Winning Through Mergers in Lean Times

The Hidden Power of Mergers and Acquisitions in Periods of Below-Average Economic Growth
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Executive Summary

Since the end of the late-1990s economic boom, there has been a massive decline in mergers and acquisitions. After reaching a peak of $3.4 trillion in value in 2000, the value of deals declined approximately 66 percent to $1.17 trillion in 2002. Parallel to this decline has been a growing realization of just how difficult it is to create value through mergers and acquisitions. Numerous studies in recent years have concluded that most mergers actually destroy value rather than create it. For example, a study conducted last year by The Boston Consulting Group for Business Week magazine found that 61 percent of large U.S. mergers occurring between July 1, 1995, and August 31, 2001, failed to create value for the acquirers’ shareholders.1

New research by BCG, however, paints a more differentiated picture and suggests that executives may be missing an important opportunity by avoiding mergers during the current downturn. We analyzed 277 M&A transactions in the United States between 1985 and 2000. In an effort to assess the impact of economic cycles, we compared the performance of mergers that occurred during periods of above-average economic growth with those that occurred during periods of below-average economic growth.2 We found that although most of the mergers in our sample (64 percent) did indeed destroy value, deals that took place during periods of below-average economic growth had a higher likelihood of success. Even more important, these weak-economy mergers generated considerably more shareholder value on average. Over a two-year time frame, they created 14.5 percent more value than the strong-economy mergers in our sample.

What explains the superior performance of weak-economy mergers? Even though control premiums remain roughly the same in both low- and high-growth periods, weak-economy mergers benefit from the lower valuations common to periods of below-average economic growth. As the stock price of potential targets approaches fundamental value, the “hidden premium” represented by high expectations built into the stock price shrinks dramatically, and potential deals become cheaper in absolute terms. In addition, successful weak-economy acquirers tend to target companies with sound finances but relatively weak profitability—and, therefore, room for creating additional value through operational improvement. Finally, weak-economy acquirers don’t get distracted by short-term market reactions. Instead, they focus on business fundamentals and on making sure that the postmerger integration is a success and that potential synergies are realized.

These findings suggest that executives who are deliberately avoiding mergers in today’s economy may be missing an important strategic opportunity. Periods of weak economic growth can be an ideal time for companies to use M&A strategically to buy weaker competitors, consolidate markets, gain share, strengthen competitive advantage, and otherwise position themselves to “accelerate out of the turn” as the economy improves. Now more than ever, companies need to develop a strategic approach to pursuing value-driven deals. When they do, they can create value through mergers and acquisitions—in good times and in bad.

The following pages describe the key findings of BCG’s new research and identify some of the misconceptions that prevent many companies from taking advantage of mergers and acquisitions in periods of below-average economic growth. The report also suggests what companies should do to create value through M&A in the current weak economic environment.

2. For a more detailed discussion of our methodology, see page 20.
The Above-Average Performance of Weak-Economy Mergers

A consistent finding of many recent studies is that most mergers fail to create value for the investors of the acquiring company. Our study is no different. We found that a full 64 percent of the deals in our sample destroyed value at the time they were announced, and 56 percent continued to do so two years after the deal. (See Exhibit 1.)

When we de-average those findings by economic cycle, however, a different story unfolds. Most mergers and acquisitions still continue to destroy value, but weak-economy mergers have a somewhat higher chance of success. Whereas only 42 percent of the strong-economy mergers created value over a two-year period, more than 47 percent of the weak-economy mergers did so. (See Exhibit 2, page 8.)

More significant, however, the average performance of those weak-economy mergers was markedly better than that of the strong-economy deals. Whereas the strong-economy deals in our sample destroyed value, on average, the weak-economy deals created value. After two years, the relative total shareholder return (RTSR) of the weak-economy mergers was 14.5 percent greater than that of the strong-economy mergers—and 8.3 percent greater than the returns of the market as a whole.3 (See Exhibit 3, page 8.)

Interestingly, on average, both types of mergers in our sample destroyed value at the time of announcement—a sign that the market is not differentiating in the short term between strong-

3. Total shareholder return (TSR) measures the change in a company’s share price, plus accrued dividends, over a given period of time. Relative total shareholder return (RTSR) compares a company’s TSR with that of a relevant stock-market index. In this report, we calculated the short-term RTRSR of a transaction by taking the change in the acquiring company’s returns from five days before the announcement of the deal to five days after and comparing it with the equivalent change in the S&P 500. We calculated the long-term RTRSR of a transaction by comparing the acquiring company’s returns with the average performance of its industry peer group from five days before the announcement of the deal to two years after the year in which the deal was announced.
When we divide our sample between those deals with positive announcement effects and those with negative announcement effects, we find further evidence of the superior performance of weak-economy mergers. Although on average all deals with positive effects created value two years after the deal, weak-economy mergers outperformed strong-economy mergers by 11.1 percent. (See Exhibit 4.) And of the deals with negative announcement effects, only the weak-economy mergers created long-term value, outperforming the strong-economy mergers by nearly 17 percent.

If we factor out the gains (or losses) from the initial announcement effect, the findings are even more dramatic. Whether they had positive or negative announcement effects, strong-economy deals subsequently declined in value, on average. By contrast, weak-economy mergers increased in value. This is an indication that the market may systematically overestimate the long-term performance of strong-economy mergers and underestimate that of weak-economy mergers.

One further sign of the superior performance of weak-economy mergers is the fact that they had almost twice the likelihood of producing relatively large returns. A full 13.5 percent of weak-economy mergers produced two-year returns in excess of 50 percent, whereas only 7.4 percent of strong-economy mergers did so. (See Exhibit 5.) In dramatic contrast, 14.9 percent of the strong-economy deals produced losses in excess of 50 percent, whereas only 6.7 percent of the weak-economy deals did so.
EXHIBIT 4
LONG-TERM PERFORMANCE OF STRONG-ECONOMY AND WEAK-ECONOMY MERGERS BY ANNOUNCEMENT EFFECT

On Average, Successful Weak-Economy Mergers Create Long-Term Value—Regardless of the Initial Announcement Effect

Sources: Securities Data Company; BCG analysis.

Note: The share price five days before the announcement date (T–5 on the horizontal axis) equals 100. Share performance from T–5 to five days after the announcement date (T+5 on the horizontal axis) equals the announcement effect.

EXHIBIT 5
THE DISTRIBUTION OF LONG-TERM RETURNS OF STRONG-ECONOMY AND WEAK-ECONOMY MERGERS

Weak-Economy Deals Are Nearly Twice as Likely to Produce Shareholder Returns Greater Than 50 Percent

Sources: Securities Data Company; Compustat; BCG analysis.
In addition to demonstrating that weak-economy mergers create more value than mergers that occur during periods of above-average economic growth, our study suggests some of the common characteristics of successful weak-economy deals. Two in particular stand out.

Acquirers create value through operational improvement. One question we examined in our study was, How do successful weak-economy mergers create value? Our hypothesis was that whereas successful strong-economy mergers tend to create value through profitable growth, successful weak-economy mergers do so more through operational improvement and industry consolidation.

For evidence supporting this hypothesis, consider the differential between the average cash-flow return on investment (CFROI) of the acquirers in our study and the average CFROI of their targets. (See Exhibit 6.) CFROI is the ratio of operating cash flow to inflation-adjusted gross assets and is the most accurate measure of profitability in a business. Successful strong-economy mergers have a relatively small differential: the profitability of acquirers is, on average, about one percentage point higher than that of their targets. But successful weak-economy mergers have an average CFROI that is five percentage points higher than that of their targets. In other words, successful weak-economy acquirers tend to be significantly more profitable than the companies they buy.

This significant CFROI differential between acquirers and targets in periods of below-average economic growth is extremely important to subsequent share performance. (See Exhibit 7.) Put simply, when the weak-economy acquirers in our sample bought targets with higher returns than their own, their value creation was comparable to the industry index. By contrast, when they acquired targets with lower returns than their own, on average they outperformed the index by more than 14 percent.
Further evidence that successful weak-economy acquirers create superior shareholder returns by improving the lagging operating performance of target companies is the history of acquirers’ CFROI improvement after the deal. (See Exhibit 8.) Not surprisingly, unsuccessful acquirers—in strong-economy and weak-economy deals—degraded their CFROI over time. Successful strong-economy acquirers improved it only slightly. Meanwhile, successful weak-economy acquirers not only had higher overall levels of CFROI than successful strong-economy acquirers (10.4 percent versus 7.8 percent). They also improved their CFROI more than three times as much (1.3 percent versus 0.4 percent)—an indication that they were successfully restructuring their acquisitions and using operational improvement to fuel profitability growth.

Successful weak-economy acquirers achieved these gains through improvement in both cash-flow mar-
gins and asset productivity. (See Exhibit 9.) The successful weak-economy acquirers in our sample improved their margins by about 20 percent (from 8.8 percent to 10.6 percent) over a three-year period. (In contrast, the successful strong-economy acquirers improved their margins by only 6.7 percent.) They also had higher levels of asset productivity (measured as the ratio of revenue to gross investment), which suggests that they were more successfully exploiting this often overlooked lever for increasing CFROI and, ultimately, total shareholder return.

In conclusion, the evidence from our study suggests that a relentless focus on operational improvement is a key success factor in weak-economy mergers. A potential acquirer should target acquisitions in which there are clear opportunities to enhance the target’s business and to create new sources of competitive advantage—through increased economies of scale, the transfer of critical capabilities, or the expansion of the company’s market share.

**Acquirers avoid targets with financial weaknesses.** Acquiring a company with financial weaknesses is
always a challenge. In periods of strong economic growth, however, the challenge is somewhat easier to address. Potential acquirers have wide access to capital. And booming stock-market valuations give companies the option of using their own stock as an acquisition currency. In periods of weak economic growth, by contrast, dealing with financial weakness in a target is often far more difficult. Although operational problems represent an opportunity in weak-economy mergers, financial problems are a warning sign. Those weak-economy acquirers that target financially strong companies with minimal indebtedness tend to be more successful.

We categorized the relative financial health of the targets in our sample by calculating their Altman Z-score.4 (See Exhibit 10.) During periods of below-average economic growth, healthy targets were far more likely than distressed targets to have a positive impact on share price. However, during periods of above-average economic growth, this difference was much less pronounced. The targets in successful weak-economy deals also have substantially lower leverage (measured as the ratio of debt to total assets), on average, than those in unsuccessful weak-economy deals. (See Exhibit 11, page 14.) By contrast, the difference in leverage between successful and unsuccessful strong-economy deals is negligible.

To assess the impact of mergers on the long-term financial health of the acquirer, we also tracked the acquirers’ Altman Z-score from the year before the deal to two years after the year in which the deal took place. (See Exhibit 12, page 14.) Whereas the financial health of the unsuccessful acquirers in our sample declined substantially, and that of successful strong-economy acquirers deteriorated slightly, that of successful weak-economy acquirers improved substantially. In another sign of improving financial health, the successful weak-economy acquirers in

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EXHIBIT 11
THE IMPACT OF TARGET LEVERAGE ON MERGER PERFORMANCE
Successful Weak-Economy Mergers Generally Involve Targets with Low Leverage

Strong-Economy Merger Targets
Ratio of average debt to total assets

Weak-Economy Merger Targets
Ratio of average debt to total assets

Sources: Securities Data Company; Compustat; BCG analysis.

1Relative total shareholder return from five days before the announcement of the deal to two years after the year of announcement was less than zero.

2Relative total shareholder return from five days before the announcement of the deal to two years after the year of announcement was greater than zero.
our sample also improved their interest coverage (measured as the ratio of earnings before interest and taxes, or EBIT, to interest expense) by more than 16 percent (from 6 to 7). (See Exhibit 13.) By contrast, the interest coverage of successful strong-economy acquirers actually declined by 10 percent (from 5.9 to 5.3).

These findings reinforce the fact that despite common fears about the negative impact of weak-economy mergers on the financial performance of the acquiring company, successful acquirers consistently improve their financial position throughout the merger and subsequent postmerger integration (PMI). As long as they are careful to select targets that are financially healthy, companies can afford to conclude deals in periods of below-average economic growth.

EXHIBIT 13
IMPROVEMENT IN INTEREST COVERAGE OF STRONG-ECONOMY AND WEAK-ECONOMY ACQUIRERS

Successful Weak-Economy Mergers Improve the Acquirer's Interest Coverage

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Sources: Securities Data Company; Compustat; BCG analysis.

1Ratio of earnings before interest and taxes (EBIT) to interest expense.
Why Most Companies Don’t Pursue Weak-Economy Mergers

If the empirical evidence demonstrates that mergers during periods of below-average economic growth have created more value for the acquiring company’s shareholders, why do many executives avoid them? Three common misconceptions lead many executives to conclude that lean times are the wrong time to make an acquisition. Each misconception needs to be examined critically.

“My stock price is significantly down from its high; I can’t afford to acquire.” A key factor driving mergers and acquisitions during periods of strong growth is the relatively high market valuations that would-be acquirers enjoy. Many companies are eager to leverage those high market values and make what they think will be a cheaper acquisition by using shares instead of cash. For example, at the high point of the most recent boom, in 2000, almost 70 percent of the $3.4 trillion in deals announced globally were financed by equity. In a period of weak or negative growth, by contrast, potential buyers are preoccupied with the declining value of their own stock as an acquisition currency. The decline in their stock price leads many to assume that they can’t afford acquisitions.

But, of course, the overall decline in market values means that the valuations of potential targets are most likely dropping as well. As the stock price of potential targets approaches fundamental value, the “hidden premium” represented by high expectations built into the stock price shrinks dramatically, and potential deals become cheaper in absolute terms. This decline in the hidden premium happens despite the fact that control premiums (what the acquirer has to pay to a target’s stockholders, over and above the current stock price, in order to seal the deal) are roughly equivalent in good times and in bad. (See Exhibit 14.)

What’s more, just because absolute valuations are falling, it does not necessarily mean that acquirers...
can no longer take advantage of strong valuation multiples. If a company funds an acquisition with equity, the strength of the company’s multiple relative to its industry competitors and potential targets is far more important than the absolute value. Independent of the economic climate, a strong relative multiple can put a company in an attractive position when it comes to M&A and acquisition currency. The end result can be that an acquirer either retains its relative valuation vis-à-vis the target or attains an even more favorable position.

The bottom line: As market values deflate, there are many excellent buying opportunities for management teams that really understand what drives value in their businesses and how an acquisition can enable them to strengthen their position. What’s more, they can take advantage of the current economic environment to strip away nonperforming assets and fundamentally restructure their company and their industry. But to succeed at M&A in today’s environment, executives must view it as an integral part of their corporate strategy—not just as a quick way to boost earnings.

“My core business has enough problems of its own; I can’t afford to lose focus by considering acquisitions.” When times turn bad, executives typically become risk averse. They narrow their horizons and focus almost exclusively on improving near-term profits. They tend to neglect the task of identifying strategic opportunities, including potential acquisitions, to enhance competitive advantage and build a long-term growth agenda.

Improving the bottom line is a critical task in any economic situation, but it is important to strike a balance. When it comes to M&A, lean times offer companies an opportunity to be proactive rather than reactive. Often, they can take the time to analyze a broader range of potential deals carefully, perform the due diligence necessary to understand the potential synergies, and arrive at a more thoughtful and well-informed valuation of a target. The right strategic, operational, and financial analysis can create a much greater degree of comfort—in terms of both the strategic logic of a particular deal and the precise impact it will have on a company’s competitive positioning and financial performance.

What often separates the winners from the losers in M&A is precisely this heightened degree of care and thoroughness in the fundamental analytical tasks of “end-to-end M&A”: determining the strategic logic, screening potential targets, valuing the target, setting the price, evaluating the strategic fit through due diligence, determining the value creation impact of the acquisition, and designing and executing the PMI.

Take, for example, the all-important issue of valuation, or what a potential target is really worth. It is striking how many acquirers conduct only the most rudimentary valuation and accretion-dilution analyses. Typically, they set the target’s standalone value by looking at its current share price and trading multiples; estimate the potential value of the combined entity by citing some industry benchmarks for, say, reduction in G&A; consider the impact of the merger on credit rating and cost of capital; and set a target price by looking at comparable transactions in their industry.

To be confident about valuation, however, companies should take what we call a high-resolution approach. The starting point is an in-depth assessment of the strategic, operational, and economic impact of a potential merger at the level of individual brands, specific customers and suppliers, and particular business units and geographies. Armed with this assessment, a company is in a position to build a more robust discounted cash-flow (DCF) model that includes scale-curve benchmarks to assess the impact of the combined entity on the scale economics of the business.

The next step is to produce a variety of scenarios to estimate the impact of changing business performance, economic trends, or capital-market condi-

5. For further information on the concept of relative multiples, see “The Continuing Relevance of Investor Expectations,” BCG Perspectives, December 2001; and “New Directions in Value Management,” BCG Perspectives, November 2002.
tions on this DCF model. Also, before closing the deal, an acquirer must start planning the road map for PMI to ensure that the synergy assumptions in the valuation analysis are as accurate as possible—and that they are then captured during the PMI.

“M&A is a discredited approach to growth.” With the backlash against using mergers as a quick way to boost earnings, M&A as a means to grow has become discredited in the minds of some executives and investors. And yet, given the likely growth gaps that most companies face in the current economy, it is the rare company that will be able to rely on organic growth alone. An effective strategy for many companies is to use mergers and acquisitions to consolidate the industry, improve profitability, and create a platform for future growth so that they are in a position to “accelerate out of the turn” as the macroeconomic situation improves. (See the insert “A Checklist for CEOs.”)

Indeed, as the evidence of our study suggests, one reason weak-economy mergers are more successful is that, unlike strong-economy deals, they tend to be more squarely focused on long-term value creation. This is due, in large part, to the fact that weak-economy acquirers have a stronger motivation to achieve a good strategic and cultural fit with the target company: they need to focus on delivering real gains.

In conclusion, periods of low or no economic growth are an excellent time for companies to start putting into place the components of a comprehensive and strategic M&A capability. Such a capability will allow them to approach potential deals strategically, not opportunistically, and to make M&A an integral part of a corporate strategy process. Such a capability will serve companies well not only in the current economic environment but also when good times return. It will allow them to analyze their options continuously, pursue deals on the basis of a sound and well-understood strategic logic, and beat the odds to create value through M&A—in good times and in bad.

Winning Through Mergers in Lean Times

Independent of the economic situation, mergers remain an important strategic tool for companies. Although periods like the current slowdown in the world economy might seem less attractive for mergers and acquisitions, in fact they can be an ideal time for strategically sound deals with a good financial and operational fit. There are seven steps that companies considering them should take.

☐ **Put M&A in the context of corporate strategy.** To succeed at mergers and acquisitions in the current environment, M&A must be an integral part of a coherent corporate strategy. Be clear about your strategy and M&A’s role in achieving it.

☐ **Understand your industry landscape.** The big strategic opportunity in lean times is to use M&A as a force for consolidation in your industry. Develop a robust understanding of both the current state and likely evolution of your industry, and the most promising ways to fundamentally transform your own competitive position.

☐ **Make sure your company is “M&A ready.”** Don’t proceed unless your company is truly in a position to pursue M&A opportunities successfully. In a period of weak economic growth, that means possessing critical capabilities such as strategic screening, due diligence, and effective PMI; having reasonable levels of debt and an adequate financial cushion; and ensuring that risks in the core business are under control and transparent to investors.

☐ **Screen potential targets against key success criteria.** In periods of weak economic growth, four important factors are strategic fit, a financially stable target, a high probability of wringing significant profit improvement out of the acquisition, and the potential to create competitive advantage.

☐ **Be aggressive, but don’t rush.** It is unclear how long the current economic environment will last, but companies have time to prepare themselves and carefully evaluate potential targets. Develop a target list and continue to monitor it. Understand what targets are really worth and don’t overpay. Eventually, the right opportunity will emerge.

☐ **Be open to alternative financing and deal structures.** Although all-cash deals are currently in favor (a reaction to the all-stock deals of the 1990s), there are still opportunities to use other types of financing (including equity and asset swaps) and deal structures (such as joint ventures and alliances).

☐ **Keep M&A at the top of the CEO’s agenda.** The CEO’s personal involvement in screening targets, executing the deal, and communicating the strategic logic to investors is vital for success.
Methodology

To develop the data sample for this study, we identified the top 25 deals by size that took place in the United States during each year between 1985 and 2000—a universe of 400 acquisitions. Next, we eliminated those deals for which critical data (for example, announcement date) were unavailable or in which the acquirer itself was taken over or went bankrupt within two years. This left us with a sample of 277 deals—an average of roughly 17 per year.

We then divided those deals into two categories: those that took place during a year in which real GDP growth was below the long-term average of 3.1 percent for this period (what we call weak-economy mergers) and those that took place in a year when growth was above the long-term average (strong-economy mergers). In this manner, we identified 89 weak-economy deals and 188 strong-economy deals.

Next, we assessed the performance of those mergers and acquisitions using two measures. To calculate short-term performance, we measured the announcement effect of the deal by taking the change in the acquiring company’s returns from five days before the deal’s announcement to five days after and comparing it with the equivalent change in the S&P 500. This gave us a measure of short-term relative total shareholder return (RTSR). Those deals in which short-term RTSR was greater than zero created value and we considered them successful; those in which short-term RTSR was less than zero destroyed value and we considered them unsuccessful.

To calculate long-term performance, we compared an acquiring company’s market returns with the average performance of its industry peer group from five days before the announcement of the deal to two years after the year in which the deal was announced. This gave us a measure of long-term RTSR and, therefore, of long-term success or failure.

For the analyses of profitability, operational performance, and financial health in the section “Characteristics of a Successful Weak-Economy Merger,” insufficient data caused us to use various subsets of our 277-deal sample. The precise number of deals analyzed is indicated in each exhibit.
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