Growing Through Acquisitions

The Successful Value Creation Record of Acquisitive Growth Strategies
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The Successful Value Creation Record of Acquisitive Growth Strategies

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This research report is a product of the Corporate Finance and Strategy practice of The Boston Consulting Group. Kees Cools is an executive adviser in the firm’s Amsterdam office and global leader of the practice’s marketing and research activities. Kermit King is a vice president and director in the firm’s Chicago office. Chris Neenan is a former vice president and director in the firm’s New York office. Miki Tsusaka is a senior vice president and director in the New York office and global leader of the firm’s postmerger integration practice.

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Executive Summary

Recent improvements in the world economy have put growth back on the agenda at many companies. It’s about time. Growth is a well-understood driver of shareholder returns. When combined with high returns on capital, it can create substantial value for shareholders.

And yet, despite improved economic conditions, many companies are finding it difficult to satisfy their growth aspirations through organic growth alone. In the past, they might have looked to acquisitions as an alternative pathway to growth. But today, many executives, board members, and investors view mergers and acquisitions (M&A) with skepticism. They have seen too many research studies showing that most mergers—as many as two-thirds—fail to create value for the acquirer’s shareholders. And they are wary of the excesses of the late-1990s, when too many companies used acquisitions as a quick but ultimately unsustainable method of boosting earnings and multiples.

This skepticism is unwarranted. New research by The Boston Consulting Group demonstrates that, contrary to academic opinion and the recent public record of acquisitions, acquisitive growth strategies create superior shareholder returns. We analyzed the long-term stock-market performance of more than 700 large public U.S. companies over a ten-year period ending in 2002, separating them into three groups based on their level of M&A activity. Our study produced five key findings:

- The highly acquisitive companies in our sample had the highest median total shareholder return (TSR)—more than a full percentage point per year greater than the median TSR of companies that made few or no acquisitions. This performance translated into a 29 percent higher return over the full ten years of our study.

- Although some individual companies have generated extraordinary shareholder value through organic growth alone, on average, the most successful acquisitive growers also outperformed the most successful organic growers.

- This superior performance was not due to higher profitability but rather to the acquisitive growth itself. The fastest-growing acquisitive companies in our sample had only average profitability, while carrying relatively higher levels of debt and delivering below-average dividends—all signs that investors are rewarding them for the value created by the acquisitions themselves.

- Our study also confirmed some basic precepts of value management. The most successful highly acquisitive companies did not try to grow their way out of their problems by pursuing growth at returns below the cost of capital. Rather, they made sure that they were delivering cash-flow return on investment (CFROI) above the cost of capital before they grew their assets.

- Finally, the most successful companies in our sample combined above-average revenue growth with high CFROI no matter what kind of growth strategy they pursued. But the highly acquisitive companies grew at nearly twice the rate of the organic companies and gained market share more rapidly.

Our research makes clear that there is no inherent disadvantage to growth by acquisition. On the contrary, under the right circumstances it can be the best way to generate value-creating growth (that is, growth above the cost of capital). But that doesn’t mean that companies should pursue acquisitive growth under any and all circumstances.

- Successful acquirers choose acquisitive growth only when it is an inherent part of their strategy and they are confident they can use it to create sustainable competitive advantage and so deliver above-average returns.

- They develop a detailed understanding of the role of M&A in achieving their growth strategy—far in advance of bidding on any particular deal.
They are unusually rigorous when it comes to valuing and pricing potential deals, an approach we call high-definition valuation.

They pay at least as much attention to the details of postmerger integration (PMI) as they do to the deal itself and work hard to strike a balance between speed and thoroughness in the PMI process.

This report lays out the findings of the BCG acquisitive-growth study. It also draws on BCG’s extensive practical experience—advising companies on more than 2,000 M&A projects over the past ten years—to identify the critical factors for M&A success. The report is divided into three parts:

- “Acquisitive Growth and Value Creation” presents the basic findings of our research and describes why and how our study differs from most recent M&A studies.
- “Strategies for Acquisitive Growth” describes three common strategies for creating competitive advantage through acquisition.
- “Becoming a Successful Acquirer” explains how companies can make M&A an integral part of their growth strategies, arrive at realistic pricing guidelines for individual transactions, and combine speed and thoroughness in the postmerger integration process.
Our study examined the stock-market performance of 705 public U.S. companies for the ten-year period from 1993 to 2002.\textsuperscript{1} We used each company's ten-year total shareholder return (TSR) as the benchmark performance measure. The sample companies, representing a combined 2002 market capitalization of $6.5 trillion, had a median annual TSR of 10 percent.

Since we were interested in how the market values different styles of long-term growth, we separated the companies into three categories based on their level of merger and acquisition (M&A) activity. The first category consists of companies that made acquisitions in five or more of the years under study and spent an amount on these acquisitions equivalent to 70 percent or more of their 2002 market capitalization. These companies pursued what we term a \textit{highly acquisitive} growth strategy. Of the 705 companies in our study, 148 are in this category.

The second category consists of companies that made acquisitions in only one year of the study (or made no acquisitions at all) and spent 5 percent or less of their 2002 market capitalization. These companies employed an \textit{organic} growth strategy. There are 108 companies in this category.

The third category is made up of the remaining 449 companies in our sample. Neither highly acquisitive nor organic, they pursued a \textit{mixed} growth strategy. (For a comparison of our research design with that of other studies of merger performance, see the insert “How Our Study Is Different” on page 11.)

Exhibit 1 compares total shareholder return for the three different growth strategies. The exhibit shows both the median TSR for each group (illustrated by the large dot) and the range of average annual returns for the middle three quintiles (illustrated by the shaded bars).\textsuperscript{2} As Exhibit 1 demonstrates, the median TSR for the highly acquisitive segment (10.8 percent) is more than a full percentage point greater than for companies pursuing an organic strategy (9.6 percent) and nearly one point greater than for companies with mixed strategies (9.9 percent).

Exhibit 1 also shows a wide variation of returns within each group. The larger relative size of the quintile bands for companies pursuing a highly acquisitive strategy (reflecting a greater variation in returns) is an indication of the inherent risks associated with acquisitions. To understand the sources of this differentiation, we further segmented each category into \textit{fast growers} (above the median rate of revenue growth for the category) and \textit{slow growers} (below the median for the category). Exhibit 2 shows that, on average, the high-growth companies in each category produced higher market returns.

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\textbf{EXHIBIT 1}

\textbf{THE IMPACT OF GROWTH STRATEGY ON STOCK MARKET PERFORMANCE, 1993–2002}

<table>
<thead>
<tr>
<th>Highly Acquisitive Companies Produce the Best Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>2nd quintile</td>
</tr>
<tr>
<td>Organic strategy</td>
</tr>
<tr>
<td>9.6</td>
</tr>
</tbody>
</table>

\textbf{Sources:} Compustat; BCG analysis.

\textbf{Note:} Top and bottom quintiles excluded because of extreme values.
no matter what type of strategy yielded the growth. Across the three growth strategies in our study, the fast growers outperformed the slow growers by roughly 6 to 7 percentage points. The fact that the median return for the highly acquisitive high-growth companies (14.7 percent) is greater than that of all the other companies in the sample is another indication that the stock market rewards long-term growth strategies that include a significant number of acquisitions.

Another clear finding in Exhibit 2 is that in order to produce roughly the same shareholder return, fast-growing acquisitive companies needed to grow nearly twice as fast as fast-growing organic companies (an average annual growth rate of 29.7 percent versus one of 17.3 percent). This is not surprising given that a significant part of the value creation resulting from acquisitions will be captured by an acquired company’s shareholders in the form of the acquisition premium paid by the buyer.

We did additional analysis of the 74 companies in the highly acquisitive high-growth segment to test whether their superior performance was indeed due to the acquisitions they were making and not to other factors. Three pieces of evidence stand out.

First, there is no industry bias in this segment. In other words, these companies are not clustered in high-growth industries and simply riding a wave of rapid industry expansion.

Second, the profitability of these companies—measured by cash-flow return on investment (CFROI) above the weighted average cost of capital—was about equal to that of the rest of the companies in the sample. So it was not high profitability or excess cash that drove these companies’ acquisitions or generated their above-average TSR. Therefore, it is most likely that their above-average TSR was indeed a product of their extraordinary acquisitive growth.

But if these companies had only average profitability, how did they fund their acquisitions? Through a combination of below-average dividends and above-average debt. (See Exhibit 3, page 10.) Typically, low dividends and high leverage decrease a company’s stock-market returns. For these high-growth, highly acquisitive companies, however, this was not the case. As Exhibit 2 shows, the median TSR of these companies is above average for the sample as a whole and even higher than that of the fast-growing companies pursuing organic or mixed growth strategies. Apparently, the value created by acquisitive growth outweighs the disadvantages of low dividends and high leverage. What’s more, the fact that their median beta (a standard measure of risk in corporate finance) is only slightly greater than that of the sample as a whole (0.97 versus 0.90) suggests that these companies were especially good at managing the extra risk that growth by acquisition typically involves.

Third, there are indications that these highly acquisitive high-growth companies did relatively

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EXHIBIT 2
THE IMPACT OF GROWTH STRATEGY AND GROWTH RATE ON STOCK MARKET PERFORMANCE, 1993–2002
On Average, Highly Acquisitive High-Growth Companies Outperform All Others

<table>
<thead>
<tr>
<th>Growth Strategy</th>
<th>Average Annual Growth Rate (%)</th>
<th>Median</th>
<th>2nd quintile</th>
<th>3rd quintile</th>
<th>4th quintile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organic low growth</td>
<td>3.9%</td>
<td>7.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Organic high growth</td>
<td>17.3%</td>
<td>13.3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mixed low growth</td>
<td>3.3%</td>
<td>7.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mixed high growth</td>
<td>18.1%</td>
<td>13.8</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Highly acquisitive low growth</td>
<td>7.5%</td>
<td>7.6</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Highly acquisitive high growth</td>
<td>29.7%</td>
<td>14.7</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: Compustat; BCG analysis.

Note: Top and bottom quintiles excluded because of extreme values.
better in individual transactions. We analyzed the announcement effects for all the acquisitions in our sample with a relative size greater than 5 percent of the acquiring company’s market capitalization at the time of the transaction. Our study confirms the common research finding that acquisitions of public targets have, on average, slightly negative announcement effects. In other words, the average public acquisition does not create value for the acquirer’s shareholders in the short term.

However, when we compare the performance of highly acquisitive high-growth companies to high-growth companies pursuing a mixed strategy, we find that the acquisitive companies do better. Although their average announcement effect for public transactions remains slightly negative, it is substantially less negative than that of the mixed-strategy companies: −1.72 percent versus −2.46 percent, a statistically significant difference. This finding suggests that at the time of announcement, investors distinguish between deals conducted by experienced acquirers and those done by less experienced acquirers. And as recent research described in the insert suggests, a negative announcement effect does not necessarily mean that a deal will fail to create value over the long term.

Our research also revealed some interesting patterns in the way these companies pursued their acquisitive growth strategies. Exhibit 4 on page 12 charts the relationship between CFROI (measured on the y-axis) and growth in the asset base (measured by change in gross investment, on the x-axis) for the 56 highly acquisitive high-growth companies in our sample that produced above-average TSR during the ten years of our study. As the left-hand

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**EXHIBIT 3**

**COMPARATIVE DIVIDEND YIELD AND LEVERAGE, 1993–2002**

Highly Acquisitive Growth Companies Pay Lower Dividends and Carry Higher Debt

<table>
<thead>
<tr>
<th>Average dividend yield (%)</th>
<th>Median leverage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.0</td>
<td>1.8</td>
</tr>
<tr>
<td>1.0</td>
<td>0.4</td>
</tr>
<tr>
<td>Other companies (n = 631)</td>
<td></td>
</tr>
<tr>
<td>Highly acquisitive high-growth companies (n = 74)</td>
<td></td>
</tr>
</tbody>
</table>

**Sources:** Compustat, Datastream; BCG analysis.

1. Leverage equals total debt divided by total assets.
2. Includes only those companies with available data for the full 1993–2002 period.

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4. We have excluded the high-growth organic segment from this analysis because it involved very few acquisitions.
The graph shows, 26 of these companies started the decade with CFROI below the cost of capital. Instead of trying to grow out of their problems, they spent the early years of the decade improving CFROI, only turning to growth once returns had reached or exceeded the cost of capital. On average, these companies grew by 300 percent over the ten-year period of our study, and their median cumulative TSR was 15 percent greater than the market average. The right-hand graph shows that the 30 companies that began the decade with CFROI above the cost of capital generated share-

HOW OUR STUDY IS DIFFERENT

Our research design differs markedly from that of most previous academic and consulting studies of merger performance. Many of those studies focus on the average performance of a sample of individual deals. Moreover, they measure this performance by looking at each individual acquisition’s announcement effect—the short-term change (relative to the market index) in the acquiring company’s share price once the deal is made public. Some studies track performance for a longer period of time—two, three, or five years.

This typical research design has some important limitations. Because such studies focus on individual transactions, they do not distinguish among acquirers in terms of their strategy or acquisition history. What’s more, this approach allows a few spectacularly bad (or spectacularly good) deals to distort overall performance.

For example, one recent study found that from 1998 to 2001, a mere 2.1 percent of U.S. acquisitions generated losses of $397 billion, while the remainder, the vast majority, generated gains of $157 billion. In other words, a relatively small number of unsuccessful megamergers were responsible for the apparently poor showing of M&A during the recent U.S. merger wave.

Another problem with the conventional approach to assessing merger performance is the assumption that the announcement effect is a strong predictor of eventual long-term results. Recent studies suggest that this may be far less the case than researchers have thought. For example, a 2003 BCG study found that a specific category of mergers—those that take place during periods of below-average economic growth—tend to create value over the long term, regardless of the initial announcement effect. A recent academic study provides additional evidence that announcement effects do not necessarily predict mid- to long-term performance. Another recent academic study argues that as much as 50 percent of the price movement in an acquirer’s stock at the time of announcement has nothing to do with the market perception of the deal but rather reflects extremely short-term technical effects because of merger-arbitrage short selling.

Our study avoids the pitfalls of typical M&A studies. Instead of focusing on the short-term performance of individual deals, we examined the long-term—ten-year—performance of individual companies, categorized by their degree of acquisition activity. Our goal was to determine whether the stock market rewards acquisition-driven growth strategies. We believe ours is the first study to take this approach.

EXHIBIT 4
PROFITABILITY AND ASSET GROWTH OF HIGHLY ACQUISITIVE HIGH-GROWTH COMPANIES (I)
Those That Generate Above-Average TSR Grow Only When Their CFROI Is Above the Cost of Capital

EXHIBIT 5
PROFITABILITY AND ASSET GROWTH OF HIGHLY ACQUISITIVE HIGH-GROWTH COMPANIES (II)
Those That Generate Below-Average TSR Erode CFROI and Shrink Their Asset Base

Sources: Compustat; Datastream; BCG analysis.

1Graphs begin in 1992 to capture change in gross investment for 1993 and end in 2001 because of unavailability of 2002 gross-investment data for many companies.
holder returns almost entirely through growth. During the period of our study, they grew by 800 percent, on average, and their cumulative TSR was a full 58 percent greater than the market average.

Thirteen companies in the highly acquisitive high-growth segment did not generate above-average TSR. Why not? As the left-hand graph in Exhibit 5 shows, two of these companies tried to grow despite a starting profitability below the cost of capital. Although at first they seemed to be growing themselves out of their problems, this growth proved unsustainable. Not only did their profitability decline over the full period of the study, but they also “hit a wall” in the later years and actually had to shrink their asset base. As a result, their cumulative TSR was a full 65 percent below the market average.

Eleven other companies (shown in the right-hand graph of Exhibit 5) were reasonably profitable at the beginning of the period, but their profitability also declined over time. Their growth, too, was unsustainable, since it came at the expense of declining returns. By the end of the period, they had to divest large parts of their portfolio. It’s likely that they overpaid for the companies they bought or, more likely, that they were unable to realize the synergies necessary to justify the acquisitions. Their median cumulative TSR was 31 percent below the market average.

The performance of the highly acquisitive high-growth companies in our sample is fully in keeping with the principles of value management. In fact, the best performers in our entire sample combined high growth with high levels of CFROI, no matter what growth strategy they pursued. Exhibit 6 segments our full sample according to each company’s level of revenue growth and CFROI: low, medium, and high. It dramatically illustrates that as CFROI increases, so does TSR. And companies that combine high CFROI with high growth generate the highest returns of all.

EXHIBIT 6
THE IMPACT OF CFROI AND GROWTH ON STOCK MARKET PERFORMANCE, 1993–2002
The Most Successful Companies Combine Above-Average Growth with High CFROI

<table>
<thead>
<tr>
<th>Average net CFROI (%)</th>
<th>Low CFROI</th>
<th>Medium CFROI</th>
<th>High CFROI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low Growth</td>
<td>–0.4%</td>
<td>3.4%</td>
<td>13.7%</td>
</tr>
<tr>
<td>High Growth</td>
<td>–1.2%</td>
<td>3.7%</td>
<td>16.6%</td>
</tr>
</tbody>
</table>

Average annual growth rate: 5.3% 5.3% 4.6% 22.1% 22.8% 23.1%

Sources: Compustat; BCG analysis.
Note: Top and bottom quintiles excluded because of extreme values.

The main implication of this analysis is simply stated: the key to above-average stock-market performance is to focus on growth opportunities that yield the highest returns on capital, no matter how that growth is achieved. To be sure, simply bulking up on acquisitions does shareholders no good unless the acquisitions are based on a sound acquisitive strategy and effective M&A capabilities. But the equivalent is true for companies pursuing a growth strategy driven by organic investments of capital. Although faster growers on average outperform slower growers, independent of the kind of growth, return on investment is the ultimate differentiator between above-average and below-average growth strategies.

5. Because of limitations in the data, we could estimate average CFROI (net of cost of capital) for only 592 of the 705 companies in our sample.

6. Although much research has been devoted to understanding why acquisitions fail, it is also important to appreciate the relative difficulty of organic growth. For example, a BCG study of nearly 600 food launches between 1997 and 2001 found that only 9 percent achieved first-year retail sales in excess of $50 million. See “Charting Your Course,” BCG Opportunities for Action, November 2003.
Our research shows clearly that there is no inherent disadvantage to growth by acquisition. But that doesn’t necessarily mean that companies should pursue it under any and all circumstances. Acquisitive growth makes sense only when executives can use acquisitions to create sustainable competitive advantage. One requirement is world-class M&A implementation skills. But success is first and foremost a question of strategy. Consider three common strategies in which acquisitions can make a decisive contribution to competitive advantage.7

Reducing Costs Relative to Competitors

An acquisitions-based growth strategy can be especially effective in fragmented industries, where companies can use M&A to consolidate the industry and achieve scale and cost advantage. The pharmaceutical industry is a classic example. Until the early 1990s, the industry remained relatively fragmented, with no company responsible for more than 5 percent of sales. But the last decade has seen a wave of acquisitions. Aggressive acquirers have been able to cut their combined cost base in administration, sales, and R&D by 8 percent on average and by as much as 18 percent in individual cases. These cost reductions have led to improvements in earnings performance ranging from 20 percent to 35 percent and have given highly acquisitive pharmaceutical companies significant advantages over their rivals.

Pfizer is perhaps the most dramatic example in the pharmaceutical industry of a company that has built a strong competitive position and substantial shareholder value, at least in part by means of aggressive acquisition. During the period of our study, the company combined above-average growth and profitability to generate an average annual TSR of 19.4 percent, outperforming the S&P 500 by more than 9 percentage points. Through two recent major acquisitions—Warner-Lambert in 2000 and Pharmacia in 2003—Pfizer has transformed itself into a nearly $40 billion company, the largest in the industry, with a market cap that makes it one of the most valuable companies in the world. This scale has allowed Pfizer to leverage its excellent sales and marketing capabilities across a broad product base, invest in new growth platforms, and position itself to manage risk more effectively in an inherently uncertain industry.

Acquiring Necessary Capabilities

Other companies use acquisitions to fill in gaps in capability rather than wait to develop those capabilities internally. Since the mid-1980s, for example, Cisco Systems has acquired some 82 companies to establish its dominant position in the data-networking industry. Even with the massive declines in market value incurred by Cisco in the aftermath of the late-1990s boom, Cisco had an average annual TSR of 28.2 percent during the ten years of our study and outperformed the S&P 500 by nearly 18 percentage points.

In the fast-moving data-networking business, intelligent acquisition is the most effective way to keep pace with technological innovation. In effect, acquisition has become an integral part of Cisco’s R&D strategy. More than half of Cisco’s acquisitions were made either to expand its offerings or to enhance the functionality of its current offerings.

Cisco has developed extremely effective capabilities in target search and selection, negotiation, and rapid integration. The company is extremely thorough in its search process. On average, it considers three potential markets for every one it actually enters and assesses five to ten candidates for every deal it consummates. Cisco’s experienced M&A team works well under highly stressful conditions.

7. This section is based in part on material from Hardball: Are You Playing to Play or Playing to Win? by George Stalk Jr. and Rob Lachenauer (Harvard Business School Press, forthcoming in fall 2004).
and keeps the company one step ahead of investment bankers in spotting opportunities and getting deals done. Cisco also emphasizes the speed and intensity of its integration efforts. The typical deal takes only three months to execute. A dedicated integration staff at headquarters integrates IT systems, sorts out the roles of new employees, creates compensation plans to retain key employees, and meets with all major customers in the first three months after the consummation of an acquisition. Finally, like a good venture capitalist, Cisco actively manages its portfolio of acquisitions. It is not afraid to divest an acquisition that isn’t working out.

**Building a New Business Model**

Another effective strategy is to use acquisition as a way to rapidly scale up a new business model. This was the approach taken by the Newell Corporation (now Newell Rubbermaid). The evolution of Newell is a dramatic example both of the success a company can achieve by using acquisitive growth to establish a new way of doing business—and of what can go wrong when a company strays from its proven strategy for acquisitive growth.

Newell began its existence in 1902 as a curtain rod manufacturer. By the early 1970s, it was still a relatively small company with less than $100 million in revenues. But company executives had been observing the growing dominance of large, concentrated retailers such as Kmart and Wal-Mart. The giant retailers were selling billions of dollars worth of merchandise supplied by myriad small manufacturers with only a few million dollars in revenue. But the proliferation of small suppliers posed logistics headaches and quality problems for the retailers. And the small companies often lacked the resources to improve their offerings or fill gaps in their product lines. Newell executives reasoned that big-box retailers would welcome a low-cost supplier large enough to meet them on their own terms—a company that could simplify purchasing and logistics, provide consistently high-quality products, and offer lower prices. So Newell set out to become a one-stop shop for megaretailers.

Over the next 25 years, Newell made some 100 acquisitions. At first, the acquisitions were quite small: suppliers of hardware and household products such as door handles, paint rollers and brushes, and metal cookware, all with revenues between $5 million and $15 million. But as the company grew, Newell was in a position to pull off progressively larger deals—most dramatically, its $340 million acquisition in 1987 of Anchor Hocking, a company whose sales of $760 million were nearly twice those of Newell at the time.

The company dramatically improved the operations of its acquisitions, exploiting economies of scale in logistics and the sales force, increasing product development, and introducing common systems and infrastructure. The result was an integrated low-cost vendor that grew to more than $2 billion in revenues by the mid-1990s and generated shareholder returns among the highest on the New York Stock Exchange.

In the late 1990s, however, Newell stumbled. The success of its business model depended on acquiring a particular type of company: reasonably well managed, in good standing with the big discount retailers, and not so large that Newell couldn’t easily intervene to obtain the desired performance. But in 1999, Newell purchased Rubbermaid, a company that met none of these criteria. Rubbermaid had been slow to recognize the power shift toward the large discount retailers and had alienated them by not being responsive to their needs. What’s more, Rubbermaid was a $2.5 billion company—and the acquisition’s nearly $6 billion price tag made it Newell’s largest by far. Because of Rubbermaid’s size, Newell had difficulty assessing its true condition, and when Rubbermaid’s troubles proved deeper and more extensive than Newell had realized, the company didn’t have enough resources to fix them quickly. Newell’s share price suffered as a result. During the ten-year period of our study, the company’s TSR performance actually lagged the S&P 500 average by 2.9 percent, largely owing to the Rubbermaid deal. The Newell story dramatically illustrates just how important it is to focus only on the acquisitions that truly fit a company’s business strategy.
Experienced acquirers like Pfizer, Cisco, and Newell have developed world-class M&A capabilities. For these companies, M&A expertise has become a competitive advantage in its own right. But what about a company that does not have deep experience in M&A or is trying to do a kind of acquisition that it has never done before? How does a company become a successful acquirer?

Companies that want to pursue acquisitive growth need to develop three key capabilities. First, they must embed their M&A strategy in a comprehensive growth strategy. Second, they need to develop a far more rigorous approach to the valuation and pricing of potential targets than typically takes place in most companies today. Third, they must learn how to break the compromise between speed and thoroughness in postmerger integration. Let’s consider each of these challenges in turn.

**Linking M&A to Growth Strategy**

It is striking how frequently executives take what is largely a reactive approach to M&A. A macroeconomic turn, a surprise auction, or an accelerated consolidation by competitors or customers catches management off guard. The board demands action, or a bidding deadline looms. Then, like a clocked chess match, moves—and mistakes—rapidly unfold. Executives focus on the deal at hand rather than on the total universe of options. They make decisions without fully considering their impact. Often, it is not until after the deal is done that a strategic rationale is made up to justify the acquisition to the stock market. As a result, opportunities and shareholder value are squandered.

For all these reasons, the first step toward becoming a successful acquirer is to define a growth strategy and determine the role of M&A in achieving it—*in advance* of bidding on any particular deal. It’s important to dedicate resources and time to fully understand the options well ahead of the emergency board meeting, the offering memorandum, or the lead story in the *Financial Times* or the *Wall Street Journal*. To do this, company executives need to ask themselves a number of questions:

- What are the prospects for organic growth in our core business?
- Are there more attractive growth paths than re-investing in the core?
- If so, how far afield should we look?
- What are the best means of entry?
- If the answer is acquisition, how can we make sure that we build value and that we have the necessary capabilities?

Only when they have detailed answers to such questions will a company’s executives know whether an acquisitive growth strategy makes sense for them. Consider the dilemma of one U.S. packaged-food producer. The company had a dominant share in the U.S. market in its legacy product line, but economic trends in the industry seriously threatened the company’s long-term competitive advantage. For one thing, the continuing globalization of the company’s big-retailer customers was transforming its category into a global business. Dominance in a single market was simply no longer good enough. In addition, there were significant scale-based cost advantages in manufacturing and distribution that favored larger players. Most important, only a full assortment of products in its category would enable the company to gain and maintain a position as “category captain” with the retailers—a status that would pay handsome dividends in the form of preferential positioning of the company’s products in stores.

All these trends were driving a rapid concentration in the industry, as it shifted from relatively small,
local, focused players to large, multiproduct, global giants. (See Exhibit 7.) Unless the company rapidly followed suit, it would be unable to compete. This put acquisition squarely on the company’s strategic agenda.

Getting a company’s growth strategy right can also shed light on precisely what kind of acquisitions make the most sense. The factors a company needs to look at include the basis for competition in its industry, its own organizational competencies, and the availability of attractive merger candidates.

For example, one durable-goods manufacturer, observing a mix of broadly diversified and narrowly focused players in its category, wanted to know if it needed to diversify in order to survive. A detailed analysis revealed that the shareholder return of diversified players in the industry was no better than that of focused ones. (See Exhibit 8, page 18.) Furthermore, the manufacturer could realize few synergies across broad categories along the value chain because the categories had dissimilar gains from scale. Distribution advantages also differed depending on the point of fabrication, and major customers did not place great value on working with a more diversified supplier. But although broad-based diversification did not make competitive sense for the company, expansion into a narrower set of related categories where the manufacturer had brand relevance and an advantage in materials science did. The company is now profitably following that strategy and using it to create value for its shareholders.

Only when a company has a clear sense of its strategy and the proper role of M&A can it narrow the field of available properties. By quickly eliminating

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**EXHIBIT 7**

**COMPETITIVE TRENDS IN THE GLOBAL PACKAGED-FOOD INDUSTRY**

For One U.S. Company, Industry Trends Made Acquisition a Strategic Imperative

- **Source:** BCG analysis.
- **Note:** This exhibit is for illustrative purposes only. Data have been disguised for reasons of confidentiality.
all the possible deals that don’t make strategic sense, executives can devote their time to preparing detailed dossiers on the most likely candidates and developing a source book and game plan for active or reactive M&A moves downstream.

Implementing High-Definition Valuation

One of the chief reasons that so many acquisitions destroy value is the willingness of senior executives to overpay for seemingly attractive targets in the pursuit of synergies that either don’t exist or cannot be achieved.9 “Deal fever” can infect even the most experienced of senior executives, causing them to talk themselves into overly optimistic estimates of synergies and the potential upside in an attempt to justify the price they think they have to pay to win the bidding. What’s more, they often underestimate the likely disruption to their core business from the cost and effort of doing the deal and carrying out the PMI.

Deciding on a reasonable price for the acquisition—and avoiding overpayment—requires careful valuation of the combined entity’s potential upside. We advocate a far more rigorous approach to valuation than most companies take. The typical approach goes something like this: the would-be acquirer analyzes comparable transactions and industry multiples, builds a discounted-cash-flow model based on the stand-alone value and likely earnings trajectory of the target, then adds overlays for projected cost and revenue synergies. To

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**EXHIBIT 8**

**THE DISTRIBUTION OF PROFITABILITY AND SHAREHOLDER RETURNS IN A DURABLE-GOODS INDUSTRY**

For This Company, Acquisition to Achieve Diversification Did Not Make Economic Sense

| Competitors (showing sales within industry category) | Company |

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**Source:** BCG analysis.

**Note:** This exhibit is for illustrative purposes only. Data have been disguised for reasons of confidentiality.
estimate cost synergies, executives typically use scale-economy rules of thumb. Revenue synergies emerge through consensus. Finally, the acquirer mines the seller’s data room, conducts site visits, and revises the valuation based on what it finds.

Such an approach falls short because a lot of information that materially impacts value lies outside its scope. The greatest information shortfall comes when new management teams tackle their first acquisition or when experienced acquirers weigh a massive or game-changing transaction. In such instances, we recommend an approach that we call high-definition valuation.

An acquirer needs to take an all-encompassing view of the value that might be created or lost in a prospective transaction—including all the external aspects of a transaction and its indirect consequences. Take the example of resource diversion. In theory, any project with a positive net present value justifies incremental investment. In practice, however, time and resources are constrained, and acquisitions rob other initiatives. For this reason, it’s important to review the impact of a potential acquisition on internal projects. For a given estimate of required acquisition and integration resources, what internal projects will be eliminated, discounted, or delayed? How much should the transaction upside be discounted as a result? Answering such questions helps ensure that the company pays only for unique, incremental transaction value and that it doesn’t credit the deal with false synergy.

It’s also important to quantify the costs of inaction. Forfeiting a property to a competing bidder not only closes off the potential upside but also exposes the company’s existing plans to a strengthened competitor. Where and how is a competing bidder likely to attack if it acquires the target company? What markets would the combined footprint of the two companies put at risk? What product launches might this new competitor preempt with strengthened R&D? How would its new cost position pressure prices? Answering such questions can help a company anticipate and minimize future damage. It also reveals the true value of acquiring the target.

When it comes to estimating the stand-alone value of a target, it often pays to do original customer research rather than base projections on historical or average performance. For example, an acquirer can research the target’s most recent product performance, interview subjects with knowledge of the target’s business (including blind interviews of important suppliers and customers), and conduct an in-depth study of heavy-user segments and their consumption trends.

There are also a number of things a company can do to test an acquisition’s upside. An acquirer can interview potential customers on the benefits of the merger in order to substantiate the estimated revenue; identify opportunities for rationalization by assessing plants and facilities; and map the overlap of acquirer and target patents, as well as tear down recent product launches, to estimate combined innovation potential.

Finally, acquirers shouldn’t wait to think about post-merger integration until after the deal closes. Pre-merger integration exercises can simulate the integration process well before a deal is imminent. Because it’s impossible to fully understand a deal’s synergy potential without evaluating the integration risks, companies should develop a set of cost and revenue up sides with quantified probability by function, along with an implementation plan for the resource commitments required to achieve those benefits. If managers are made accountable for their analyses, this exercise builds realism into the valuation. It also provides a detailed road map for the eventual postmerger integration.

Of course, even the most painstaking evaluation is meaningless if the upside is squandered in the bidding. A structured approach to setting opening and walk-away price points can ensure that identified value is brought back to shareholders. And it can inoculate management against deal fever. It is important to establish opening bids on the basis of precedent transactions, a conservative estimate of value creation, and an understanding of the trans-
action upside and the funding constraints of competing bidders. It is no less vital to set and stick to walk-away price points based on an aggressive but achievable estimate of the upside and of critical thresholds for funding, dilution, and earnings-per-share accretion. Finally, it’s essential to develop a clear-eyed view of possible competing bidders and their bidding potential. When an acquirer’s estimated upside is based on a unique advantage, competitors should be unable to match its bid.

The real power of high-definition valuation is in the timing. Every aspect of the analysis can be accomplished well ahead of the bidding, across a number of worthy properties, without an offering memorandum, and without a data room. This type of early valuation provides a commanding view of options for expansive growth. It enables a potential acquirer to move swiftly, value accurately, and bid intelligently when the time is right.

Realizing Value Through Effective Postmerger Integration

In the end, it’s not the acquisition itself that creates value but rather the postmerger integration. This is where the synergies that will pay for the acquisition are actually realized. The integration process can make or break a merger and often differentiates experienced, successful acquirers from the less successful ones.

Effective postmerger integration is a complicated balancing act. On the one hand, speed is of the essence. Potential synergies must be realized quickly—in the first 12 to 18 months after the deal—in order to communicate to the market that the merger is on track. What’s more, the longer senior executives are preoccupied with the internal details of the integration, the more likely they are to lose focus.

On the other hand, an integration has to be thorough. In far too many cases, speed comes at the expense of comprehensiveness. Because executing a postmerger integration is such a high-pressure activity, there is a great temptation to declare victory too early. Executives often settle for suboptimal decisions. Interim organizations that are more the product of organizational politics than business logic have a way of becoming permanent. Potential synergies are identified but never completely captured because the organization loses its concentration. Good ideas are never thoroughly pursued. In many cases, substantial money is left on the table as a result.

It takes courage and persistence to challenge such compromises and see things through to the end. It’s critical, of course, to have a structured PMI process with clear objectives and accountabilities, well-defined phases and timetables, and ambitious targets with strong incentives to achieve them. But process alone is not enough. It is even more important to have the right mindset—an animating vision that makes the process robust and results oriented as opposed to simply mechanistic. Senior executives can achieve these goals by focusing on three specific objectives.

The first is to minimize the PMI’s disruptive effect on the core business. Pulling off a successful PMI is too important to do in magic time or assign to executives who already have important line responsibilities. Tasks need to be segregated from the core business, and the PMI needs its own organization, responsible executives, and faster-than-normal governance and decision-making processes. That’s why experienced acquirers such as Pfizer, Cisco, and Newell appoint dedicated executives and explicitly carve out management-team time to lead their PMI efforts.

Second, any serious PMI process needs to have a plan in place to ensure the smooth functioning of the core business. Companies need to be extremely vigilant about any falloff in revenue and ready for rapid intervention should it occur. Typical mechanisms for doing so include early-warning tracking systems to monitor emerging revenue trends, special temporary incentives to ensure continuity of performance on the part of salespeople and other key staff, and strategies to make sure that soon-to-expire contracts aren’t poached by competitors.
Once a company has detailed plans in place for running both the PMI and the ongoing business, it will find that there are many opportunities for cross-fertilization between the two. Take the example of a global industrial-goods conglomerate that had recently purchased a smaller rival. As might be expected in this highly capital-intensive business, the initial focus of the PMI was mainly on taking cost out of the combined manufacturing operation of the two companies. But the global PMI effort uncovered an unanticipated opportunity on the revenue side in marketing and pricing.

One of the PMI teams, based in Asia, discovered that there were no explicit rules for pricing to customers in the same segment that bought the same or similar products. When the team plotted its findings, the result was a cloud of dots showing no discernible rhyme or reason to the prices charged to similar customers.

When the company’s executives learned of the Asian team’s discovery, they made it the focus of a major effort: the development of a framework for segmenting customers and setting prices that could be applied across all the 46 countries where the company operated. The work identified opportunities for improving the company’s net margin by 1 to 2 percentage points, an enormous increase in a business where a half-point reduction in cost is significant. In effect, postmerger integration became the catalyst for a major shift in the company’s pricing strategy.

A third way to break the compromise between speed and thoroughness is to routinely revisit synergy targets and results in the years after the formal integration is completed. Often during a PMI, a company has to make decisions for pragmatic or political, as opposed to purely business, reasons. They may make sense at the time, but unless they are revisited later, they can build uncompetitive costs into the business.

Executives at one newly merged global food company, for example, knew that their company’s international business was subscale. The logical move would have been to create a global unit combining the new company’s two chief segments. But this new organizational design faced a major obstacle: the opposition of the two powerful senior executives who headed the separate units and believed that integrating them involved too much business risk. The senior management team agreed to keep the two organizations separate for the time being. But they also made an explicit decision to revisit the move in two years. When the time was right, the company created an integrated global unit and achieved the cost savings that came with increased scale.

As important as it is to hit a company’s synergy targets, it is also important to remember that PMI is not just a numbers game. It is a complex change process that reknits the human fabric of the organization. Executive careers are on the line. PMI leaders have to identify and retain key talent and persuade the two organizations that they have a better future together than apart. What’s more, all this must be done in an environment that will inevitably be colored—and, to a degree, distorted—by uncertainty and anxiety. In PMI, this “soft stuff” is often the hardest to get right.

One company, for example, had an acquisition disrupted by the unanticipated loss of some key individuals from the target company on the very first day of the PMI. A few years later, when the company was in the process of acquiring a second target in what was the largest acquisition in the history of its industry, senior executives were determined not to make the same mistake again. A team in corporate HR developed a sophisticated tracking tool that captured key information about tens of thousands of employees at the acquired company.

The system linked every employee to the most appropriate division or department of the acquiring company. It also included the employee evaluations conducted as part of the integration process, which identified “high-talent” personnel. The system tracked the positions in the new combined company for which each individual had been interviewed. It also noted any offers extended to them, whether they had accepted, their willingness to
relocate, and other pertinent information. As a result, management had a way of tracking and retaining high-talent employees. Just as important, from the very first day of the PMI, all the employees had a clear understanding of where they stood and to whom they reported. (Among other things, they were already included on the relevant e-mail distribution lists.)

Practices like these help to make a company’s approach to PMI disciplined, rapid, and thorough. When combined with a well thought-through strategy and rigorous valuation and pricing, they allow a company to capture the full value of a potential acquisition. Developing such capabilities puts a company in a strong position to take full advantage of future opportunities for acquisitive growth.
Conclusion

Despite negative studies and headlines, mergers and acquisitions will continue to be an important component in building successful strategies for growth. Whether fueled organically, through acquisitions, or by a mixture of both, growth is growth, and any kind of growth has the potential to create shareholder value when it achieves consistent levels of operating returns above the cost of capital. The winners will be companies with a clear strategy for growth, an understanding of the conditions in which acquisitive or organic growth makes sense, an ability to anticipate and manage the risks involved, and the capabilities in place to deliver on their strategic goals.

The debate should not be about whether an acquisitive or an organic strategy creates the most value, but when and under what circumstances to grow through M&A and when to grow organically. It’s not about avoiding or embracing acquisitions but rather about how to build a growth strategy that will create a substantial cash return on the investment.
The Boston Consulting Group has other publications on corporate finance that may be of interest to senior executives. Recent examples include:

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- **“New Directions in Value Management”**
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- **Back to Fundamentals**
  The 2003 Value Creators report by The Boston Consulting Group, December 2003

- **Winning Through Mergers in Lean Times: The Hidden Power of Mergers and Acquisitions in Periods of Below-Average Economic Growth**
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