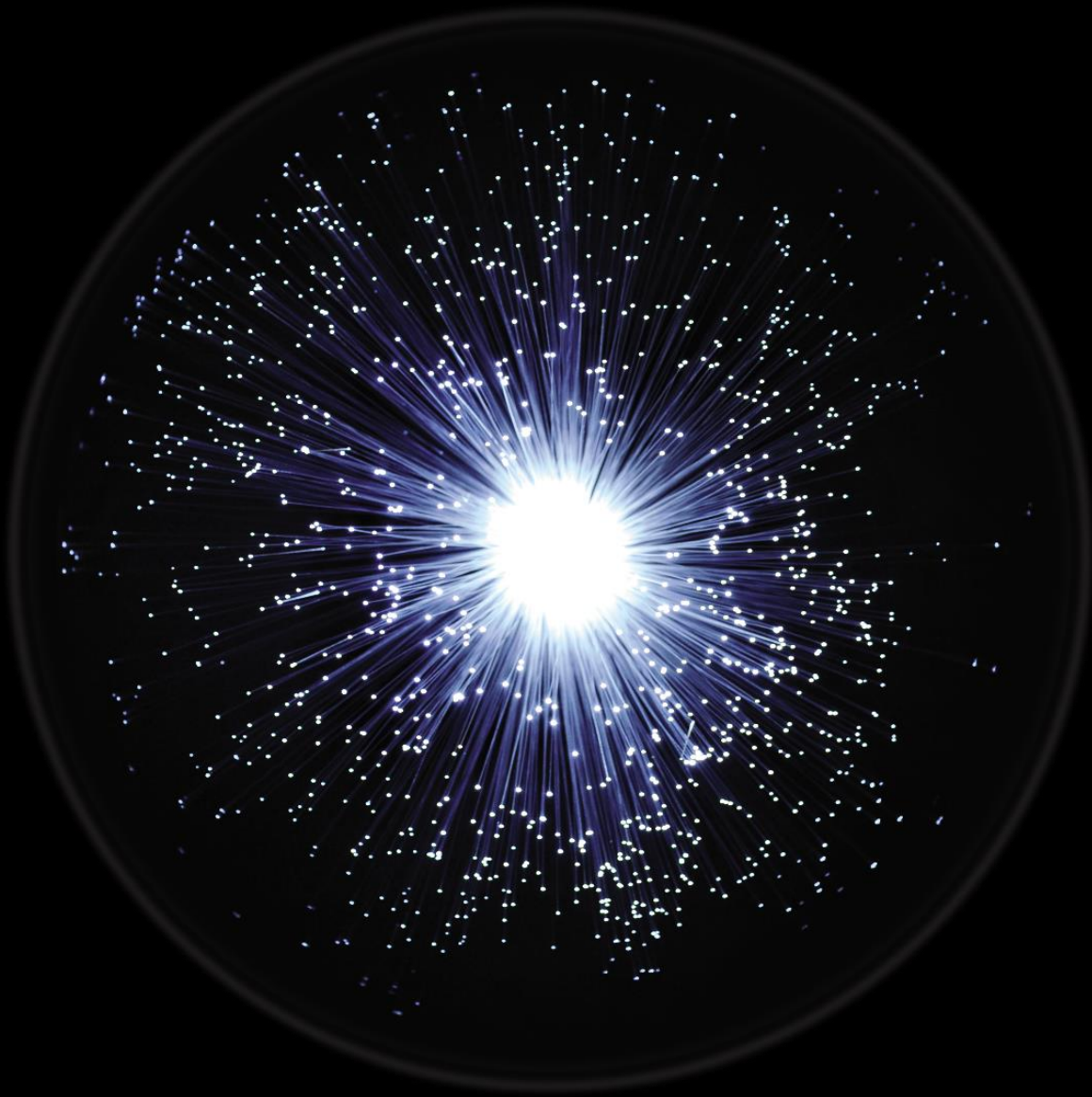


**Deloitte.**



**M&A Making the deal work**

Strategy



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## M&A: A critical tool for growth

By William Engelbrecht and Tanay Shah

Global merger and acquisition (M&A) activity hit a record high of \$4.7 trillion in 2015 and continued its momentum in the first half of 2016 reaching \$1.7 trillion.<sup>1</sup> Although that may prove to be the high-water mark for deal flow, a majority of corporate executives and private equity (PE) professionals nonetheless expect deal activity to remain strong in 2016.<sup>2</sup> Conducive macroeconomic conditions have helped fuel the boom, but astute observers can see an evolving strategic rationale for deal-making.

M&A can be an important means for building scale, improving a target's performance, or removing excess industry capacity, and can fuel long term, profitable growth. M&A's numerous potential benefits dictate that it be viewed as an important arrow in the corporate quiver; ready to be loosed when needed. However, companies should not wait until an attractive target is in view to sharpen their M&A capabilities; proactive planning can improve the odds of hitting a strategic bulls-eye. In fact, Deloitte's *M&A Trends Report 2016: Our annual comprehensive look at the M&A market*,<sup>3</sup> found that corporations are placing more emphasis on developing an M&A strategy in 2016.

The sluggish pace of global economic growth enhances the attractiveness of M&A. In addition, sustained low interest rates, strong US equities markets, cash-rich balance sheets, and increasing business confidence give companies the ability and attitude to pursue deals as a means to grow. In fact, executives' most commonly cited reasons for engaging in M&A are growth-oriented: accessing new customer bases, gaining entry into new geographic markets,<sup>4</sup> and expanding products and services.<sup>5</sup>

Access to new intellectual property (IP) is also an important driver of growth-oriented deals, especially in highly innovative industries such as pharmaceuticals and technology, where IP is a company's lifeblood. Case in point: Over the past five years, the cost to develop a pharmaceutical asset has increased by roughly a third, while average peak sales for the industry have fallen by 50 percent over the same period.<sup>6</sup> M&A provides an additional means of bringing promising therapies into a pharma company's portfolio.

Meanwhile, big technology firms are making headlines for their deal activity (and a fair number of deals are not disclosed or publicized). For instance, a major social media platform company has completed more than 50 deals in its short history, with recent acquisitions adding capabilities in e-commerce, virtual reality, speech recognition, and other fields. Some companies' portfolio of IP-related acquisitions is even more eclectic. Adding credence to this trend, Deloitte's latest corporate development survey reveals that the pursuit of innovation is transforming the M&A landscape. Roughly two thirds of corporate development leaders who responded to the survey said their function has become a more important source of innovation over the past two years, and nearly 60 percent of executives believe that the volume of innovation-centered deals will increase over the next two years.<sup>7</sup>

In the midst of this boom, it is worth remembering that not all M&A deals add value. Thirty-nine percent of corporate respondents and 56 percent of private equity (PE) respondents said that more than half of their transactions completed over the past two years had not generated expected

returns.<sup>8</sup> However, reported failures should not necessarily discourage companies from pursuing M&A. Well-developed due diligence, valuation, and integration capabilities can anchor an effective risk mitigation strategy. There is enough knowledge and experience among the M&A community and associated professionals that properly prepared acquirers can expect to gain considerable financial and competitive value from their M&A pursuits.

M&A is expected to remain a critical tool for growth and long-term shareholder value-creation. Management teams planning to engage in strategic deal-making should focus on building internal M&A capabilities and partnering with experienced advisors to improve their chances of hitting a bulls-eye.

## End Notes

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## The Crux of Corporate Strategy

### Building an advantaged portfolio

By Mike Armstrong, Jonathan Goodman and Gavin McTavish

One of the central objectives of corporate strategy is for executive management to think holistically about a company's portfolio of businesses—conceiving and spearheading ways to make the aggregate value of a company's holdings durable over time, and greater than the sum of its parts. This vital mission comprises two central questions: In which businesses should we participate? And, how do we create value within and across<sup>1</sup> our businesses? In other words, where will we play and how will we win<sup>2</sup>, at the portfolio level?

Monitor Deloitte has found<sup>3</sup> that the most successful portfolios typically exhibit three broad characteristics: They are *strategically sound*, *value-creating* and *resilient*. Perhaps this seems obvious. But in our experience—maybe because it requires consideration and testing across a wide range of attributes—companies seldom apply this tripartite “Advantaged Portfolio” approach.

In this paper, we explore the characteristics of an Advantaged Portfolio and the trio of attributes that constitute each (Figure 1). These attributes in aggregate are key to fully assess, assemble and maintain a top-performing corporate portfolio. A company may need to include additional company-specific criteria to meet its specific goals and aspirations,<sup>4</sup> and the specific weighting of attributes will vary by company. But the nine attributes noted in Figure 1 are “default” criteria that may be relevant in a wide range of portfolio contexts.

Executives, academics and consultants have devised numerous frameworks for building and sustaining an optimal corporate portfolio. Our experience suggests that any successful portfolio design framework (as distinct from the portfolio itself) should have three important features: It should be multi-dimensional in its criteria because portfolio evaluation and construction cannot be reduced to a simple 2 x 2 matrix; it should focus on the performance of the portfolio

as a system (i.e., how the parts interact), not just on the individual components; and it should be tailorable to the company in question, since each company has different goals and aspirations. The Advantaged Portfolio framework is designed to meet these criteria.

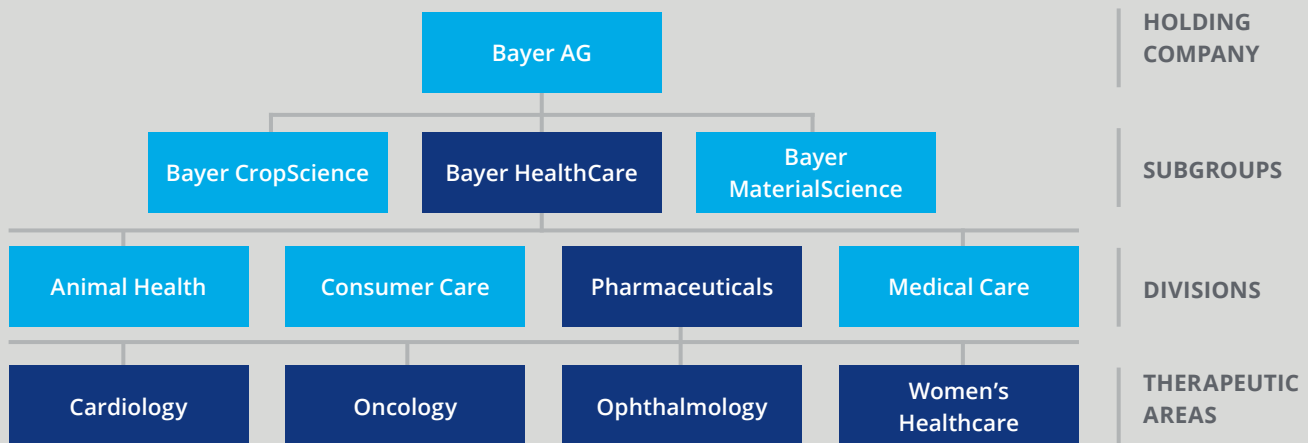
Figure 1: Characteristics of an Advantaged Portfolio



**What Is a Portfolio?**

In a corporate strategy context, a portfolio is the collection of businesses than an organization chooses to own or invest in. Portfolios can exist at multiple levels within a company. In a corporate-level portfolio, the unit of analysis is the strategically distinct business (SBD), each of which has distinct competitors, geographies, etc. SBDs may or may not correspond to a company's organizational business units or reporting units. Portfolios also can exist within a business unit, a division, or even a product line, as depicted in Figure 2 by Bayer AG's multiple sets of portfolios. The correct unit of analysis for a portfolio will change based on the level of the portfolio being assessed.

**Figure 2: Portfolios Can Exist at Multiple Levels of an Organization**



# An advantaged portfolio should be strategically sound



An Advantaged Portfolio, first and foremost, should be strategically sound. That means it should foster a strong competitive position, support multiple levels of innovation, and create synergy.

## Competitively Positioned

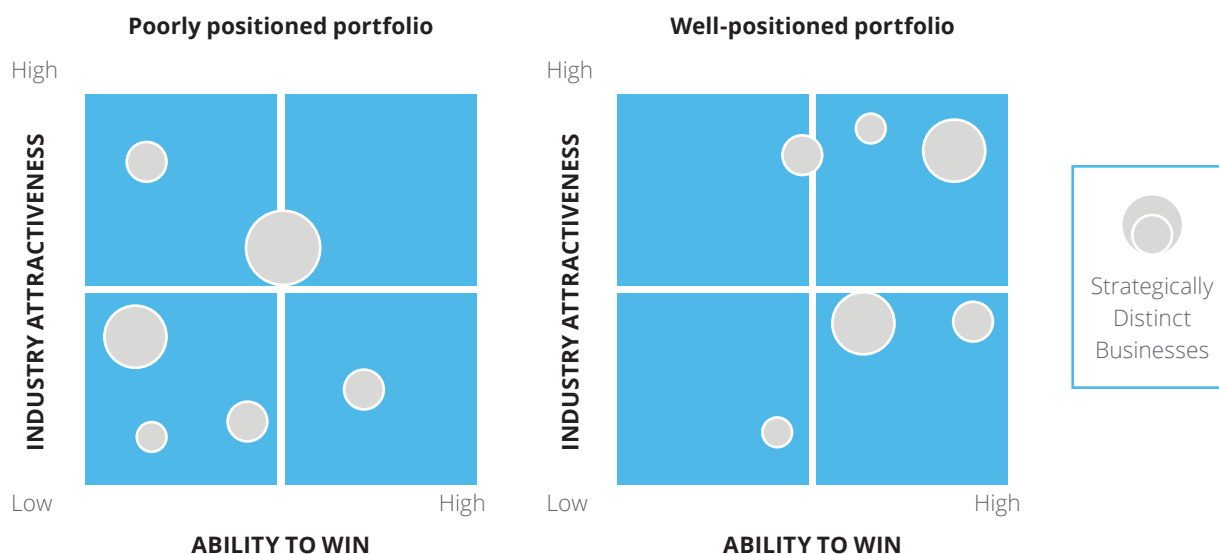
When a portfolio is competitively positioned, its businesses in aggregate participate in more structurally attractive markets and can more effectively compete in their chosen markets. Even in the context of blurring industry boundaries, the concept and applicability of structural attractiveness endures. According to Michael Porter, in his book *Competitive Strategy*, industry attractiveness is a function of five forces: competitive rivalry, the bargaining power of buyers and suppliers, the threat of new entrants, and the threat of substitution.<sup>7</sup> The simple fact is that some industries or segments are more likely to support higher returns over time than others.<sup>8</sup> Of course, a company is able to realize the full potential of any industry or segment by winning—i.e., being better than competitors at both creating and capturing value for customers.

Thus, an effective portfolio is weighted in favor of structurally attractive markets in which the company has a demonstrated ability to win (Figure 3). Portfolios that are more widely distributed—or worse, weighted toward structurally unattractive markets with no (or no enduring) advantage—are far less likely to produce attractive returns over time.

In their recent book, *Playing To Win*, A.G. Lafley and Roger Martin set out a clear and pragmatic strategic framework based on the Strategic Choice Cascade, a demonstrated approach to addressing strategy as a set of five interrelated questions, including: Where will an organization play? And, how will they win? The framework was developed over 20 years by strategy consulting firm Monitor Group and used by hundreds of organizations. It provides a powerful approach to thinking about strategic choice and action.



Figure 3: Competitive Position Matrix



### Balances Innovation

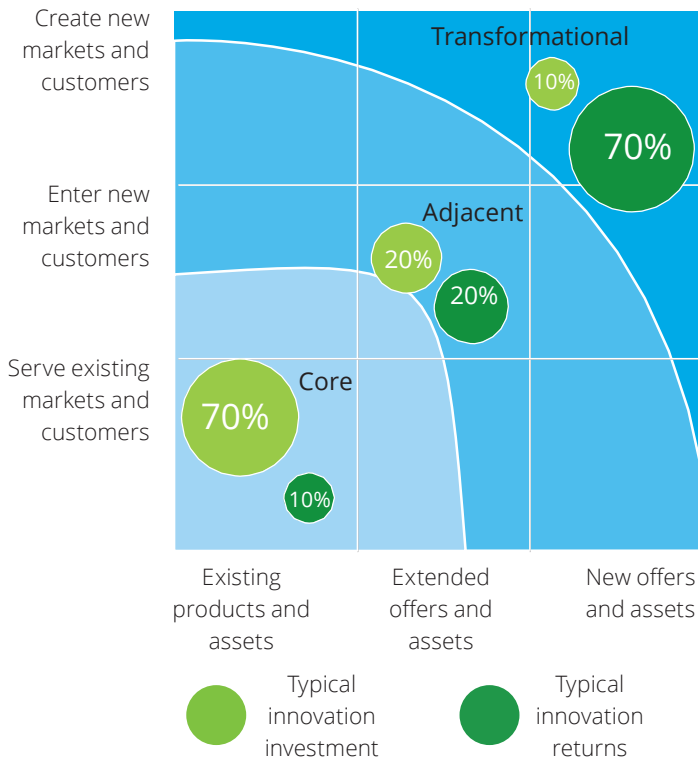
To be strategically sound, portfolios should also reflect an appropriate blend of innovation opportunities. The idea is to sow the seeds for growth across various time horizons (short, medium, and long-term) and various levels of risk and reward in line with a company's ambition and risk tolerance. As shown in Figure 4, innovation opportunities can be classified as core, adjacent or transformational, depending upon how far they diverge from existing offerings and customer base. A "core innovation" is an incremental improvement to an existing product targeted at existing customers. A "transformational innovation" is an initiative focused on offering new products to new customers or to serve needs that have never been expressed.

There is a "Golden Ratio" for allocating innovation investments. According to Monitor Deloitte research published in the *Harvard Business Review*,<sup>9</sup> companies that allocated about 70 percent of their innovation activity to core initiatives, 20 percent to adjacent initiatives, and 10 percent to transformational initiatives outperformed their peers—typically realizing a P/E premium of 10 to 20 percent. The ratio is an average across industries and geographies and the right balance will vary by company. A technology company, for example, likely will find a greater investment in adjacent and transformational innovations to be optimal.

Interestingly, the same research data show that the ratio of returns on investment is roughly the inverse of the ideal investment allocation: core innovations typically generate 10 percent of the returns on innovation investment, adjacent efforts generate 20 percent and transformational generate 70 percent.

An Advantaged Portfolio will support a spread of innovation initiatives across core, adjacent and transformational horizons, consistent with the degree of threat and opportunity presented by disruptive technologies, disruptive business models, or competitive activity in the industries represented in the portfolio. In so doing, the portfolio will typically improve the competitiveness of the enterprise in the short, medium and longer terms.

**Figure 4: The Innovation Ambition Matrix and Associated Returns on Innovation Investment**



“Given the time and investment it takes to create a transformative innovation, we are always working on multiple ideas at any point in time. [Procter & Gamble’s] Gillette organization is masterful at managing S-curves in blades and razors. As one transformative platform is being launched, the next two platforms are already being designed. In between new platforms their innovations extend the advantages and build on Gillette’s outstanding equity.”<sup>10</sup>

—Kathleen Fish, Chief Innovation Officer, Procter & Gamble

**Creates Synergy**

Synergy is a well-worn term that is all too often used to justify acquisitions or the presumed soundness of an existing corporate portfolio. But for a corporate entity to create value over time, it should add value above and beyond that which could simply be created (and captured) within its existing stand-alone businesses. In other words, the value of the whole should be greater than the sum of the parts. In this context, Advantaged Portfolios create, support or reinforce synergy across at least one of the following four dimensions (and often across several):

- *Management-oversight synergies* can be created by using enhanced management processes and skills in the corporate center to boost the top line or reduce costs across the SDBs. Examples include sophisticated target and incentive setting; exemplary training and recruitment; and superior treasury and capital allocation processes.

- *Horizontal synergies* are typically produced in two ways: applying valuable assets and capabilities resident in one business to other businesses in the portfolio, or combining assets and capabilities in different businesses to create new value. Examples include joint purchasing, joint R&D, brand extensions, and sharing best practices.
- *Downward synergies* can come from leveraging the parent company’s assets in the business units. Examples include access to the parent’s balance sheet, extending the parent brand to the BUs; and access to parent networks and relationships.
- *Portfolio system synergies* refer to the value created when a portfolio’s parts interact with each other as a system. Examples might include combining countercyclical businesses to dampen excessive volatility or vertically integrating key operations to address failed supply or demand markets.

Articulating the synergies in a portfolio is not only necessary when designing a new portfolio. It is increasingly important for day-to-day portfolio management as shareholders, and activist investors in particular, ratchet up the pressure on public companies. In many cases of shareholder activism, the portfolio’s composition is at issue.<sup>11</sup> Management should be able to explain clearly and concisely why the company’s various businesses create more value together than apart.

“Synergies are not only about cost reduction. Synergies can be access to markets, exchange of products, avoiding overlaps, and exchange of best practices.”<sup>12</sup>

—Carlos Ghosn, Chief Executive Officer and Chairman, Renault Nissan

# An advantaged portfolio should be Value-Creating



The second core characteristic of an Advantaged Portfolio is that it should create more value than alternative portfolio options. But that value should be viewed through three lenses to help provide a clear picture: intrinsic value, capital markets value, and the value of the assets to other owners. Focusing on any one to the exclusion of the others risks overlooking value-creation opportunities, if not destroying value outright. It's important for a company to consider and balance all three

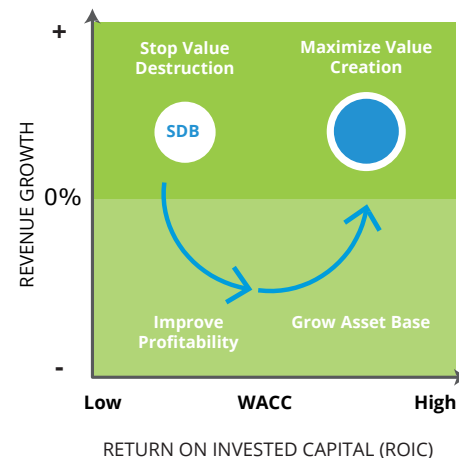
## Maximizes Intrinsic Value

Intrinsic value can be best represented by the risk-adjusted cash flows (net of investments) a corporation's existing (and expected future) businesses produce, and is best measured by discounted cash flow (DCF) analysis. An Advantaged Portfolio is simply one whose intrinsic value is greater than that of competing portfolio options, all other things being equal.<sup>13</sup> Moreover, value is created over time by improving intrinsic value—whether by increasing returns on existing capital employed, consistently investing new capital to generate returns that exceed a company's cost of capital, or by releasing unproductive capital. Hence an Advantaged Portfolio is one that lends itself to increasing intrinsic value—which, typically, is more likely if the portfolio in aggregate is competitively positioned (as described earlier).

As with any attribute of an Advantaged Portfolio, maximizing intrinsic value should start with evaluating the current portfolio's performance. This involves assessing where value is being created or destroyed within the portfolio, which requires looking at the two critical drivers of intrinsic value: the revenue growth and return on invested capital (ROIC) of each component business.

This is a critical step in forming preliminary views on how to treat each business going forward: Should we reduce investment or increase it? Do we need to fix performance first? (See Figure 5). The second, and typically more difficult step of maximizing intrinsic value comes in constructing the new portfolio. Management should conceive different portfolio options, estimate and aggregate the cash flows of each component business, and layer in *both the synergies and dis-synergies inherent in each option*. For instance, what is the value of cross-selling Business 1 products into Business 2? What input cost synergies can we get from combining procurement activities across businesses? What are the tax implications if we exit Business 3? Done effectively, an Advantaged Portfolio maximizes these aggregate cash flows.

**Figure 5: Intrinsic Value Creation**



“Intrinsic value [is] an all-important concept that offers the only logical approach to evaluating the relative attractiveness of investments and businesses. Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life.”<sup>14</sup>

—Warren Buffet, Chief Executive Officer, Berkshire Hathaway

One of the mistakes we see all too often in public companies is excessive management focus on how investors value the portfolio. While a company must address the current market value of a portfolio in certain circumstances (which we describe below), it can maximize long-term shareholder value through a ruthless focus on enhancing intrinsic value—i.e., the present value of expected future cash flows

### Address Capital Markets

As already noted, intrinsic (DCF) value should be the primary metric for assessing the value of a portfolio and different portfolio options. However, market value cannot, and should not, be ignored; it can be as important as intrinsic value in certain circumstances. In theory, market value (driven by market expectations) should align with intrinsic value. In practice, the two measures of value can diverge at a given moment for reasons not related to business performance. For example, a bidding war in a consolidating sector may cause a listed company's equity to trade above its intrinsic value. Conversely, a large-bloc shareholding in the company that constrains trading liquidity may drive down the share price. In such cases where intrinsic and market values diverge, a company may have to (or wish to) make changes to its portfolio that it would not otherwise make.

A significant under-valuation of a business in the capital markets can actually hurt intrinsic value (e.g., by reducing financing options) and in extreme cases can jeopardize a company's independence (e.g., by increasing exposure to a hostile bid). Similarly, if management believes a firm's equity is over-valued in the market, the firm might consider using that valuable equity currency to fund acquisitions that it otherwise might not make. Such over- and under- valuations often occur when the portfolio contains businesses that trade at markedly different multiples. In these cases, portfolio moves may be warranted due to changes in market values, despite no change in underlying cash flows and associated intrinsic value. An Advantaged Portfolio is guided by intrinsic value creation but is not blind to potential threats or opportunities created by the capital markets.

### Find the Right Owner

When management identifies the option that both maximizes intrinsic value and addresses capital markets pressures, value will be maximized, right? Not so fast.

Even if a portfolio owner is creating significant intrinsic value for a business, the owner may not be creating as much value as another owner could. A financial buyer might be able to extract more value from the same assets through leverage and financial engineering. A competitor might have an adjacent business through which it could create synergies the current owner cannot. In such cases, the current owner should consider selling the under-exploited business for full value to the value-maximizing party, sometimes called the "natural owner." The proceeds could then be paid out to investors or re-invested into higher-potential businesses—businesses for which the company is truly the value-maximizing owner.

Slow-growth, cash-generative businesses used to be seen as necessary sources of financing for higher-growth businesses in the portfolio. However, with the rise of private equity and other specialized market players, the capital markets have created multiple means of monetizing these "cash cows," often for even greater value than the current owner could generate from the asset. Unless capital markets are particularly tight and financing and M&A are constrained, companies should not feel compelled to keep a business unit just because it generates cash. Generating cash by selling an asset may in fact be the best way to maximize value.

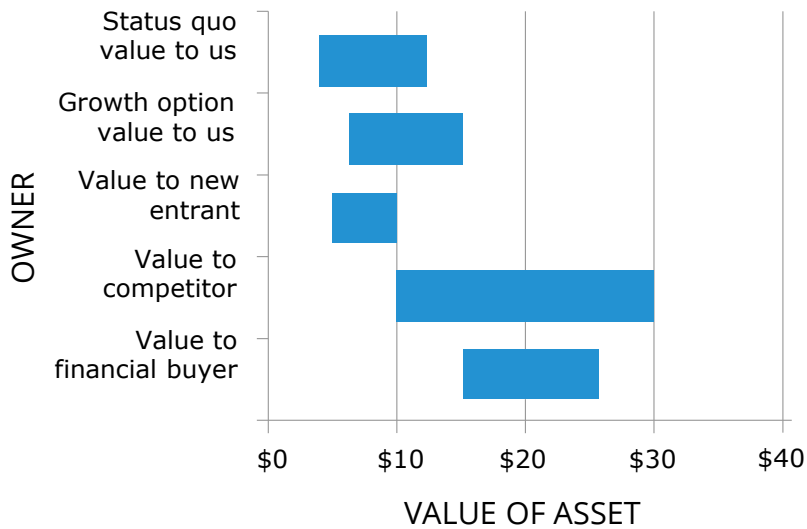
As executives evaluate or redesign their portfolios, they should consider the potential stand-alone value of each business to different potential buyers and compare those values to the intrinsic value of keeping the business within the portfolio, as illustrated in Figure 6. On balance, over time, an Advantaged Portfolio will consist of assets for which the current owner is the value-maximizing owner.

"As separate publicly traded entities, each company should benefit from enhanced management focus, more efficient capitalization and increased financial transparency. In addition, shareholders will have a more targeted investment opportunity, and incentives for management and employees will be more closely aligned with company performance and shareholder interests. Given these advantages, we are confident that this transaction will enable Brink's Home Security (BHS) and Brink's, Inc. to more quickly realize the valuations they deserve."<sup>15</sup>

**—Michael Dan, Chairman, President and Chief Executive Officer, The Brink's Company in discussing the pending separation of his two businesses**



Figure 6: Assessing the value of an asset to different owners

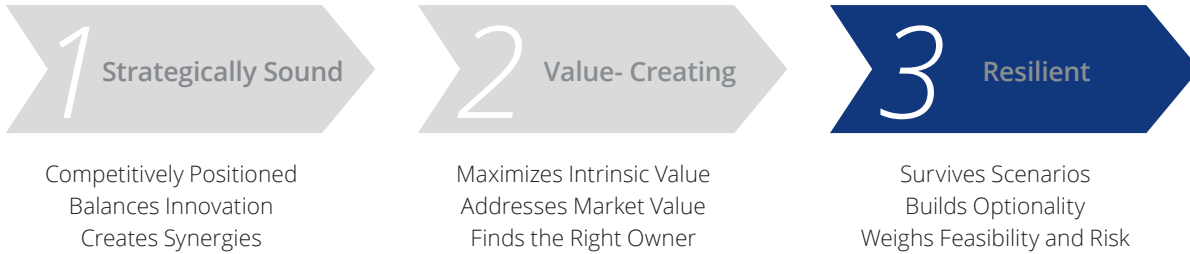


“We are trying to be as intellectually honest as we can with ourselves and look at each operation on a present value basis. And just as [CEO Joe Quarin] has said repeatedly, if we are not the best owners, find out who is.”<sup>16</sup>

—Ian Kidson, Executive Vice President and Chief Financial Officer, Progressive Waste Solutions



# An advantaged portfolio should be Resilient



An Advantaged Portfolio should be not only strategically sound and value-creating, it is also resilient. In our experience, matters of risk and resilience are among the most overlooked, and least understood, dimensions of portfolio evaluation and design. However, they also are among the most important

Three attributes define resilience.

### Survives Scenarios

We live and operate today in a period of great change and uncertainty. With shifting economic conditions and the possible consequences of massive disruptive technologies, no one can be certain how customer needs, competitive dynamics, or industry boundaries might change. In some instances, executives deny uncertainty; in others, they become paralyzed by it. The trick is to confront uncertainty, especially when assessing and designing corporate portfolios. In this context, an Advantaged Portfolio is one that—in aggregate—is more likely to perform well in a variety of different, plausible, future environments, not just one that might reflect an executive team’s official future.<sup>17</sup>

Leading-practice companies use scenarios to stress-test the performance and risk of individual businesses and portfolios overall. Scenarios go beyond simple sensitivity analyses (for example, deviations of 5 to 10 percent from some base-case forecast). They describe coherent stories about how the relevant macro environment might evolve very differently five, 10 or 15 years in the future, and illustrate the potential

consequences for industry dynamics and boundaries, customer interactions, or the winning business models

A company should create a number of scenarios and portfolio options, and evaluate the likely value of the options in each scenario. Consider the example in Figure 7. In this instance, the status quo option appears to do well in only one of the scenarios (Scenario 4). It thus is less robust than Option 3, which does well in two. Scenarios not only serve an evaluative purpose. They also play a creative role, helping companies to generate novel strategies and portfolio options.

“We’re testing our portfolio under different scenarios and... we’ll see that we have a resilient portfolio with flexibility to adapt if circumstances warrant. Now some things might change, but here’s what’s not going to change. We’re going to allocate capital prudently. We’ll continue to migrate our portfolio to a lower cost of supply. We’ll maintain capital and financial flexibility and we’ll pay our shareholders first.”<sup>18</sup>

—Ryan Lance, Chairman and Chief Executive Officer, ConocoPhillips

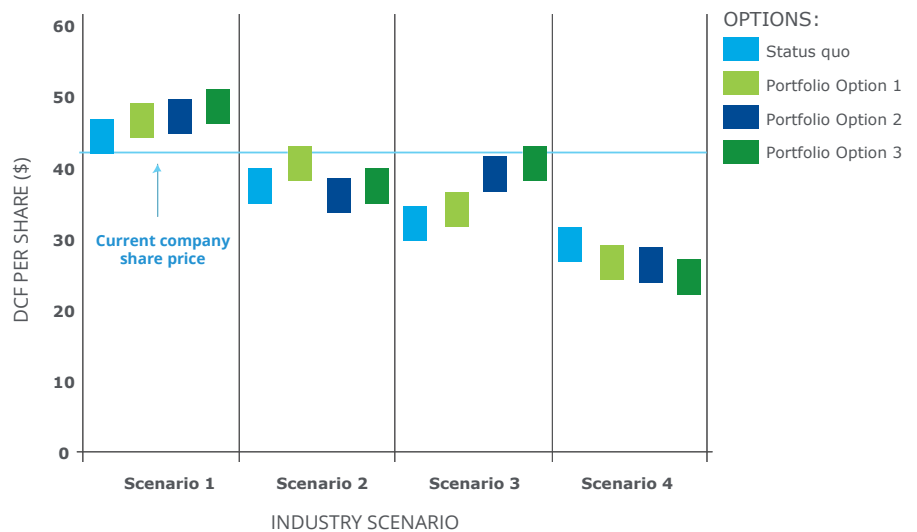


Figure 7: Discounted Cash Flow Value of Strategic Options by Scenario

### Builds Optionality

Executives tend to think their strategies' success hinges largely on a particular event (availability of an acquisition target; passage of a law; successful test of a technology, etc.). However, these events may not happen for some time (if at all), and their final form or effects might be less desirable than what the company had hoped. Moreover, as described earlier, significant uncertainty is pervasive across industries and geographies. An Advantaged Portfolio prudently builds optionality into its portfolio choices, thus enabling multiple potential routes to value in the future. Several tools can help create such optionality:

- **Stage-gating:** mapping strategic choices a company will have to make as various industry events occur or fail to occur ("if/then");
- **Defining transaction pathways:** mapping alternative deal sequences a company could pursue depending on the success or failure of specific desired acquisitions; and
- **Identifying trend triggers:** identifying the leading indicators of critical trends so a company can dynamically adjust a portfolio over time.

It might be asked whether building optionality runs afoul of the idea of commitment – the idea that you should choose one path rather than many, and do the one thing well. In this case, the answer is no, because the optionality we are dealing with here is different. Optionality in the Advantaged Portfolio sense involves hewing to one path that has many forks, and taking one of those forks when a defined event occurs. It helps keep a company on one path at a time, preventing it from "letting a thousand flowers bloom" with the attendant costs of watering them all.

### Weighs Feasibility and Risk

Ultimately, considering, constructing and refining a corporate portfolio is an exercise in weighing feasibility and risk. Feasibility addresses the challenges of constructing a new portfolio. Can we finance it? Does management have the bandwidth to create

it? Are there targets available with the assets we need? Risk addresses the potential for unfavorable developments once the portfolio is created. Will competitors launch a counter-measure? How much does the portfolio depend on the success of a new technology? Will the regulatory environment change? The portfolio of today, indicative of a company's current strategy, constitutes a certain risk profile. Alternative portfolio options present different risk profiles in both the nature and magnitude of risk. An Advantaged Portfolio is one whose feasibility and risk are more attractive than alternative portfolios, given the company's ambition and risk appetite.

In this respect, a company should be comprehensive in considering the types of feasibility and risk (see Figure 8 below), recognizing many executive teams tend to underestimate the risk of the status quo and overestimate the risk of doing (or in this case, constructing) something different.<sup>19</sup>

"I can't take the risk of choosing the 'double down in the core' portfolio or a 'step-out' portfolio today. I need to know whether I can get the necessary deals done for each before I commit one way or the other. I need the option to go either way depending on what we learn."

—Chief Executive Officer,  
Electronic Materials Company

**Figure 8: Sample Risk-Assessment Framework**

Sample dimensions	Portfolio option X	Portfolio option Y
<b>Feasibility (pre-build)</b>		
Ability to Finance	HIGH	LOW
Availability of Targets	MED	MED
Antitrust Feasibility	HIGH	LOW
Management Executability	HIGH	HIGH
<b>Risk (post-build)</b>		
Competitive Reaction	LOW	LOW
Technology Risk	MED	MED
Regulatory Risk	HIGH	HIGH
Capital Markets Reaction	MED	HIGH
M&A Integration	LOW	LOW
Macroeconomic Risk	MED	LOW



Importantly, a company should address feasibility and risk both at the component and the portfolio or system levels. For instance, the component parts of the portfolio may be executable individually, but may not be manageable in aggregate. Portfolio-level risks are not always, however, simply an aggregation of individual risks. Aggregate portfolio risk, for example, can be lower than the individual risk levels of the BUs, if the BU profit curves are counter-cyclical or uncorrelated in nature and effectively “smooth” the aggregate portfolio’s profit performance.

#### A Case in Point: Disney

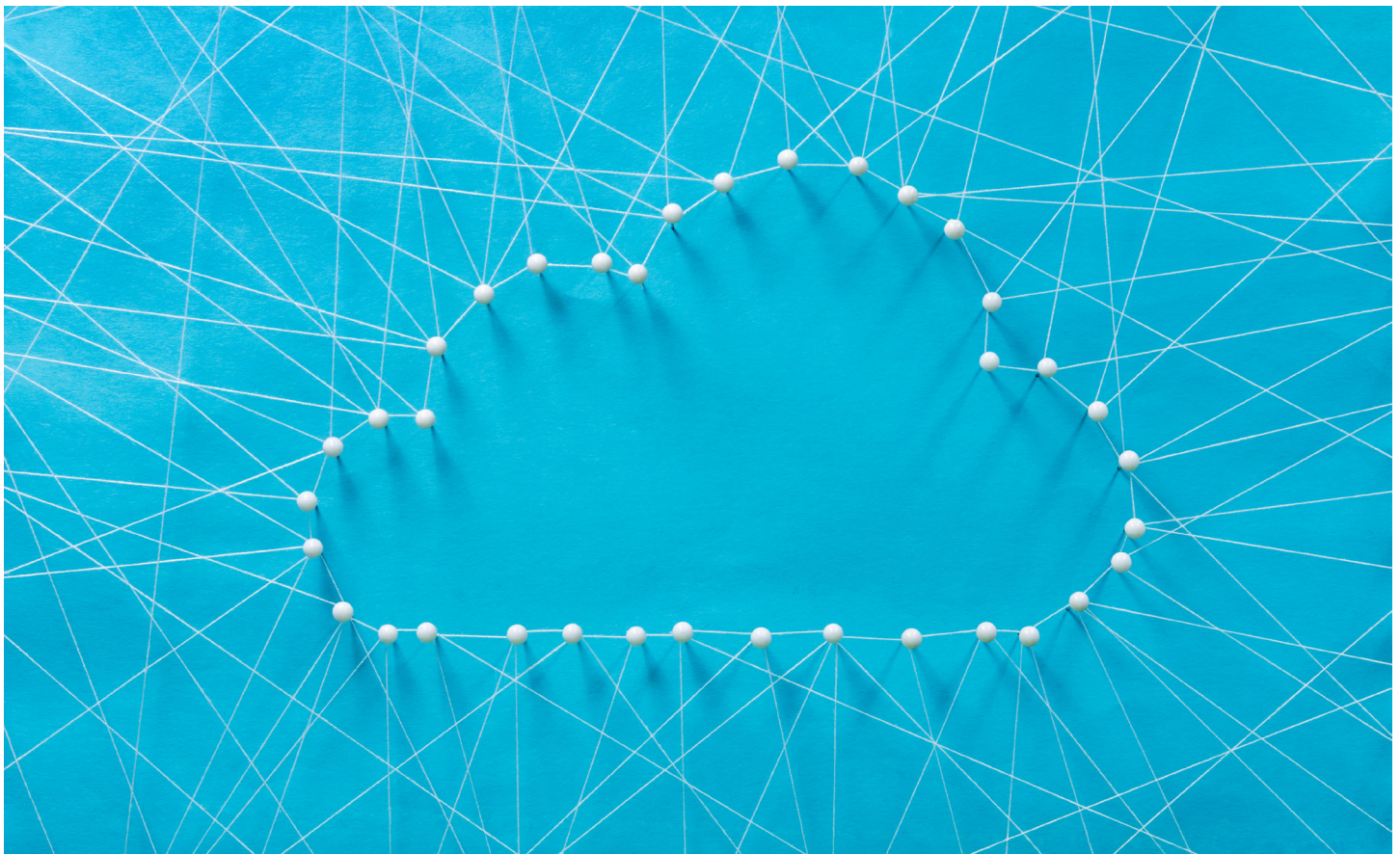
Disney is a notable example of a company in which successive generations of executive management (starting from Roy Disney himself) have carefully considered, constructed and nurtured an Advantaged Portfolio. Leveraging its historic core capabilities in character-development and animation, Disney has built very successful positions in five related

businesses: animation, parks and resorts, cable channels, consumer products, and interactive media. Its portfolio is strategically sound—most of its five business units are among the leaders in their industry, and they are knitted together with clear synergies.

For example, its animated characters populate its theme parks, media networks and merchandise. And two recent acquisitions—Marvel and LucasFilm<sup>21</sup>—have not only advanced these cross-BU synergies, but have reinvigorated the company’s innovation engine by injecting new characters and storylines. Disney’s portfolio is also value-creating, which the capital markets have recognized. In the past five years,<sup>22</sup> in fact, its share price has risen more than twice as fast as the S&P 500.<sup>23</sup> Impressively, it has done so in a stable and consistent fashion over that period, demonstrating a great degree of resilience.

“We manage our business as a portfolio and believe we are positioned very well to invest, innovate and balance risk with performance during any economic environment. This balance gives us a competitive advantage especially during times when markets are in transition or seeing slower growth.”<sup>20</sup>

—John T. Chambers, Chairman and Chief Executive officer, Cisco Systems





# Conclusion

An Advantaged Portfolio of businesses—one that is strategically sound, value-generating, and resilient—is at the heart of many successful companies. The nine attributes we discussed illustrate what an Advantaged Portfolio should look like, at least at the most basic level for a typical company. They can serve as a valuable guide for executives in their ongoing work to define the businesses in which they should participate and the ways in which they create value within and across their businesses. Of course, building an “Advantaged” portfolio is not easy. It is not a matter of assessing things on just two or three dimensions. It is not simply a matter of evaluating the strength of individual businesses. Nor is it an arithmetic or algorithmic exercise or a matter of applying a rigid set of criteria to all companies.

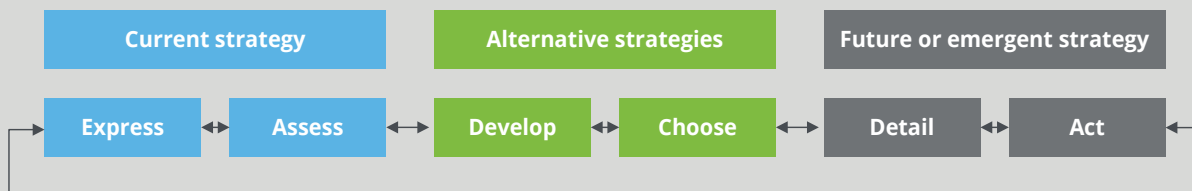
In reality, developing an Advantaged Portfolio is more about creativity and optimization than linear calculation. It involves viewing portfolio options through a wide array of lenses, as well as evaluating both individual and system effects. And it involves using criteria tailored to the company at hand. Most of all, however, designing advantaged portfolios demands hard work: the hard work of wrestling with data, making trade-offs, and making tough choices. In fact, in our view, management should be prepared to hold challenging, data-rich, iterative discussions about what to do (as well as what not to do) when creating an Advantaged Portfolio. Because at the end of the day, good strategy is all about choices. And making the right choices is fundamental to sustaining growth and competitive advantage over the long term.

## The Process of Building an Advantaged Portfolio

Thus far we have focused on describing the characteristics of an Advantaged Portfolio to answer the question, what does *it look like once I get there?* The next obvious question, though, is *how do I get there?*

The short answer is that there is a well-defined process for creating an Advantaged Portfolio, and we call it StrategybyDesign™. This portfolio-shaping process encompasses three major stages (see Figure 9): expressing or assessing a company's current portfolio strategy; developing and choosing among alternative portfolio options; and finally, detailing and acting on the future strategy and its associated execution and change management requirements.

**Figure 9: The StrategybyDesign™ Process**



The key to using this process effectively is to tailor it to the needs of the company at that particular point in time. Some companies need help simply articulating or expressing their portfolio strategy so management can align around it. Others need help assessing whether their current portfolio actually works and will continue to work in the future. Some need help generating options or choosing from among an already-agreed set of options. Others may just need help getting traction on a portfolio strategy they have already agreed to. And still others may need to work through the process from end to end. The best counsel on process is for executives to figure out where the company might be getting stuck across this spectrum of steps, and customize the portfolio-design process accordingly.

## End Notes

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## Winning in M&A

# How to become an advantaged acquirer

By Mark Sirower, William Engelbrecht and Steve Joiner

Mergers and acquisitions (M&A) continue to be a favored corporate development tool of executive teams, as evidenced by last year's record-setting level of deal-making. By the end of 2015, companies had spent some \$3.8 trillion on M&A—the highest amount ever—according to data compiled by Bloomberg.<sup>1</sup> And while M&A may not continue at this pace, the trend seems far from abating. Many companies intend to continue combining for numerous strategic reasons, including expanding in existing markets and gaining scale efficiencies, according to a recent Deloitte *CFO Signals*<sup>™</sup> survey (see sidebar, “Reasons to deal”).<sup>2</sup>

2015's M&A volume indicates that we may be in a “merger wave”—concentrations of accelerating M&A activity—possibly the sixth so far in the last century.<sup>3</sup> While time will tell if we have crested the wave, this type of heated pace can trigger buyer mistakes, such as deals that don't fit strategically or achieve anticipated benefits. Moreover, premiums that acquirers agree to pay over the target's pre-bid share price tend to escalate as competition intensifies.

Amid such deal exuberance, it may benefit companies to not only become an acquirer, but to become an *advantaged acquirer*. Several factors that have been driving M&A for the last few years—low interest rates, accessible and inexpensive financing, healthy balance sheets, and a U.S. economy that's growing at less than four percent annually—remain intact.<sup>4</sup> Winning and creating value in this environment may require something more: a set of detailed action steps to help companies proactively identify and transact strategic deals rather than reactively pursue disparate, ad hoc opportunities. This article examines some common buyer mistakes during merger waves and suggests ways that companies

can potentially avoid them by becoming advantaged acquirers.

### Merger wave challenges

Merger waves happen when deal volumes increase dramatically, crest, and then fall. The first such period began in the 1920s and ended with the Great Depression. Subsequent waves occurred in the 1960s and in each decade since the 1980s. While the reasons behind these merger waves vary, there are several common mistakes that acquiring companies often make during them.

The first mistake is having an **undefined growth strategy** or one that does not clearly consider the role that M&A will play in that growth—both of which can push companies into being reactive buyers. Some companies unwittingly outsource their growth strategy to investment bankers and, as a result, end up reacting to available deals those intermediaries present instead of proactively identifying viable candidates that support their strategic growth goals. While that deal-making process is fairly common in the general M&A landscape, it tends to be magnified during merger waves, as more inexperienced acquirers enter the arena, making capital investments they weren't making before, and experienced players expand their risk profiles in the search for attractive targets.

**Overpaying** is another mistake that often happens as deal volume escalates. Academics Peter Clark and Roger Mills argue that there are four distinct phases in merger waves, as reflected in assets' purchase prices.<sup>5</sup> Bid premiums in phase one have averaged just 10-18 percent during merger waves since 1980; premiums rise to 20-35 percent in phase two, reach beyond 50 percent in phase three, and may surpass

100 percent in phase four. This final phase is where many ill-advised and costly deals are struck—often leaving a legacy of broken promises and lost value.<sup>6</sup>

The third challenge is a **lack of options**. Amid continued market volatility, there is concern that the US economy may not be the driver of corporate growth that many had hoped. In such an environment—and often at the urging of activist shareholders—companies may turn to M&A in an effort to increase shareholder value simply because they believe they have no other choice. Also, because deal-making has become so common in certain industries—consumer products, technology, and health care, to name a few—various stakeholders, including investors and company boards, may favor M&A over organic growth.

### The potential benefits of being an advantaged acquirer

- Develop a better pipeline of priority targets as part of the company's M&A strategy.
- Save tremendous resources by not focusing on inappropriate deals.
- Be less driven by someone else's (e.g., competitor) timing and rush to close.
- Understand which auctions are most important and which should be avoided.
- Raise diligence and integration issues before valuation and negotiation begin.
- Use landscape education process to reassess growth pathways and alternative transactions.
- Build credibility with the board and efficiently move targets through the pipeline.

Source: Mark L. Sirower, “Becoming a Prepared Acquirer,” *Corporate Dealmaker*, June, 2006

## Characteristics of the advantaged acquirer

A large percentage of M&A transactions do not deliver the value promised at the time of the deal.<sup>7</sup> Acquiring companies that avoid this fate—particularly during merger waves—tend to have a disciplined process that enables them to identify value-creating targets and avoid the likely underperformers, thereby maintaining a competitive edge and delivering shareholder value. The tenets of this process typically include the following:

1. **Self-assessment.** A company's executive team members should assess the organization's strengths, weaknesses, and opportunities for growth, both in revenue and value. This may include deciding which customer segments and associated geographies are most attractive to serve and how to do so in ways that competitors cannot easily replicate; and understanding the capabilities and market access required to achieve those goals. Essentially, a company should develop an M&A strategy to complement strengths and backfill weaknesses. A company that hasn't gone through that process will likely trap itself into being a reactive acquirer, working backward from the deal into a strategy.
2. **Identified priority pathways.** Advantaged acquirers which have conducted a careful assessment know what their M&A priorities are. In other words, they know if M&A is going to comprise 10 percent of their growth, 20 percent, or more. As part of the process, they likely have identified priority pathways at the business-unit (BU) level that address new products or solutions they will bring to market at prices that will add value for customers. Corporate-level growth expectations can be de-averaged to the BU level and used to highlight gaps and prioritize the role of M&A across those units. Without that prioritization, you can likely expect to face a reactive political process—with various business executives championing their favorite deals versus potential deals that are in the best interest of the BU or the company.
3. **Competitor signaling.** It's important to look at competitors' strategic intent. Much can be learned from examining competitors' M&A deals over the last several years in terms of geographies, capabilities, size, product or service offerings, and targeted customer segments. Call it competitor signaling—past behavior will often foreshadow which acquisition targets may be next on their priority lists. Armed with that information, an advantaged acquirer can often determine if a deal it is considering does or does not make sense, or whether to begin preparing for a battle on a priority deal.
4. **Strategic screening.** Once they identify the universe of opportunities, advantaged acquirers strategically screen them. While M&A strategy helps to develop prioritized pathways for growth, target screening filters the deal universe in those pathways to generate portfolios of priority candidates. These filters may include everything from size, geography, and customer segments to technology and talent. Management may debate what the strategic priorities are along those pathways; however, the filters are important strategic choices that can help senior executives and the board to understand why a particular priority target was identified in the first place. As one Fortune 100 executive told us, "The more you look, the more you find; the more you look, the more you learn; and the more you look, the more you test your strategies."
5. **Disciplined execution.** Advantaged acquirers consider integration to be an essential element of target identification and prioritization in the transaction execution process. For example, if the potential for difficult culture issues, such as compensation, autonomy, labor disputes, or distribution gaps exist in a particular deal, acquirers should factor them into the screening process. It can be extremely difficult to analyze synergy potential or conduct a detailed valuation without evaluating such integration risks and determining if the right resources and talent are available to integrate the acquisition effectively.

## Reasons to deal: Why will CFOs pursue M&A?

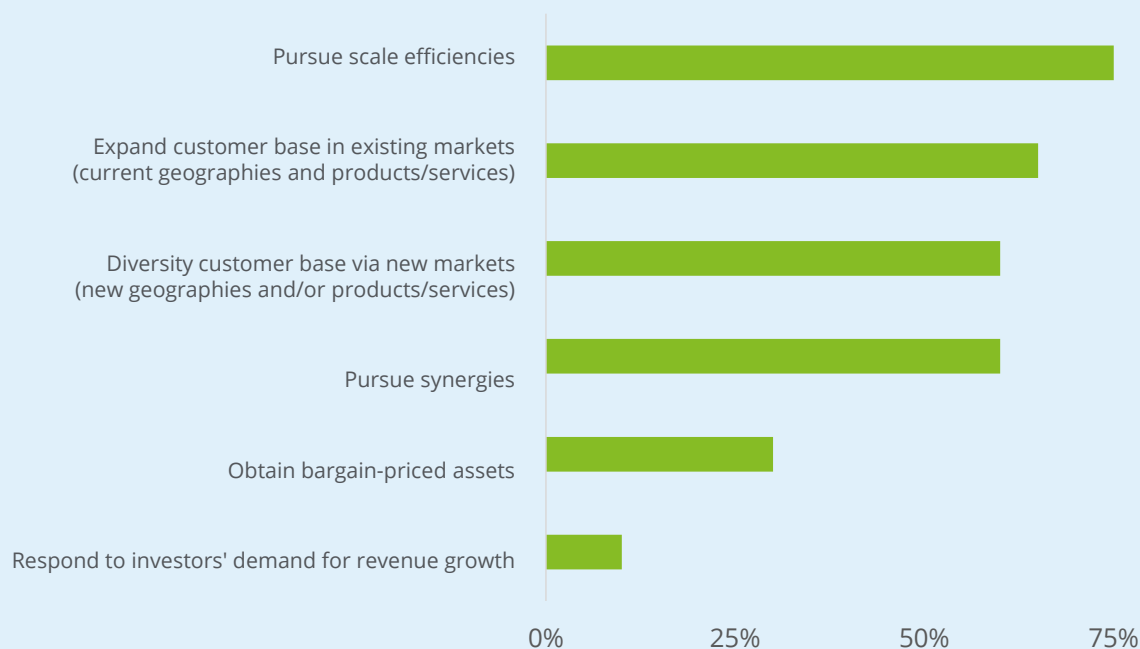
### The case for 2016

In Deloitte's Q4 2015 *CFO Signals* report, some 63 percent of CFOs indicated that they expect to pursue M&A deals in 2016. Among them, however, there is considerable diversity of purpose; sometimes reflecting industry differences but often reflecting company-specific factors:

- **M&A deals serve multiple purposes:** CFOs selected an average number of 2.6 purposes for M&A, indicating significant breadth in expected outcomes. Just 17 percent of CFOs selected only one purpose (most often to diversify their customer base or to obtain bargain-priced assets), and 29 percent selected just two purposes (expanding and diversifying their customer base or diversifying their customer base and pursuing scale efficiencies).
- **Heavy growth focus:** About 54 percent of CFOs selected expanding in existing markets, and 51 percent selected diversifying into new markets (27 percent selected both). Overall, 80 percent of respondents selected at least one of these growth purposes. Those who didn't select growth tended to pick a combination of pursuing synergies and scale efficiencies, with a significant number selecting obtaining bargain-priced assets.
- **Heavy scale efficiency focus:** Sixty percent of CFOs selected pursuing scale efficiencies; only one percent solely selected this purpose. Among CFOs not citing scale efficiency, 40 percent chose pursuing synergies, half chose growth in current markets, and 54 percent chose growth in new markets.
- **Vertical integration and consolidation synergies:** About half of CFOs selected pursuing synergies. More than 80 percent of these CFOs also chose a growth purpose, selecting expansion in existing markets (which suggests possible vertical integration strategies) or pursuit of scale efficiencies (which suggests possible consolidation strategies).
- **Bargain-priced assets often an add-on benefit:** Thirty percent of CFOs selected obtaining bargain-priced assets, and almost all of those also chose at least two other purposes—implying bargain-priced assets are often a secondary (or even tertiary) benefit of M&A deals rather than the primary benefit.

## What will be the purpose of your M&A deals for 2016?

Percentage of CFOs selecting each purpose (N=70)\*



\*Results are only for the 63% of CFOs who expect M&A deals in 2016.  
Source: *CFO signals*, Q4 2015, January 2016, US CFO Program, Deloitte LLP.

### Executive teams bring discipline and patience

To be strategically sound, portfolios In our experience, advantaged acquirers use the above process to develop a watch list of opportunities that they continually refresh. They also tend to close just a small fraction of the potential deals on that list. As long-term successful acquirers, they regularly talk to and negotiate with companies but only pull the trigger on deals that fit their overall strategy at appropriate valuations. In addition, their senior executives typically bring both discipline and patience to the process. Specifically, executive teams act as stewards by determining whether a specific deal fits the company's agreed growth strategy and operating plans. They do so by sticking to their defined rationale and not becoming overly enamored of a particular target so that its acquisition could harm the company. Moreover, executive teams can help bring discipline to the M&A process by assembling the right people in finance and

accounting, technology, operations, strategy, and human resources to make sure that acquired assets are integrated properly. Finally, they can demonstrate patience by having strategic alternatives in case anything goes awry. Along the way, these executive teams are often guided by several common questions:

- Are we looking at the right deals? Being an advantaged acquirer ultimately means knowing the potential targets most important to the company. That involves understanding the universe of opportunities so a company is not in the position where an investment banker or seller proposes a deal the company hasn't already considered.
- Have we measured the transaction's potential impact on ourselves—and our competitors? Acquiring companies should conduct scenario planning to measure how a potential deal could support overall strategy, as well as how it could impede

that strategy if the target was acquired by a competitor. There may be times when it is in a company's best interest for competitors to capture the prize because of the time it will take to integrate the acquisition or the limited value it adds in certain markets.

- Do we have the appropriate integration capabilities? Can we execute this strategy with the resources we have? It's often the financial team's responsibility to not only identify what financial resources should be allocated to the transaction, but also what talent is needed—and the cost of that talent—to integrate the target properly.
- What can we walk away to? A company should always have a best alternative to every deal. As premiums rise, executive teams should be in a position to decide if it is better to buy at 50 times earnings or walk away and do something else with the capital.

Many senior executives complain that they have trouble finding quality assets. One of the other demonstrated benefits of being an advantaged acquirer is that these quality assets typically find the acquirer as it uncovers the universe of opportunities in the market. This holds true for companies of all sizes (see sidebar, “Leveling the playing field”). Once a company has completed its self-assessment, strategy development, target identification and prioritization, the viability of a particular deal should become increasingly clear. And if a deal does not meet agreed-upon parameters, there is often an option to walk away and pursue other high-priority deals on the watch list or to reapply the funds to other segments of the business. After all, advantaged acquirers can afford to be patient—they know what they want.

### **Leveling the playing field: Tips for mid-sized companies**

M&A deals typically fall into the hands of serial acquirers, large companies which have developed this core competency, understand how to strike deals, know how to translate them into shareholder value and, thus, have greater success winning bids. Companies with scale can seemingly afford to take larger risks and pay higher prices. Given this landscape, it can be challenging for mid-size companies to prevail in the M&A auction process, where they often face unique challenges, including: limited M&A experience/skill sets, constrained access to capital, and potential internal resistance from boards unwilling to approve high valuations or take on perceived risk. In short, mid-sized organizations typically appear outgunned—however, they may significantly improve their odds of winning by following the first principle of an advantage acquirer—self-assessment—and doing the following:

- **Prepare to make smarter and bigger bets**—Being crystal clear about which targets are absolute “must-haves” may enable a mid-size buyer to engage in an exclusive deal, avoiding the auction process altogether. If the target does call for an auction, defining the unique value proposition for these assets and the strategic trade-offs may bolster company confidence to pay higher premiums.

- **Build a reputation as an “acquirer of choice”**—Sellers prefer being acquired by companies that will accelerate their value-creation trajectory, a consideration that is often as important as price (especially if the target’s management remains in place or has a continuing financial interest in the company). Building a reputation as an acquirer of choice takes time, but can start with communicating the company’s value proposition, strategic intent, and corporate culture principles.
- **Be a serious and engaged buyer**—Sellers gravitate to buyers that create certainty. Mid-size companies should be prepared to explain a well-designed deal rationale and integration strategy to the target’s management. Buyers should actively participate during due diligence, asking the right questions, and proactively addressing the seller’s integration concerns. Prudent use of experienced external advisors can augment internal M&A capabilities, aid preparation and professionalism, and raise the buyer’s level of credibility and certainty.

While mid-sized companies will often feel like M&A underdogs, they can tip the odds in their favor and, in doing so, be positioned to win a greater share of the acquisitions they pursue.

## End Notes

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## Due diligence for synergy capture

### Building deals on bedrock

By Mark Sirower

As corporations and private equity (PE) firms consider mergers and acquisitions that will combine operations, they generally rely on high-level, top-down assumptions to identify cost synergies that are built into valuations. Yet these same organizations are often surprised when assumed post-deal operational improvements aren't as significant as planned or take longer than expected to realize.

Acquirers typically spend three to four weeks on *financial accounting* diligence to normalize EBITDA and *commercial* diligence that tests the real market opportunity and customers' satisfactions and dissatisfactions with the target. Unfortunately, diligence teams often gloss over cost reductions that are perceived as easy to achieve—the “magic 10 percent.” Yet this oversight can have huge ramifications on realized value and management credibility if those synergies do not occur or are delayed. Prospective acquirers may be able to negate this issue by performing *synergy-capture diligence*—a vital piece of operational due diligence that can be done alongside typical financial and commercial diligence.

The story is a familiar one. Post-close, when an acquirer needs to quickly launch critical integration activities around geographic, headcount, and functional alignment, the executive team belatedly realizes that projected cost reductions have not been fully tested and related decisions have not been made. What often happens next? Integration teams are forced to perform diligence that should have taken place

pre-close, and the resulting integration slowdown causes confusion and angst in the workforce. Questions then surface about the credibility of the deal's true value or, even worse, the deal's overall investment thesis.

Synergy-capture diligence, a bottom-up approach that puts management's skin in the game early on, can help identify where specific cost reductions may be achieved. Such diligence can help justify valuations and drive early alignment around the new operating model for the combined businesses.

Pre-close synergy-capture diligence may enable acquirers to avoid predictable problems such as:

- Planning delays, lack of management focus, and unrealistic integration schedules
- Failure to think through costs that will be incurred to achieve each benefit
- Deal team vulnerability to increase the bid price without a credible fact base
- Lack of accountability for specific synergies and no input from management about responsible parties
- Little consideration of scenarios that might help or hinder projected performance improvements, often leading to surprises
- Delayed attention to customers and revenue-generation, opening the door to competitor actions

#### Synergy-capture diligence by the numbers

Acquirer management teams should consider structuring a bottom-up approach to synergy-capture diligence that tests initial top-down assumptions about synergies and builds a blueprint for accelerating synergy capture during post-merger integration. Based on Deloitte's work with clients in numerous industries, we have identified five steps in the “diligence and plan” process (Figure 1):



**Figure 1. The Synergy-Capture Process**

		<b>Execute</b>	
<b>Initiate</b>		<b>Diligence and Plan</b>	<b>Launch and monitor synergy achievement</b>
<b>“Top-down” analysis</b>		<b>“Bottom-up” analysis</b>	
<ul style="list-style-type: none"> <li>• Develop synergy targets based on high-level review of company P&amp;Ls</li> <li>• Validate synergy estimates based on industry deal data or past experience</li> </ul>	<ul style="list-style-type: none"> <li>• Create consistent cost and functional baselines</li> <li>• Segment and prioritize synergy opportunities</li> <li>• Quantify specific benefits costs and owner of each opportunity</li> <li>• Develop new financial model</li> <li>• Create synergy—capture blueprint</li> </ul>	<ul style="list-style-type: none"> <li>• Facilitate organizational decisions and develop detailed operating model</li> <li>• Plan synergies customize synergy tracking tools, and develop reporting templates</li> <li>• Implement specific projects and monitor synergy realization</li> <li>• Provide periodic reporting to Acquirer senior management</li> </ul>	

1. *Create consistent cost and functional baselines.* The acquirer’s management team should begin by gathering profit & loss (P&L) data from recent financial statements for both companies to view the total “pie” and normalize the statements by removing one-time, nonrecurring costs. The team can use this information to create a consistent baseline that maps the cost pools from the combined P&L to specific functional areas such as finance, HR, and marketing.
2. *Segment and prioritize synergy opportunities.* Team members should make initial hypotheses about synergies that can be realized quickly (Phase I)—such as full-time-equivalent (FTE) rationalization, corporate insurance, public company costs and audit fees, and management overhead. Also important are hypotheses about synergies that require additional information (Phase II), such as information technology (IT) and customer relationship management (CRM) consolidation, fleet and vendor rationalization, and corporate facilities and customer service site rationalization.
3. *Quantify specific synergy opportunities and cost-to-achieve by functional area.* Through detailed interviews with executives and functional leaders, the acquiring company should next identify redundancies across all functional support areas for Phase I synergies. This helps to build the new organization from the ground up, identifying responsible parties who are “signing up” for the plan. Other parts of this step are determining the costs to achieve synergies, such as severance pay, lease termination, and other one-time exit costs; and identifying additional overhead cost pools that may have been missed in initial assumptions.
4. *Develop new financial model and explain variances from initial assumptions.* The buyer’s management team can use the bottom-up cost-reduction and cost-to-achieve estimates to develop a new financial model and resulting P&L to present to the company’s board of directors. The model should identify and explain all variances—positive and negative—from the initial top-down analysis.
5. *Create a synergy-capture enterprise blueprint and integration road map.* An enterprise blueprint is a definitive statement of how the new organization should operate to achieve the deal’s intended business results. Developing this blueprint is a critical final step in the “diligence and plan” process because it functions as a road map—with milestones, dependencies, and potential bottlenecks—guiding the organization from overarching deal rationale through post-deal value-capture measures. While the combined organization’s end-state vision likely will evolve as new information is assimilated during the M&A transaction, an enterprise blueprint provides a valuable frame of reference for focusing the entire organization on desired results.

The economics of M&A deals are straightforward: the cost-of-capital clock begins ticking the moment capital is invested. As a result, unexpected and needless delays in realizing synergies can become costly to investors. By following the above steps to pre-deal synergy-capture diligence, acquirers should be able to surpass traditional testing of top-down cost reduction assumptions, whether they are provided by bankers or based on past industry experience. This process also encourages relevant management involvement, input, and personal commitment from the outset. (See: “Practical lessons for working with buyer and target teams.”) It stress-tests the valuation according to size, timing, and investment required to achieve specific cost-reduction targets, and is designed to generate a flexible financial model to accommodate new information as it is revealed.

Because responsible functional parties are identified along with specific synergy initiatives, senior management can focus much earlier on the new end-state operating model, serving customers, and preserving and growing revenue—the life blood of any acquisition.

### Synergy-capture diligence in action

The following examples illustrate how Deloitte’s synergy-capture diligence professionals have supported organizations in their efforts to determine realistic synergies, costs to achieve those synergies, early blueprints for end-state operating models, and tactical steps for effective translation of the strategy into execution during the integration process.

#### Pre-deal synergy assessment: Regional utilities company

Business issue—Assess the client’s synergy estimates for its largest-ever potential acquisition.

#### Scope and approach

- Deloitte supported the executive team by performing due diligence to validate its synergy estimate and update the company’s final bid.

- The evaluation encompassed G&A and support-function cost elements—for example, operations, finance, marketing, and HR—where a “bottom-up” analysis was conducted.
- We gathered financial data and conducted interviews with senior executives to provide estimates of net efficiency gains focused on: reducing headcount redundancies—for example, two operators serving customers in the same region; consolidating span of control and reducing redundant senior management positions; and identifying new synergy opportunities not previously considered—for example, inclusion of corporate insurance and audit fees.

#### Value achieved

- Our client identified 50 percent more incremental synergies than its previous top-down synergy estimates indicated would be possible.

#### Pre-deal synergy validation: Life sciences tools company

Business issue—Validate and refine the client’s synergy opportunities by cost pool and function for its acquisition of a target twice its size in terms of revenue.

#### Scope and approach

- Deloitte supported the executive team’s pursuit of a life-event transaction for the acquirer by conducting pre-deal synergy identification to inform the deal valuation.
- We engaged both acquirer’s and target’s functional leaders in validating and quantifying synergies across COGS, R&D, sales and marketing, and G&A with timing and cost-to-achieve considerations, thereby facilitating leaders’ buy-in on synergy targets.
- In complete confidentiality, Deloitte provided pre-deal support to both acquirer and target from pre-signature—45 days prior—through announcement date.

#### Value achieved

- Our client identified approximately \$150 million more in incremental synergies than initial estimates, and also front-loaded synergy capture to 50 percent in the first year.
- We helped the client determine a purchase price that was accretive for investors, and our work helped boost management’s confidence and clarity regarding objectives for jump-starting the synergy-capture process.

#### Practical lessons for working with buyer and target teams

#### Potential implications for the buyer

- *Assembling the right team:* Numerous target company functional areas may offer post-deal synergy opportunities. It is critical, therefore, that buyer team members who are conducting the pre-deal synergy assessment be knowledgeable about those functions.
- *Gaining rapid access to internal data:* A buyer may miscalculate the time required to gain access to their internal data, which may slow analyses that require financial information from both target and buyer. Product purchase and selling prices, detailed functional cost breakdowns, and other internal data are typically required to build functional baselines and assess potential synergies.
- *Appreciating synergy-realization challenges:* A buyer’s M&A team may underestimate the time and costs required to achieve anticipated synergies as well as overestimate run rate benefits. A senior executive should play the “pressure-testing” role across each function before synergy assumptions are built into valuation models.
- *Safeguarding deal confidentiality:* One of the common challenges of performing bottom-up synergy diligence is maintaining deal confidentiality. Because this is essential, the buyer’s diligence team should be as small as possible. Where it is not possible to have representatives from each function, external advisors can help fill any gaps.

- *Building a flexible synergy model:* The synergy team should build a flexible financial model that accommodates multiple scenarios (e.g., initial estimates, worst case and best case). As management uncovers new information throughout the diligence process, having a flexible model can help the team quickly adjust the high and low ranges by function and facilitate discussions about which cases are most realistic for each function.

### Potential implications for the target

- *Requesting and prioritizing data:* Because rapid access to target data is critical during a pre-deal synergy assessment, establishing a quick, simple, and trackable data request process will help the buyer team avoid delays and missed data as it becomes available. Prioritizing requested data enables the target's management to focus on and invest time in providing the most important data first.
- *Coordinating with the entire diligence team:* Buyers only get so many opportunities to interact with target management, so it is important that the synergy, accounting, commercial, and operational due diligence teams are coordinated. That enables the buyer to leverage data already captured from the target.
- *Asking questions that yield unbiased answers:* Cost synergies can be a sensitive subject, so questions should be phrased to elicit unbiased responses from the target's executives. For example, rather than asking about poor performers, questions could focus on current employee evaluation policies and recent results.
- *Assisting the target with data preparation:* Tactfully communicating the buyer's knowledge about the target company's information technology (IT) systems and data sources, such as enterprise resource planning (ERP) systems and data warehouses, may help to expedite the data-gathering process with the target's employees.
- *Assessing confidential and sensitive data:* Bottom-up analyses of cost and revenue synergies often involve accessing sensitive target company information. This may include employee salaries, hire dates, and termination policies for possible headcount reductions; or pricing information for potential cross-selling initiatives. Management teams can use external advisors to help manage confidentiality concerns related to this information and help avoid potential antitrust issues.

## Deal-making in downturns

### The “big, black cloud of slowdown” has a silver lining

By Bruce Brown, Raghav Ranjan, Will Engelbrecht and Tanay Shah

#### Market downturns can deliver disguised M&A opportunities that create value and drive long-term growth

Words like “downturn,” “recession,” and “slowdown” may send a cold chill down the spines of most company executives – and rightly so, since they are widely associated with periods of stunted growth and poor performance, and may lead to pay cuts, layoffs, and cost-reductions. However, within the big black cloud of an economic slowdown there is a silver lining; an opportunity that many organizations fail to acknowledge, let alone seize. During market downturns, strategically focused companies can challenge the status quo and disrupt stagnant thinking by using mergers and acquisitions (M&A) to create new avenues for significant growth, shareholder value, and competitive advantage.

Common wisdom holds that acquisitions should be pursued when the economy is strong and companies are flush with cash, a strategy termed “buy rich.” However, by solely following this path, companies may

miss downturn-driven opportunities to “buy for value” at lower market premiums and better interest rates, which could position them for long-term revenue growth and cost synergies.

While select corporate “strategic shoppers” understand that market downturns<sup>1</sup> present an opportunity to acquire companies that are heavily leveraged or poorly managed, more often, Private Equity (PE) players take advantage of this approach. In fact, in the early 2000s, PE groups increased their M&A activity during the economic slowdown, in contrast to corporate M&A activity (Figure 1). During the financial crisis of 2007-2009, PE firms initially slowed their M&A activity, only to crank it up again as they recognized the value presented by lower valuations. This is because a slowdown in economic activity may present a much more significant challenge for smaller or underperforming companies versus their larger and better-capitalized competitors, resulting in opportunities for consolidation, distressed sales, and buyouts.

*Why do savvy shoppers wait for clearance sales before making large purchases?*

*Why do bargain hunters line up outside the electronics store the night before Black Friday?*

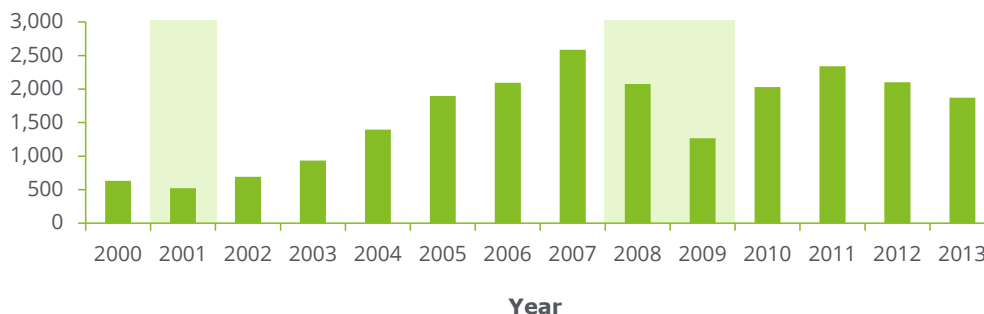
*Why does a league-leading baseball player wait for a curve ball before swinging for the fences?*

*Why does stock price increase when the buyer's acquisition bid is perceived to create value?*

.....They are all making  
EFFECTIVE USE OF TIMING

Figure 1: M&A Activity among Private Equity groups

#### Number of Deals



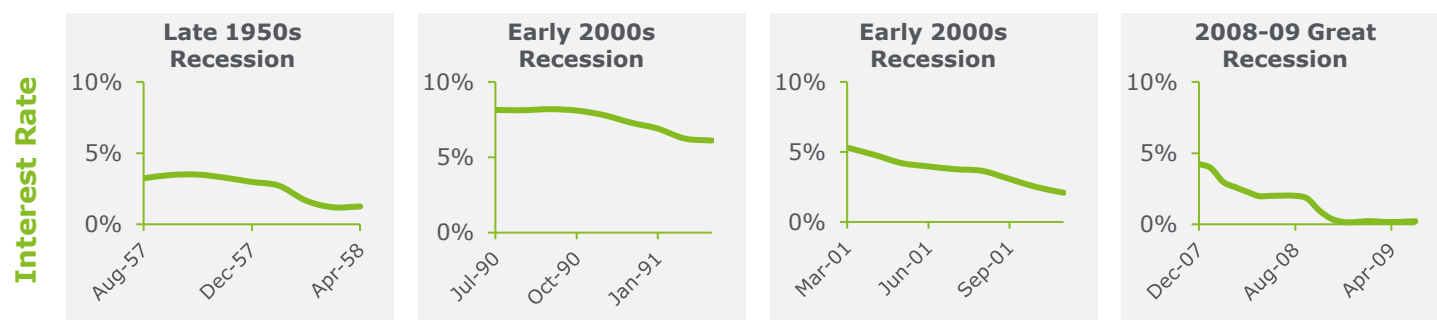
Source: Deloitte Internal Analysis 2016

Economic slowdowns also may be an opportune time for larger and well-capitalized manufacturers to go shopping, as they can acquire smaller players at a reduced market premium and recoup a significant return on investment (ROI) from their M&A plays. Furthermore, companies can raise capital to fund M&A transactions by shedding underperforming assets or taking advantage of cheaper debt financing

due to decreased interest rates. Figure 2's charts show that interest rates can drop significantly during periods of downturn. Deloitte analysis shows that over the past nine recessions, the Effective Fed Funds rate has dropped by 390 basis points, on average (Figure 2). Lower interest rates reduce the cost of debt and make downturns an opportune time to increase M&A activity.



**Figure 2: Interest rates during downturns**



Source: Deloitte Internal Analysis 2016

Note: Recession is defined based on the National Bureau of Economic Research

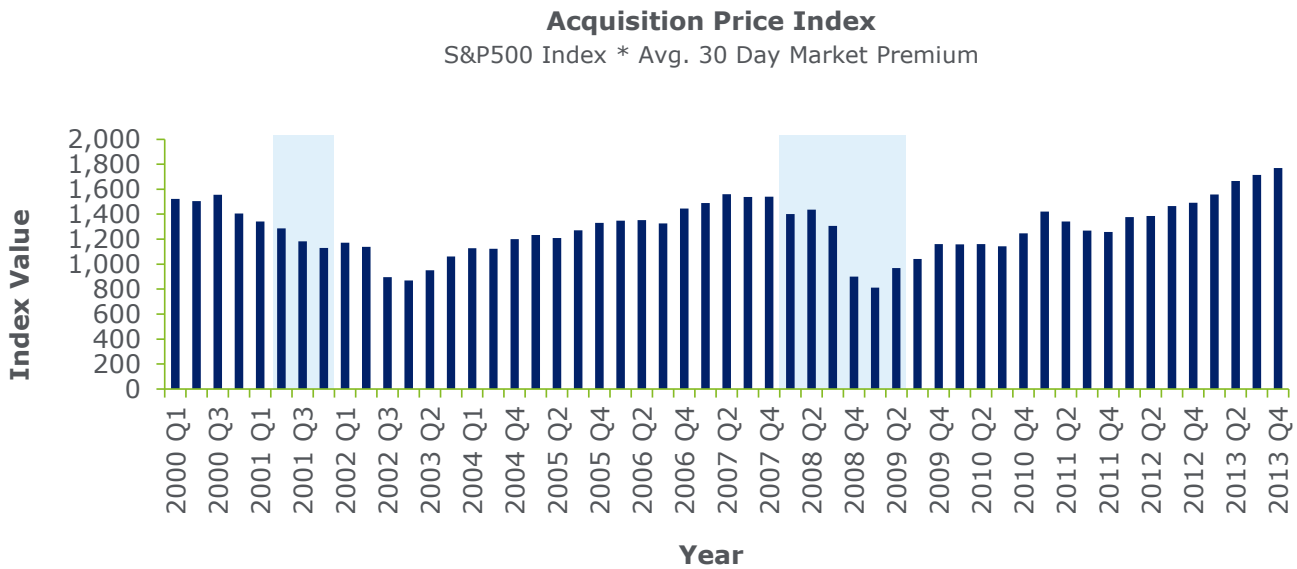
Whether companies overpay or underpay for an acquisition is typically measured by the 30-day Average Market Premium. During the onset of an economic downturn, the premium typically dips, indicating lower valuations. During the downturns starting in 2001 and 2007, the premium dropped significantly from the previous year and well below the long-term average of 27 percent. However, market premiums are factored on an asset's market value, which itself often drops drastically during a downturn. This means that the same business that previously was valued much higher by capital markets may be perceived as less valuable in the downturn, rewarding investors who bring a long-

term and strategic perspective. Hence, a "cleaner" premium or discount for a deal is better understood by measuring the market premium within the context of market valuations. The Acquisition Price Index, defined as the product of the 30-day Average Market Premium and S&P 500 index, represents the normalized acquisition premium paid for a deal, factoring in both the lower asset value and the lower premium produced by slower expected growth and greater uncertainty.

Upon examining market premiums in conjunction with the broader market's underlying value, represented by the Acquisition Price Index, it is apparent

that overall valuations are lower during downturns (Figure 3). This is because asset values are depressed and premiums may also be reduced as a reflection of risk and uncertainty. In the 2001 recession, the Acquisition Price Index (Figure 3) dropped more than 10 percent. This discount was even more apparent during the Great Depression of the 1930s, when the Index dropped more than 30 percent below its peak, only to rise by more than 70 percent four years later. The deflated Acquisition Price Index/reduced premium on transactions makes downturns an opportune time to shop for deals.

Figure 3: Acquisition Price Index during downturns



Source: Deloitte Internal Analysis 2016

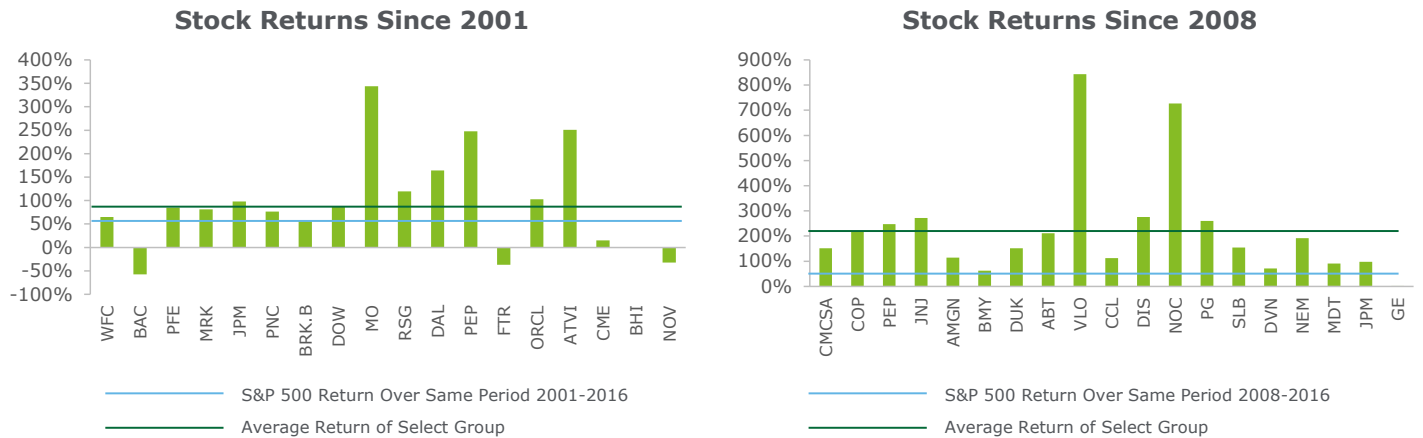
Note: Timeframe of 2000-13 was selected for this analysis to assess M&A activity and market trends in the period leading to economic recessions, and until the effects of slowdown were fully observed or neutralized

**Making acquisitions by leveraging low interest rates and lower valuations during a downturn has the potential to generate significant shareholder value by enabling companies to compete more effectively in the broader market.**

Looking at the 20 largest acquisitions that took place during the 2001 and 2008-09 recessions, acquirers subsequently have exhibited substantial upticks in their stock price (Figure 4). Across industries, many large players who made acquisitions in

recessions have outperformed the S&P 500 index over the period. In other words, the stock markets also reward those companies that demonstrate the courage to make buyouts during a recession.

Figure 4: Market returns for largest public acquirers during 2001 and 2008-09 recessions



Source: Deloitte Internal Analysis 2016

Undoubtedly, downturns create heightened uncertainty, which can ultimately impact valuations and potentially challenge the rationale for a buyout. The Chicago Board Options Exchange (CBOE) Volatility Index (VIX) is a widely used measure of market risk that is often referred to as the “investor fear gauge.” It is a forward-looking expectation of 30-day volatility, constructed from the implied volatilities of a wide range of S&P 500 index options (both calls and puts). Some key insights can be gleaned by evaluating the average CBOE VIX during downturns.

There is a significant uptick in volatility during downturns, as illustrated by the surging VIX index of 2001-2002 and 2008-2009 in Figure 5. Furthermore, there is an inverse correlation between the CBOE VIX and the S&P 500 indices. A higher CBOE VIX index and a lower S&P 500 index would imply lower valuations during times of increased uncertainty. This begs the question of whether companies can take advantage of this increased volatility during downturns to acquire at reduced valuations. An interesting pattern that emerges is that eroding market value (indicated by a

downturning in the S&P 500 index) offsets the heightened risk (indicated by an upswing in VIX index). For example, the VIX volatility index rose from 23 in 2000 to 27 in 2002 while the S&P 500 index dropped from nearly 1500 to 800. In other words, increased volatility during downturns allows for a shift in bargaining power, better enabling acquirers to negotiate favorable terms and valuations. It’s only natural to fear downturns, but organizations that overcame that fear and engaged in M&A were rewarded with returns that outweighed the risk.

**Figure 5: Comparison of Avg. CBOE Volatility Index vs. S&P 500 Index**



Source: Deloitte Internal Analysis 2016

The following perspectives on the Mining, Automotive, and Industrial Products industries illustrate how companies have capitalized on downturns to drive significant strategic value.

**What's happening across industries?**

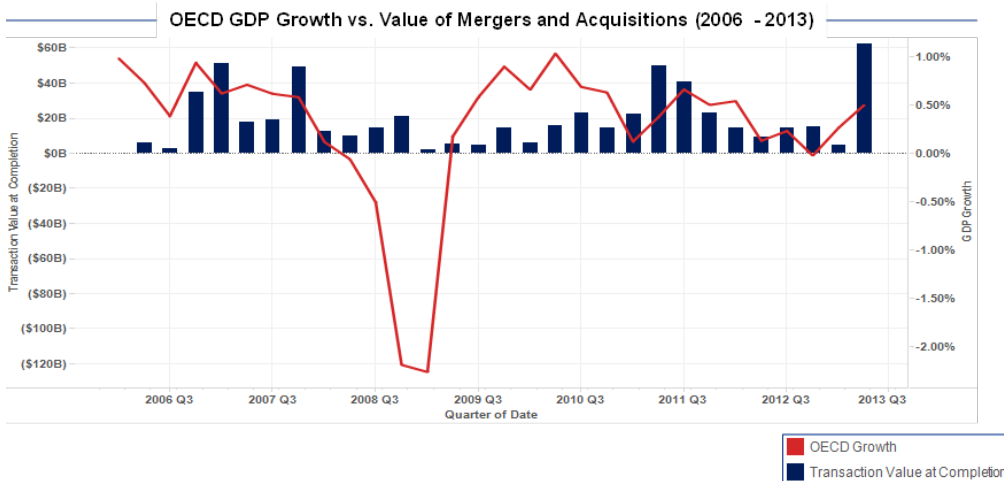
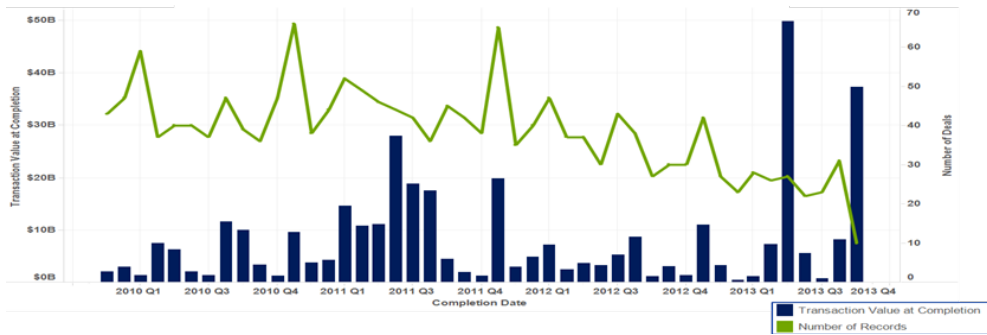
**Spotlight: Mining**

- Weaker global demand since 2014, especially in China, has led to a decline in commodity prices and mine closures throughout the world, including South America, Southeast Asia, and Australia. Environmental regulations have also driven the closure of coal mines in the US and Europe, as developed countries shift to cleaner energy sources

- Larger mining companies are selectively acquiring smaller ones that are struggling to stay profitable as commodity prices fall

During 2013-2015, the mining industry was still responding to slower GDP growth in late 2012. Recent M&A activity suggests that companies may be purchasing targets when earnings expectations are higher, which may result in overpaying or eventual write-downs. Therefore, if miners focused on M&A activity in the midst of downturns rather than, say, six months after conditions are improving, they could achieve higher returns on their acquisitions.

**Figure 6: Value & Count of Mergers & Acquisitions in Mining against OECD growth (2010-13)**

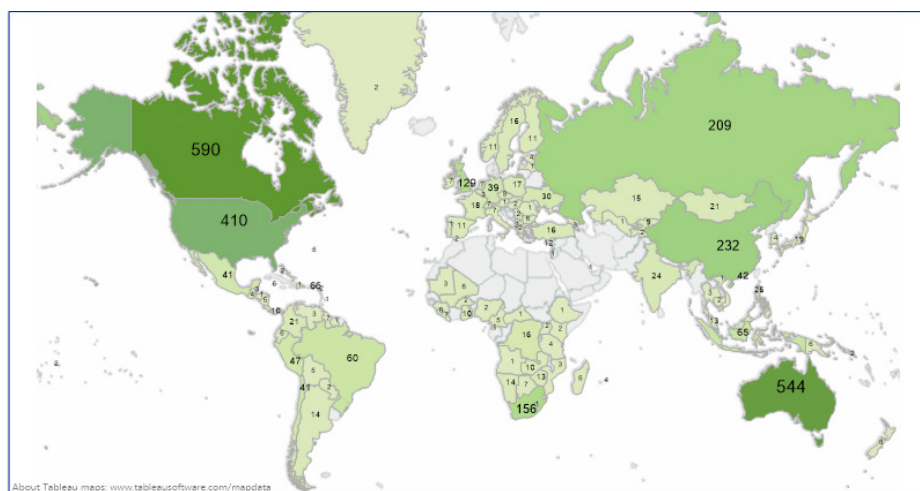


Source: Deloitte Internal Analysis 2016



- Most Mining industry M&A deals since 2006 have involved companies based in Canada, Australia, the US, and China (Figure 7).

**Figure 7: M&A Deals in Mining by geography**



*Depth of green color and size of text increase with the number of M&A deals since 2006*

Source: Deloitte Internal Analysis 2016

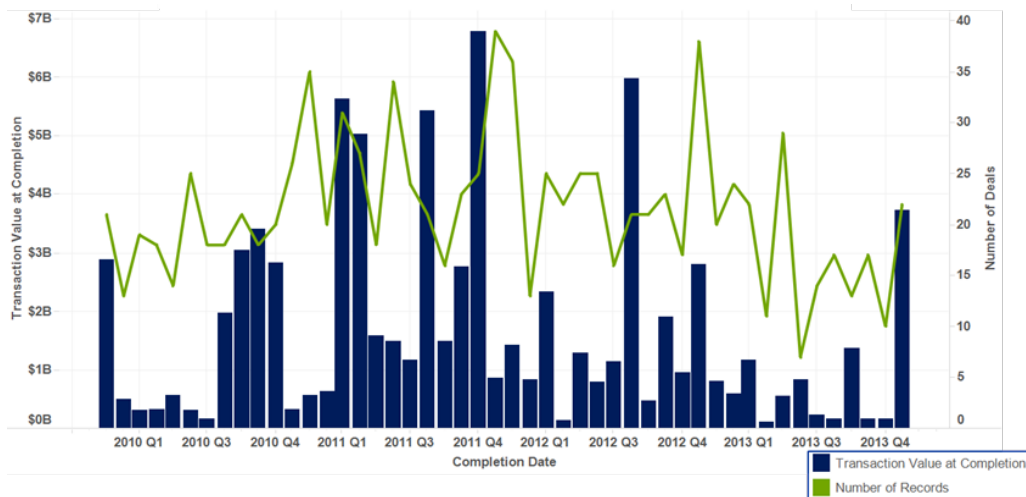
- Deloitte analysis shows that many mining equipment manufacturers are forming alliances with suppliers to offer a full portfolio of parts and services to their customers globally. For example, one of the largest mining equipment manufacturers has more than 40 alliance partners that provide mines with products ranging from lubricants to safety technologies.

Situation	How to derive value?
<p><b>Mining companies and contractors, particularly smaller players, are undergoing significant financial and operating stress.</b></p>	<ul style="list-style-type: none"> <li>• Larger, cash-rich companies could use the downturn as an opportunity to buy struggling players in anticipation of the mining industry reviving in 2017-18.</li> <li>• Such acquisitions could be funded by trimming underperforming mining assets or using leveraged financing that takes advantage of lower interest rates.</li> <li>• Mining equipment OEMs can dip further into their alliance programs and offer a host of equipment and services to large miners looking to consolidate vendors.</li> </ul>

**Spotlight: Automotive**

- Deloitte analysis shows that some/ many/ most automotive suppliers and original equipment manufacturers (OEMs) that aggressively cut costs during the 2008-2009 economic downturn are consolidating to bolster competitive advantages and better leverage global platforms.
- Economies of scale and global leadership are key drivers of merger and divestiture activity among auto suppliers.
- Transaction value has fluctuated over the past four years while deal volume has remained relatively constant (Figure 8).

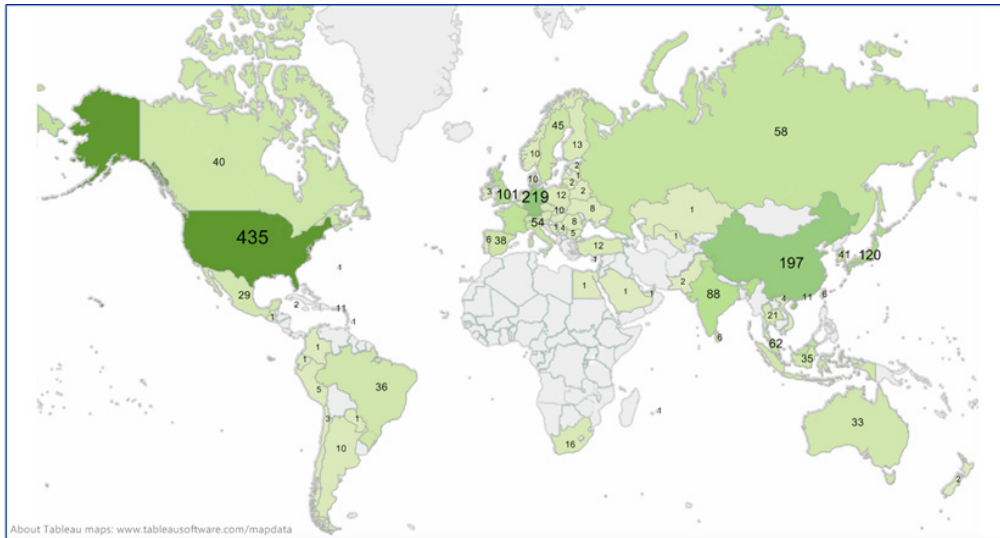
**Figure 8: Value and Count of Mergers and Acquisitions in Automotive (2010-13)**



A. Most Automotive industry M&A transactions since 2006 have involved companies based in the US, followed by Germany and China.

Source: Deloitte Internal Analysis 2016

Figure 9: M&A Deals in Automotive by geography



Depth of green color and size of text increase with the number of M&A deals since 2006

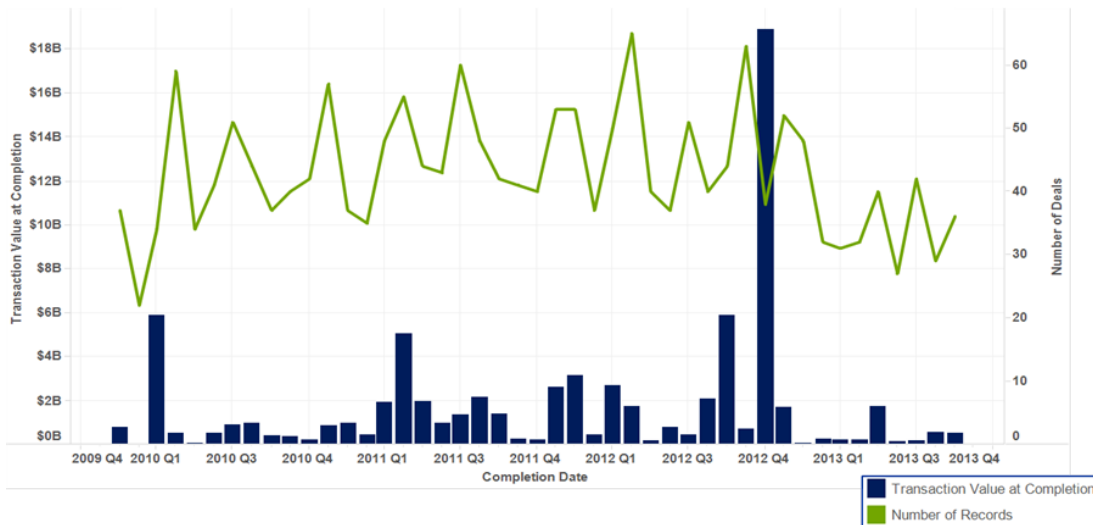
Source: Deloitte Internal Analysis 2016

Situation	How to derive value?
<p><b>The global Automotive industry, particularly in the US, is growing tremendously and posting significant profits since it was paralyzed in the most recent downturn</b></p>	<ul style="list-style-type: none"> <li>• While market premiums are high, automotive players may consider divesting underperforming or non-core businesses where they don't expect much growth.</li> <li>• They could then focus on strategic initiatives to expand market share and grow their customer base.</li> <li>• Further, they may make investments to gain competitive advantage in their core businesses, either organically or through acquisitions.</li> </ul>

**Spotlight: Industrial Products**

- Cost-cutting measures and slow global growth have driven Industrial Products companies to pursue deals in high-growth sectors, such as alternative energy.
- Similar to the Automotive and Mining industries, some Industrial Products companies are consolidating to take advantage of economies of scale and reduce costs.
- Notable heavy equipment manufacturers have been pursuing innovations such as next-generation Underground Mining Equipment through joint ventures and alliances. Such moves are occurring as the Mining industry is at an all-time low, which illustrates the resolve and strategic thinking of OEMs to invest in core high-growth areas during a downturn in anticipation of long-term returns when the market recovers.

**Figure 10: Value and Count of Mergers & Acquisitions in Industrial Products (2010-13)**

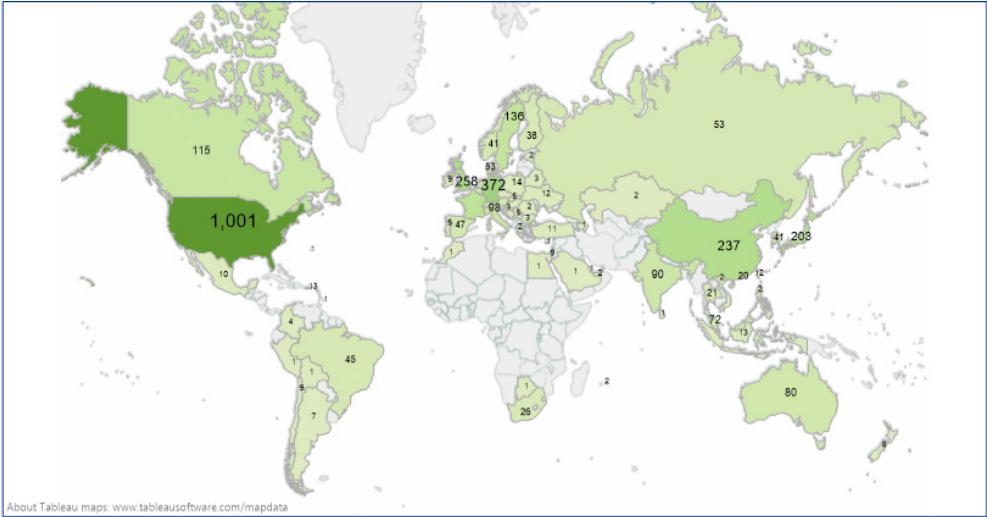


- The majority of Industrial Machinery M&A deals since 2006 have occurred in the US, Germany, and Britain (Figure 12).

Source: Deloitte Internal Analysis 2016

Note: Timeframe of 2010-13 was selected for this analysis to assess M&A activity and market trends in the period leading to economic recessions, and until the effects of slowdown were fully observed or neutralized

Figure 11: M&A Deals in Industrial Products by geography



Depth of green color and size of text increase with the number of M&A deals since 2006

Source: Deloitte Internal Analysis 2016

Situation	How to derive value?
<p><b>Industrial Products manufacturers are under tremendous pressure to manage costs effectively while serving rising global demand</b></p>	<ul style="list-style-type: none"> <li>• Companies could consider this a potential restructuring opportunity to gain operational efficiencies or economies of scale among their related businesses.</li> <li>• Further, consolidation of their businesses could position them as “one-stop-shop” preferred vendors to better serve OEMs that are looking to streamline suppliers.</li> <li>• Industrial Products manufacturers that are not as diversified could grow their portfolio by acquiring businesses that deliver economies of scale.</li> </ul>

Source: Deloitte Mergers and Acquisitions Communications Playbook

**How does a company capture value in downturns?**

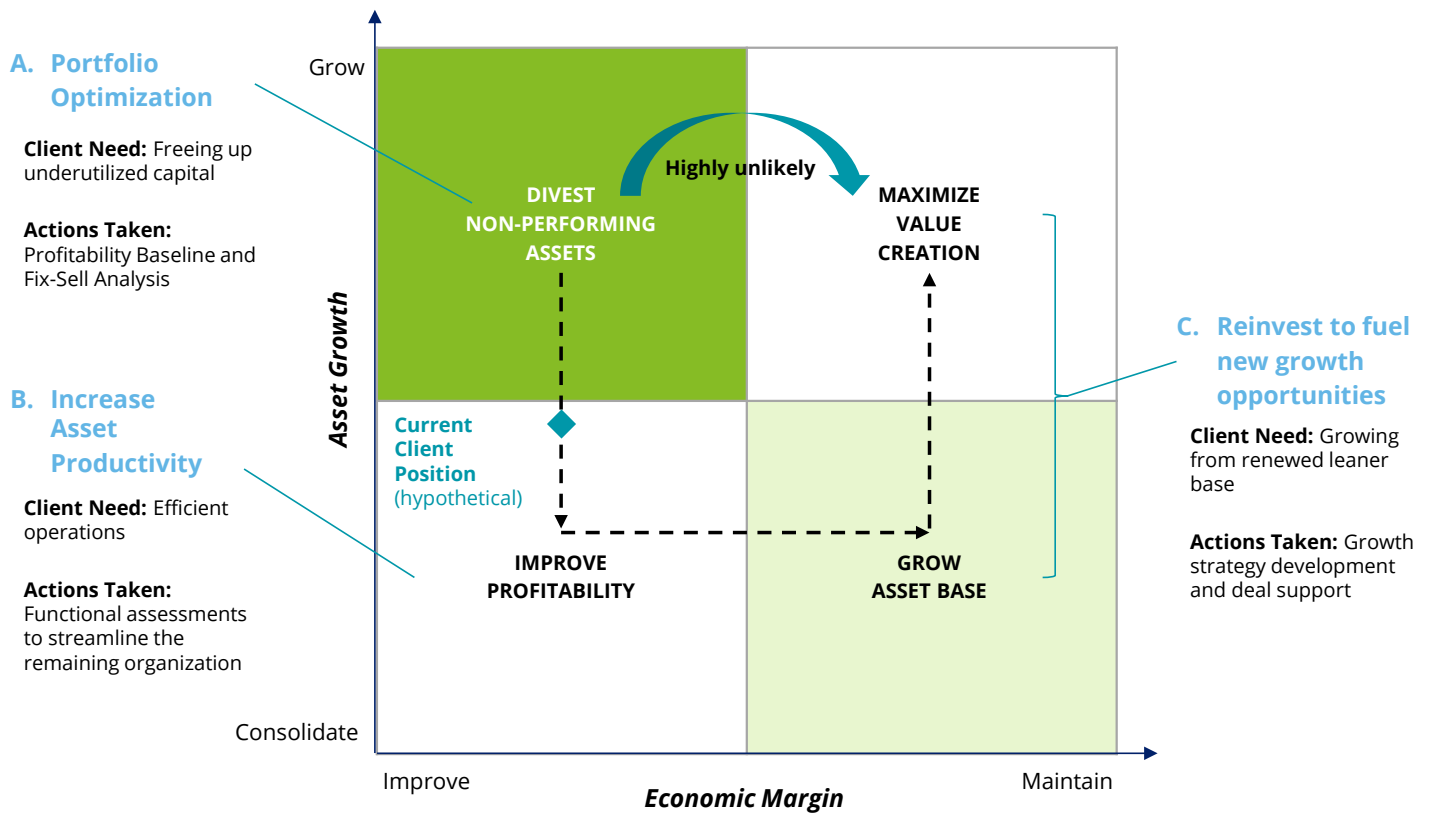
PE firms and corporate leaders that regularly employ the following two approaches should be well-positioned to leverage organizational performance during a downturn and capitalize on the ensuing economic recovery.

- A. Optimize portfolio & free up capital by divesting non-performing assets
- B. Discipline spending and costs of remaining portfolio to increase asset productivity
- C. Reinvest capital in new growth targets leveraging lower prices during the slowdown

**1. Target inorganic growth**

Companies that use the three-step framework depicted in Figure 12 that focuses on inorganic growth can evolve their business models as needed to pursue acquisitions in high-growth areas. Steps include:

**Figure 12: Deloitte’s Fuel for Growth Framework**



## 2. Target organic growth

Taking advantage of organic growth opportunities can increase sales and build upon a company's current strengths, helping to put it in a better position if and when executives begin to evaluate the potential for future acquisitions.

For example, Manufacturing OEMs and suppliers could take advantage of recent market consolidation to offer existing customers a global, one-stop-shop value proposition that contrasts with smaller players that have limited offerings and a regional geographic presence. They could also attract existing and new customers with alliance programs that offer global supplier contracts and benefits. Additionally, market downturns may push downstream companies to the wall, forcing them to trim their supplier base. This could give larger, well-managed companies an advantage compared to smaller players, due to their global presence, focused relationships, and alliance programs. Engaging in these and other organic growth strategies may help companies bolster their market capitalization and balance sheet strength, and provide a favorable jumping-off point for executing a stock purchase or cash buyout when the timing is right.

## How can Deloitte help?

- Deloitte has knowledge, tools and resources to assist organizations looking to make strategic acquisitions to create new or expanded portfolios; or to divest non-core or non-performing businesses.
- Deloitte's capabilities span the M&A transaction lifecycle, from advisory and execution planning to implementation and integration. Services includes Target Identification, Diligence (Commercial/ Operational/ Finance/ Tax/ IT), M&A or Divestiture/Spinoff Day-1 Planning, Deal Execution, and Post Day-1 Integration.
- Deloitte's Pricing practice can help in structuring discounted pricing levels and frameworks for global customers.
- Deloitte's Sourcing practice can assist in developing sourcing and logistics strategies for OEMs to serve global customers.
- Deloitte's Supply Chain practice can help streamline the acquired entities' supply chain costs and operations to derive economies of scale and scope.
- Deloitte can perform benchmarking and diagnostics of operations such as production, manufacturing efficiency, order to delivery, time to customer, and stock availability.
- Deloitte can provide integration planning and assist in execution to realize cost savings attributed to process synergies, organizational design, and system consolidation.

## End Notes

1. Note: Timeframe of 2000-13 was selected for this analysis to assess M&A activity and market trends in the period leading to economic recessions, and until the effects of slowdown were fully observed or neutralized
2. Note: Timeframe of 2010-13 was selected for this analysis to assess M&A activity and market trends in the period leading to economic recessions, and until the effects of slowdown were fully observed or neutralized



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# M&A *Institute*

## **About the Deloitte M&A Institute**

The Deloitte M&A Institute is a community of clients and practitioners focused on increasing the value derived from M&A activities, powered by Deloitte's M&A Services capabilities. The Institute serves as a platform to build connections, showcase thought leadership, and accelerate experience and learning for those involved.

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