M&A: Down but Not Out

A Survey of European Companies’ Merger and Acquisition Plans for 2009

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1. Introduction

This paper assesses the impact of the current economic and financial crisis on companies’ merger and acquisition (M&A) plans, based on a survey of the CEOs and senior managers of 164 publicly listed European companies—believed to be the first study of its kind.¹

Conducted by The Boston Consulting Group (BCG) and UBS Investment Bank during one of the bleakest financial periods in living memory, within six weeks of the collapse of Lehman Brothers, the survey reveals a remarkable commitment to M&A for such a turbulent period.

◊ Most of the companies surveyed have not changed their M&A plans in the wake of the crisis, and only 15 percent believe it is too risky to do a deal at the moment.

◊ Overall, almost one-third of companies expect to make an acquisition over the next 12 months, and more than 20 percent intend to enter into relatively large deals.²

◊ More significantly, 43 percent of companies believe there will be “transformational” deals in the coming year. This would be consistent with previous crises, such as those of the 1930s and 1970s, when many mergers not only transformed the fortunes of individual companies—catapulting several corporations into positions of long-term dominance—but altered the direction of entire industries.

Mergers and acquisitions, of course, are a risky game. Across all economic cycles, fewer than half of all transactions create value, on average. However, as BCG’s research has demonstrated, downturn deals have a greater probability of succeeding and generate substantially higher long-term returns than transactions executed in periods of above-average economic growth.³ There is also evidence that both buyers and sellers of divested assets can enjoy high, above-average returns during downturns (and most companies in our survey anticipate an increase in divestitures).⁴

Seizing these opportunities will not be easy: most of the companies surveyed said that they currently face some internal or external obstacles to executing large deals. Nor is it certain that companies’ M&A plans will remain as ambitious as they currently appear, especially if the economic climate deteriorates even more sharply.⁵ But there are good reasons to believe that the current level of M&A activity, which is still much higher than many commentators recognize, could remain relatively robust, not least owing to the large cash balances that many companies still hold. The history of M&A in financial crises reinforces this belief—and suggests that deals in the coming months could radically change the corporate landscape. And, as we’ve seen with the current financial crisis, history has a habit of repeating itself.

¹ The survey was carried out between mid-September 2008 and the first week of November 2008. It included 63 companies with a market capitalization of more than $5 billion and 24 companies with a market capitalization of more than $20 billion.
² Large deals are transactions in which the target’s sales represent more than 10 percent of the acquirer’s sales.
⁵ See BCG’s regularly updated Collateral Damage series of articles, which analyze the ongoing financial and economic crisis, highlight potential developments, and explain how companies can rise to the challenges, at www.bcg.com.
2. Acquirers Remain Quietly Bullish

Since the third quarter of 2007, when the credit crunch started to bite seriously, the level of M&A activity has plummeted, with global deal values and volumes falling by approximately 30 percent and 15 percent, respectively, on a year-on-year basis. However, the deteriorating financial situation has not shaken companies’ confidence in M&A as a key weapon in the corporate arsenal.

During the last 12 months, more than half of the companies surveyed have stuck to their M&A plans, and a significant proportion even stepped up their planned levels of deal activity. Overall, 29 percent of companies—mainly large corporations—expect to do an M&A in the coming 12 months, including a significant proportion of large deals. Moreover, this commitment to M&A does not appear to be at the expense of organic investment. In fact, there has been a 9 percentage point net gain in the proportion of companies increasing their organic investment plans over the last 12 months.

A. Companies Are Sticking to Their M&A Plans

Mergers and acquisitions have always gone in waves, with clear peaks and troughs, usually mirroring GDP growth. The latest wave, which started in 2004 and is the largest in history by volume and the second biggest by value after the peak of 2000, has obviously declined dramatically, but the ongoing crisis has not killed it off.

◊ Fifty-one percent of the companies surveyed said that their M&A plans over the last 12 months have not been affected by the deteriorating financial and economic climate.

◊ More significantly, 22 percent of companies claim to have increased their M&A plans during the crisis, indicating that many not only sense an opportunity but also have the resources to capitalize on it despite current capital-market restrictions. However, not all companies are so bullish: 27 percent have downgraded their M&A plans over the last 12 months. The net impact is that just 5 percent of all the companies surveyed have reduced their planned M&A activity—a very modest drop given the scale of the crisis. Organic investment plans have not altered much either, suggesting there has not been a major shift from acquisitive to organic growth as might be expected. Overall, there has been only a 9 percentage point net gain in the proportion of companies increasing their organic investment plans.

◊ The sectors that have increased their M&A investment plans are generally those that were hit later by the crisis, such as industrials and chemicals, as well as less cyclical industries such as pharmaceuticals and biotechnology. (See Exhibit 1.) Industries that were affected earlier, such as banking and construction, have tended to scale back their plans.

◊ Across all sectors, nearly one-third of companies (29 percent) are likely to do a deal involving a target with sales of more than €250 million over the next 12 months. Half of the large companies in our sample said they are likely to do such a deal, compared with 38 percent of midsize companies and 20 percent of small companies.\(^6\) One possible implication of this finding is that small companies have a greater chance of becoming targets.

These findings suggest that M&A activity in 2009 could drop less than many observers expect if companies sustain their current plans. Although the M&A market has contracted substantially over the last 12 months, one fact that is often overlooked is that deal values and volumes are still relatively high, almost matching the levels achieved in 2006 and higher than those during most of the 1990s. (See Exhibit 2.) Even the third quarter in 2008 was comparable to the same quarter in 2005.

At an industry level, our findings indicate that CEOs will need to think carefully about how they respond to changes in their competitors’ M&A plans. In sectors where planned deals have been reduced, companies

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\(^6\) The companies in our survey, measured by market capitalization in mid-September 2008, are as follows: “large” companies are worth more than $20 billion, “midsize” companies are worth $5 billion to $20 billion, and “small” companies are worth less than $5 billion.
Exhibit 1. M&A Plans Have Generally Not Changed Dramatically but There Are Substantial Differences Between Industries

Net proportion of companies that have increased or decreased their M&A investment plans over the last 12 months, by industry

Increase
- Media: 37%
- Pharmaceuticals and biotech: 37%
- Industrials: 33%
- Transport: 25%
- Utilities: 9%
- Energy: 1%
- Metals, mining, and steel: 0%
- Telecom: 0%
- Retail: 0%
- Consumer: 0%
- Technology: 0%

Decrease
- Media: 0%
- Pharmaceuticals and biotech: -5%
- Industrials: -20%
- Transport: -26%
- Utilities: -26%
- Energy: -13%
- Metals, mining, and steel: -38%
- Telecom: -45%
- Retail: -20%
- Consumer: -26%
- Technology: -33%
- Banks: -5%
- Construction: -28%
- Support services: -38%

Source: UBS and BCG CEO/Senior Management M&A Survey of 164 publicly listed European companies.
Note: Calculated as the percentage of companies that plan to increase M&A activity less the percentage of companies that plan to decrease M&A activity.

Exhibit 2. M&A Values and Volumes Are Still Similar to Those Achieved in 2006

Value and number of M&A transactions completed worldwide and global nominal GDP, 1981–2008

Number of transactions
- 1981: 0
- 1983: 0
- 1985: 0
- 1987: 0
- 1989: 0
- 1991: 0
- 1993: 0
- 1995: 0
- 1997: 0
- 1999: 0
- 2001: 0
- 2003: 0
- 2005: 0
- 2007: 0
- 2008: 0

Value of transactions ($billions)
- 1981: 0
- 1983: 0
- 1985: 0
- 1987: 0
- 1989: 0
- 1991: 0
- 1993: 0
- 1995: 0
- 1997: 0
- 1999: 0
- 2001: 0
- 2003: 0
- 2005: 0
- 2007: 0
- 2008: 0

Nominal GDP ($billions X 10)
- 1981: 0
- 1983: 0
- 1985: 0
- 1987: 0
- 1989: 0
- 1991: 0
- 1993: 0
- 1995: 0
- 1997: 0
- 1999: 0
- 2001: 0
- 2003: 0
- 2005: 0
- 2007: 0
- 2008: 0

Sources: Thomson Financial/SDC; The Economist Intelligence Unit; BCG’s M&A Research Center.
Note: Transaction values shown are enterprise values including net debt of target. Based on a total of 438,486 completed M&A transactions, excluding repurchases, exchange offers, recapitalizations, and spinoffs; 2008 figures extrapolated based on actual figures as of November 18, 2008.
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might be able to make valuable opportunistic acquisitions with relatively little competition. Conversely, companies in industries with increased activity could be left behind or even acquired if they sit on the sidelines.

Of course, some companies may have altered their M&A plans since responding to our survey; the situation is changing almost daily, and companies may have undergone new planning cycles with very different assumptions. But even if companies have reduced their M&A plans, there are several reasons why deals are unlikely to dry up.

First, companies have always done deals, even during economic crises such as the 1930s, the 1973 oil crisis, or following the 1987 stock market crash. Second, many companies still have the cash and profitability to fund transactions themselves. The cash surplus of the S&P 500, for example, is about 70 percent higher than in 2000, when M&A activity was greater than it is today. The average profitability of these companies, measured by earnings per share, is also higher than in 2000. And even if companies cannot fund transactions on their own, there are still alternatives to the capital markets, including sovereign wealth funds (SWFs), which currently have about $3 trillion of assets under management, and minority stakes from private equity firms. In fact, SWFs could become major players in the M&A market in their own right, especially as the political considerations that previously constrained their M&A activity as majority investors are likely to be overlooked in favor of offering economic lifelines to ailing industries. SWFs also appear to be keen to diversify their portfolios beyond government debt into different asset classes.

There is no doubt that now is a good time to do a deal. As an earlier study revealed, downturn transactions tend to generate substantially higher long-term shareholder returns than deals executed in upturns. The study found that the average downturn merger outperformed the stock market by 8.3 percent two years after the transaction was closed, while the average upturn deal underperformed the market by 6.2 percent over the same period—a 14.5 percentage-point difference. In addition, downturn deals are nearly twice as likely to generate returns in excess of 50 percent in the long run as transactions executed in periods of above-average economic growth. Several major players in the M&A market, including private equity firms that still have the strength to do deals, have already said that they plan to capitalize on these downturn opportunities, especially in view of the current pricing of fundamentally healthy targets and reduced competition.

B. Many Deals Could Be Large

One of the striking findings of the survey is that there is still an appetite for large deals.

- About one fifth (21 percent) of the companies surveyed said they are likely to acquire relatively large targets.

- Furthermore, just over half (51 percent) of all companies that plan to engage in any M&A larger than €250 million over the next 12 months anticipate doing a large deal, in which the target’s sales are worth more than 10 percent of the acquirer’s sales.

- Large corporations are most likely to do big deals: 25 percent of these companies said they will make relatively large acquisitions, compared with 13 percent of midsize companies and 22 percent of small companies.

- Companies in highly profitable industries that still have big stockpiles of cash, such as energy and utilities, are most likely to do large-scale transactions. (See Exhibit 3.) Not surprisingly, companies in industries that have already experienced significant consolidation, such as telecommunications, do not expect to play this high-stakes game. Banks also said they are likely to sit on the sidelines, but the reality will probably be very different. As we discuss later, banks might have to do deals to survive and to accelerate the unavoidable consolidation that is required in the industry. Other sectors, such as construction, are likely to find themselves in the same boat.

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7. See Winning Through Mergers in Lean Times.
While there are clear differences between sectors, the fact that such a high proportion of companies are prepared to embark on large deals at such an apparently risky time is significant. It indicates not only that companies still have the cash or cash flow to fund transactions but also that they see the current crisis as an opportunity to make bold and potentially transformational deals. In fact, most companies expect to see transformational deals in the coming months.

3. Expect an Era of Transformation

Despite the immediate pressures of the financial crisis, companies are nearly three times as likely to use M&A over the next 12 months to gain a long-term competitive advantage as to improve their short-term operational performance. As in the 1930s and other major downturns, this suggests two main types of deals could feature in the coming months: transformational M&A that reshape entire industries and restructuring deals that sharpen or radically alter the focus of companies’ portfolios of businesses.

Nearly half of the companies questioned believe there will be transformational deals in their industry, which is reinforced by our finding that many deals are likely to be relatively large. Almost 60 percent of companies also expect the number of restructuring transactions to rise, which could lead to additional divestitures, creating further opportunities for both buyers and sellers.

A. Long-Term Strategic Goals Trump Short-Term Operational Gains

While it might be reasonable to expect companies to adopt short-term defensive tactics to reduce costs and boost revenues in such an uncertain climate, many companies appear to be taking a longer-term perspective, viewing the crisis as an opportunity to seize the strategic high ground.

The largest percentage of companies (42 percent) said their most important reason for acquiring a firm in the next 12 months is “to fill a strategic gap”—nearly three times the percentage that cited cost-driven “economies of scale” as the main driver (16 percent). Only 8 percent said their top priority is to “secure new revenue streams to drive a slowing top line.” However, within certain industries, other
In banking and insurance, for example, “achieving economies of scale with respect to cost” is the biggest driver of M&A at the moment.

Moreover, 45 percent of the companies that plan to do large deals in the coming year intend to do so for strategic reasons, either to add a new leg to their portfolio of businesses or to strengthen the products or services portfolio, the supply chain, or the geographic reach of their existing business units.

This long-term strategic focus is underlined by the fact that 90 percent of companies claim that the target’s strategic fit is the most important factor when assessing its relative attractiveness, significantly ahead of the other top-three selection criteria, including the target’s operating performance (cited by 65 percent)—which was perhaps pushed up the list by the current economic environment—and cultural fit (36 percent). The relatively low importance attached to the target’s cultural fit could indicate that some companies still underestimate the importance of this factor. Other, more technical selection criteria, such as the target’s balance-sheet utilization and relative market valuation, are considered comparatively unimportant.

The emphasis on deals with long-term strategic potential, rather than operational strength, is understandable: strategic flaws cannot be corrected once a deal is done, while operational deficiencies can, highlighting the importance acquirers need to attach to the strategic assessment of the target. This requires taking a strategic perspective through the entire transaction process, from target search and due diligence to integration. Just as companies pay detailed attention to the financial due diligence, they should also consider how to bring the best available strategic expertise to a potential deal.

**B. Many Companies Anticipate Transformational Deals**

The likelihood of large, strategically oriented transactions increases the chances of industry-changing deals. In fact, a high proportion of companies think the coming months could see a number of transformational deals, mirroring the experiences of previous crises.

Forty-three percent of the companies surveyed believe there will be a transformational deal in their industry within the next 12 months, while 23 percent are unsure if this will occur, reflecting a significant level of uncertainty about the direction of the economy and the markets. Only 34 percent of companies think their industry will see no transformational deals.

The industries considered most susceptible to a transformational deal are generally those that have suffered the greatest cost and capital pressures during the crisis. For example, 71 percent of insurance companies and 67 percent of banks believe these types of transactions are likely in their respective industries. Similar proportions of telecommunications and technology companies expect transformational deals in their sectors (67 percent and 63 percent, respectively). (See Exhibit 4.) Given that companies in most of these sectors said they do not plan to do large transactions, these results imply that no one wants to move first but everyone sees the necessity for consolidation or change. In other words, transformational deals could be triggered by companies needing to sell themselves to survive, as we have recently seen in the banking sector.

Consolidation is likely to be the biggest driver of transformational deals (cited by 70 percent of companies), followed by cheaper prices (62 percent) and the rising number of ailing businesses (56 percent). However, within individual sectors, senior executives believe other factors will come into play. In industries such as metals, mining, and steel, as well as in energy, companies believe that transformational deals will be fueled by a race for additional sources of raw materials. The arrival of new players from Asia and the Middle East is expected to shake up a number of other industries, such as cyclical consumer goods (including clothing) and technology (including software and IT services).

As history has shown, transformational deals are not just a common feature of crises. They can also have a major long-term impact on companies’ fortunes and the competitive landscape. During the Great Depression, for example, four financially distressed German car manufacturers, including Audi, came...
together in 1932 to form the Auto Union and swiftly capitalized on their collective strength to establish a dominant position, quadrupling their revenues over the next six years. In fact, the main bank behind the deal, the Sächsische Staatsbank, was only prepared to fund the combined entity, not the individual businesses—an approach that funders might apply to certain industries in the coming months. Today, Audi (now part of Volkswagen) still pays tribute to this transformational moment in its history through its logo: four interlinked rings symbolizing the merger of the four founding companies. Unilever was also born in the 1930s, through the merger of British soap maker Lever Brothers and Dutch margarine producer Margarine Unie, creating the world’s first global consumer goods company.

The 1973 oil crisis had a different yet equally dramatic impact. It sparked a wave of “conglomerate” mergers as companies attempted to diversify out of oil-dependent industries. Shell, for example, acquired the Dutch metals and mining company BHP Billiton and established joint ventures with companies such as Gulf Oil and Bechtel Corporation to explore nuclear power and the construction of electricity generation facilities. While most of these conglomerates have since de-merged, they radically altered how businesses thought and acted for nearly a decade.

More recently, Sony showed how downturns can be used to create a new business model and transform the direction of an industry when it acquired CBS Records immediately after the 1987 stock market crash. Sony recognized that future growth lay in marrying its hardware with software (in this case, CBS’s music library), and the company reaped the benefits of this model, ensuring the success of its new audio technology—a model that other companies have since imitated, most notably in the MP3 music market. Later, Sony attempted to apply the same hardware-software model by acquiring Columbia Pictures in a bid to dominate the video market. This transaction, however, was complicated by integration issues, highlighting that even strategically sound deals can fail unless there is flawless execution, including careful target selection, rigorous due diligence, and thoughtful integration.

Given that industry-changing deals can be around the corner at any time, it is essential that senior executives be ready for these types of transactions. The critical question that every company needs to address is

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Exhibit 4. Industries Hit Hardest by the Crisis Are Most Likely to Experience Transformational Deals

<table>
<thead>
<tr>
<th>Industry</th>
<th>Proportion of companies expecting transformational deals in 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance</td>
<td>71%</td>
</tr>
<tr>
<td>Telecom</td>
<td>67%</td>
</tr>
<tr>
<td>Construction</td>
<td>67%</td>
</tr>
<tr>
<td>Metals, mining, and steel</td>
<td>63%</td>
</tr>
<tr>
<td>Media</td>
<td>50%</td>
</tr>
<tr>
<td>Transport</td>
<td>50%</td>
</tr>
<tr>
<td>Energy</td>
<td>50%</td>
</tr>
<tr>
<td>Support services</td>
<td>45%</td>
</tr>
<tr>
<td>Pharmaceuticals and biotech</td>
<td>36%</td>
</tr>
<tr>
<td>Consumer</td>
<td>33%</td>
</tr>
<tr>
<td>Industrial</td>
<td>33%</td>
</tr>
<tr>
<td>Retail</td>
<td>26%</td>
</tr>
<tr>
<td>Retail</td>
<td>20%</td>
</tr>
<tr>
<td>Retail</td>
<td>6%</td>
</tr>
</tbody>
</table>

**Proportion of companies expecting transformational deals in their respective industry in 2009**

**Source:** UBS and BCG CEO/Senior Management M&A Survey of 164 publicly listed European companies.
whether it will be a potential predator or potential prey in any transformational battle. This will determine the appropriate course of action, including any remedial steps needed to go on the offensive or repel an attack.

**Predator or Prey?** BCG has developed a simple methodology to help companies establish whether they could be predators or prey, given two key factors: the company’s relative position in the capital markets based on its current valuation and historic shareholder returns, and its financial health, including its operational performance and leverage. As Exhibit 5 illustrates, companies with a relatively high valuation multiple and strong shareholder returns compared with their peers, plus solid profitability and low leverage, are most likely to have the resources and power to become predators in a downturn. Companies with the opposite characteristics could easily become prey and be taken over, either by a financially stronger competitor or by a financial investor such as a hedge fund or private equity firm. This risk is especially high if the company is operationally strong yet financially weak with a high debt burden, a poor valuation, and disappointing shareholder returns.

All companies should evaluate where they stand on the predator-prey battleground and develop appropriate strategies. Potential predators should identify suitable prey, while potential targets should attempt to remove themselves from predators’ firing line by restructuring their businesses and divesting units that are undermining their fundamentals and shareholder returns.

**Strategies for Predators.** In addition to identifying targets with the right strategic fit, acquirers need to consider three main factors when assessing potential prey: the target’s relative profitability, its financial health (especially its leverage), and its relative size.

Previous research has shown that companies acquiring targets with significantly lower profitability than their own during a downturn outperform the market by 14 percent over the two years following the acquisition, while companies that buy businesses with higher profitability produce returns that are comparable

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**Exhibit 5. Capital Market Factors and Fundamentals Indicate Whether Firms Could Be Predators or Prey**

<table>
<thead>
<tr>
<th>Relative position in the capital market: valuation multiple versus shareholder return</th>
<th>Financial health: operating performance versus leverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Two-year historical TSR</td>
<td>Five-year average ROGI (ex goodwill) or ROE</td>
</tr>
<tr>
<td>Low relative valuation, strong value creation</td>
<td>Low debt burden, strong earnings power</td>
</tr>
<tr>
<td>High relative valuation, strong value creation</td>
<td>High debt burden, fundamentally healthy business</td>
</tr>
<tr>
<td>Expensive? Stock deal? Predator?</td>
<td>Predator?</td>
</tr>
<tr>
<td>Cheap, with a fall from peak value Prey?</td>
<td>Low debt burden, low earnings power</td>
</tr>
<tr>
<td>High relative valuation, but a fall from peak Tier-two acquirer?</td>
<td>High debt burden, low earnings power</td>
</tr>
<tr>
<td>EV/EBITDA</td>
<td>On the sidelines? Restructuring opportunity?</td>
</tr>
<tr>
<td>(Debt+Pensions)/EBITDA</td>
<td></td>
</tr>
</tbody>
</table>

*Source: BCG analysis.*
to the stock market average. In successful downturn mergers, the difference in profitability between the acquirer and the target, measured by cash flow return on investment (CFROI), is roughly five times higher than in successful upturn deals. This difference enables acquirers during a downturn to improve the target’s CFROI by three times as much (1.3 percentage points) as their upturn counterparts (0.4 percentage point), highlighting the importance of subsequent operational improvements as a key M&A value driver during downturns.

While it can be attractive to buy operationally underperforming assets, it is essential to ensure that the target is financially healthy with a reasonable level of debt. Using a well-established technique to categorize the relative health of targets, known as Altman-Z scores, BCG has found that healthy targets (with an average debt-to-total-assets ratio of 47 percent) are nearly 50 percent more likely to create shareholder value than distressed targets (with an average debt-to-total-assets ratio of 61 percent).

Finally, acquirers should pay attention to the target’s size: the larger the transaction relative to the size of the acquirer, the greater the risk that the deal will destroy shareholder value. For example, targets worth more than 50 percent of the acquirer destroy nearly twice as much value as targets worth less than 10 percent of the acquirer. Furthermore, absolute size matters: deals worth more than $1 billion destroy nearly twice as much value as transactions worth less than $1 billion, reflecting the difficulty of integrating large targets.

Defensive Tactics for Potential Targets. Once a company comes into play as a potential target, there is a high probability that it will be acquired. To minimize this risk, it is essential that potential targets improve their profitability, optimize asset productivity, focus on paying down their debt, and look for stable long-term shareholders. Companies may also need to revise their strategies to reflect the harsher realities of today’s capital markets. More generally, all companies—whether they are predators or prey—must treat their portfolios of businesses as a collection of value creators and value destroyers, divesting noncore and irreparable businesses. As we discuss below, divestitures can offer several powerful advantages, even in the current environment.

C. Restructuring Deals Are Also Expected to Increase

Under normal economic conditions, restructuring is relatively rare, with possibly as few as 5 percent of companies going down this avenue each year. However, our survey indicates that a much higher proportion of companies could be affected by deal-based restructuring in the coming months, leading to a rise in the number of spinoffs, carve-outs, and closures of individual businesses.

- Fifty-eight percent of companies expect more deal-based restructuring over the next 12 months in their respective industries, while 29 percent think the level will stay the same. Only 8 percent of companies believe there will be less deal-based restructuring. (See Exhibit 6.)

- Most companies (63 percent) claimed that their M&A-based restructuring plans have not been affected by the economic outlook. However, a substantial proportion (23 percent) said the outlook has increased the likelihood that they will divest assets, and more than half of these companies (58 percent) said they might divest even though they are worried about receiving a lower price in a downturn. Financial pressures, such as the current debt capital market situation, might force a significant proportion of companies to do restructuring deals at lower prices than they would like. However, 26 percent of the companies that said they are more likely to restructure in today’s environment claimed that lower prices are not their main concern and that their divestiture activity would mainly be driven by the strategic conviction that “divestitures are currently a good way to focus our business.”

- Not surprisingly, the sectors that have been most severely affected by the financial crisis are most likely to restructure using M&A. For example, all the banks and insurers in our survey believe there will be more restructuring deals in their industries, with approximately 70 percent expecting “much more”

8. See Winning Through Mergers in Lean Times.
and around 30 percent expecting “slightly more.” This explains our apparently contradictory finding that banks and insurers don’t plan to do large deals but expect transformational transactions within their industries: these transformational deals are likely to result from restructuring M&A. In other words, banks and insurers recognize that consolidation is unavoidable, but only a few are planning to be acquirers. Indeed, several high-profile restructuring deals have already been seen in these sectors, including JPMorgan Chase’s acquisition of Bear Stearns, Bank of America’s takeover of Merrill Lynch, and Lloyds TSB’s proposed merger with HBOS.

◊ Other industries with an above-average probability of seeing restructuring deals include transport—reflecting downward pressure on shipping rates—as well as construction and telecommunications. Even stable industries expect more restructuring M&A, including more than half of the utility companies surveyed.

As earlier research has demonstrated, divestitures present substantial value-creation opportunities for both buyers and sellers—provided companies adhere to some basic principles. 9

**The Value of Downturn Divestitures.** For acquirers, divestitures produce positive shareholder returns under all economic conditions—unlike acquisitions of entire companies, which tend to destroy value. Although acquirers’ returns from divestitures during downturns are slightly lower than during upturns, they are still significantly positive and relatively stable.

Companies divesting assets also enjoy substantial gains, increasing their shareholder value by 1.5 percent, on average, across all economic cycles. Interestingly, there is evidence that companies earn higher returns from divested assets in downturns than in upturns. Although a seller’s immediate concern in a recession may simply be to obtain the best possible price for the asset, an additional increase in shareholder value can provide useful protection against predators and shareholder activists.

**Success Criteria for Buyers.** Companies buying divested assets that strengthen their core businesses, enabling them to reap cost and revenue synergies, earn 24 percent higher returns than companies that buy

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9. See *The Return of the Strategist.*
divested assets in noncore areas. Acquirers also generate greater returns when the divestiture is relatively large for the buyer and relatively small for the seller. One possible explanation for this is that while such assets tend to be neglected by the seller, they are likely to receive greater attention and commitment from the buyer because the stakes are much higher.

**How Sellers Can Optimize Their Returns.** Our research reveals that sellers rarely optimize the value of their divested assets, squandering $28 million per deal on average, compared with companies that are sold in their entirety. To avoid this pitfall, sellers should target potential buyers that are most likely to create the greatest value from the divestiture—and consequently to pay a higher premium. In addition, companies that divest when they are in financial difficulties earn twice the returns of financially healthy companies that sell a business, implying that forced restructuring divestitures can be totally appropriate in terms of value creation.

**4. It Won’t Be an Easy Journey**

While many companies plan to do large and possibly transformational deals, most concede that it will be more difficult to execute such transactions in the current environment. Nine out of ten companies said that they face external obstacles, including lack of funding, while more than 60 percent cited internal barriers, including the need to focus on profitability rather than growth.

Buyers have also become more demanding and circumspect, making it harder for sellers to secure a deal and possibly lengthening the time between the first contact with the target and the closing of the deal. For instance, most companies expect to pay lower prices in terms of multiples and lower acquisition premiums. They are also applying tighter selection criteria, including more rigorous due diligence.

Nevertheless, most of these obstacles can be surmounted, provided both buyers and sellers adapt to the new environment. For example, buyers will have to alter their screening criteria and conduct a more rigorous due diligence process, including economic stress-test scenarios, while sellers will have to satisfy buyers’ additional information requirements and market their assets even more effectively to secure the most attractive price.

**A. Most Companies Face Internal and External Barriers to Executing Deals**

A very high proportion of companies in our survey claimed that various external and internal obstacles were likely to restrict their ability to carry out large M&A. However, on closer analysis, the challenges are not quite as daunting as the headline figures suggest. (See Exhibit 7.)

- Ninety-one percent of companies see external barriers to doing a deal, but there is no one obstacle that is limiting all companies. In fact, there was not a single external barrier that was mentioned by more than 40 percent of the companies surveyed. There are two main categories of external barriers: macroeconomic and target specific. Lack of funding was the most commonly cited macroeconomic hurdle, yet only 37 percent of companies said this was a constraint, implying that it is not a problem for 63 percent of companies. Around a quarter of companies are also concerned about investors’ reactions and uncertain future demand. In addition, several target-specific obstacles were mentioned: 37 percent of companies claimed that there is a lack of strategically attractive targets, irrespective of price, while 29 percent said that prices are still too high.

- Sixty-eight percent of companies said there are internal barriers, but once again, each of the barriers cited affects only a fairly small proportion of the companies in our sample. The top internal obstacle, cited by 31 percent of companies, is the need to focus on profitability rather than growth. Other key internal hurdles include the need to integrate recent acquisitions first (cited by 24 percent of companies) and to finalize the company’s future strategy before embarking on new deals (19 percent).
Interestingly, only 15 percent of companies think it’s too risky to do M&A in the current environment. Although this could mean that companies are underestimating the risks, the fact that most companies are satisfied with their M&A processes implies that their confidence could be well founded.

The most remarkable finding is that nearly two-thirds of companies do not face funding difficulties, despite the fact that debt issuance has dropped by more than 60 percent and credit spreads have nearly quadrupled for corporate debt in certain rating categories since the crisis started. This implies that many companies still have sufficient cash on their balance sheets, strong cash flows, or access to credit on reasonable terms.

In fact, even if companies do not have an immediate source of funding, there is a good chance that they will be able to find alternative sources beyond the capital markets. Private equity firms, for example, are becoming increasingly open to the notion of taking minority stakes. Sovereign wealth funds are another possibility. In general, companies will have to think more creatively about funding, as Mars did when it enlisted the financial support of Warren Buffett to acquire the Wrigley Company.

The internal barriers cited by executives in our survey can also be overcome, often within a year or two, enabling many companies to return to the M&A market in a fitter and more battle-ready state—a development that could trigger a more aggressive wave of deals in the medium term.

**B. Buyers Are Applying Stricter Investment Criteria**

Mirroring the stricter scrutiny now being applied to the world’s capital markets in the wake of the crisis, many companies are tightening up their M&A investment criteria.

- Forty-three percent of companies said they are assessing deals differently in the current climate. Of these companies, 67 percent are imposing stricter financial criteria and 44 percent are performing additional due diligence and risk assessment.

- Twenty-nine percent of companies said they need to improve their strategic assessment of targets.
Tighter financial criteria will inevitably lead to fewer deals going beyond the investigation stage. But buyers will need to be careful not to dismiss potentially valuable deals by applying arbitrary discount rates and other subjective criteria that have been a feature of so many companies’ evaluation procedures in the past. Instead they must employ more rigorous, evidence-based analyses, including cash-flow scenario planning and cyclicity assessments. Any approaches or processes that are used must be battle tested—this is not a time for experimenting with new methodologies. Companies will also have to be exceptionally vigilant at the due diligence stage to avoid buying strategically flawed businesses, especially as it will be much harder to divest such businesses in the current environment.

Sellers will need to be equally rigorous, not just to satisfy buyers’ additional information requirements but also to identify potential acquirers that will offer the best price. In addition, sellers will have to put together a compelling equity story, rooted in a detailed scenario-based cash-flow plan and a clear, fact-based understanding of prospective buyers’ strategic objectives and long-term potential, taking into account industry and market trends.

To rise to these challenges, buyers and sellers should ensure that they have adequate internal and external M&A expertise on board so they can seize any opportunities and counter any threats as soon as they arise.

C. Sellers Are Likely to Receive Lower Prices and Lower Premiums

Market values and multiples have fallen dramatically over the last 12 months, presenting cash-rich buyers with some potentially extraordinary bargains. And most companies now expect bargains.

- Seventy-two percent of the companies surveyed expect to pay lower prices in terms of multiples. (See Exhibit 8.) However, most of these companies (52 percent) said they expect prices to be only “slightly lower,” while only 20 percent believe that prices should be “much lower.” Across all industries, just 8 percent of companies said they didn’t know whether prices should be lower, indicating that the vast majority have a clear view of reasonable values, which could leave unprepared sellers with little room to negotiate prices upwards.

- Seventy percent of companies also expect to pay lower acquisition premiums. This is probably because most anticipate generating lower synergies from mergers—typically around 15 percent of EBIT, which is substantially lower than the historical range of acquisition premiums of 20 to 25 percent.

- Predictably, the industries hit hardest by the crisis, such as construction, financial services, and technology, are most likely to expect lower prices and premiums. At the other end of the spectrum, half the companies in the chemicals industry believe that prices and premiums will stay the same.

The widespread belief among companies that they should pay lower premiums in the current environment is understandable but potentially counterproductive: it could rule them out of deals with substantial long-term value-creation potential and thus destroy shareholder value. As we found in previous research, value-creating deals, surprisingly, have a higher average premium (21.7 percent) than value-destroying transactions (18.1 percent).10

This doesn’t mean that paying high premiums necessarily translates into superior shareholder value. The key to success is to focus on companies with below-average multiples; fundamentals drive long-term value, not acquisition premiums. As Exhibit 8 illustrates, a combination of low multiples and high premiums often produces superior returns.

There’s another, more logical reason why acquirers should not push too hard for lower premiums. Given that absolute prices have fallen significantly recently, buyers will already be paying lower absolute premiums than before, even if they are paying the same relative premiums.

D. Integration Is the Achilles’ Heel of the M&A Process

While 77 percent of companies claimed they are satisfied with their M&A processes, they identified several areas where there is room for improvement, with postmerger integration (PMI) at the top of the list.

- Forty-two percent of companies admitted they need to sharpen their PMI planning and execution.
- Twenty-seven percent said they want to speed up their deal execution. The same proportion said they need to improve their internal decision making.
- Twenty-one percent said their negotiation skills could be better.

PMI is clearly the area needing the most work; it is also one of the most critical and misunderstood parts of the M&A process. One of the most common problems is that acquirers often treat PMI as a mechanical process that occurs after the deal is done. Although a PMI has to be systematically and rigorously controlled at the implementation stage, it is the strategic and tactical choices made before the deal is legally closed—and often before the bid has even been made—that ultimately determine whether the integration succeeds or fails. There is no such thing as a one-size-fits-all merger. Each has its own speed, focus, and rhythm.

A consolidation merger, for example, should be rapid, with an aggressive timeline, and approached in the spirit of a takeover, with a highly directive top-down leadership structure. A growth merger, on the other hand, requires a more gradual, arm’s-length approach, with the target treated much more as an equal. The reality, of course, is that most M&A are a complex mix of both consolidation and growth synergies, depending on the business units involved. As a result, a segmented approach is required. And this requires early and careful planning.11

11. For further insights into how to plan for a PMI, see the first report in BCG’s “Trends in Postmerger Integration” series, Powering Up for PMI: Making the Right Strategic Choices, BCG Focus, June 2007.
5. The Long-Term Prognosis Is Positive

Most companies believe that the importance of M&A will intensify over the next five to ten years. And, as always, the strategic logic of a deal will be the primary factor that determines whether it succeeds or fails.

- Forty-two percent of the companies surveyed expect M&A to increase in importance over the next five to ten years, especially for small companies. (See Exhibit 9.) Fifty percent of small companies believe that M&A will become more important for them, compared with 29 percent of large companies. Industries that expect deals to play an increasingly valuable role in their long-term strategic development include energy, telecommunications, and transport: more than 60 percent of companies in each of these industries agree that M&A will become more important for them. Across all industries, 49 percent of companies believe the significance of M&A will stay the same over the next five to ten years, and only 4 percent expect its importance to decline.

- Eighty percent of companies said that strategic logic and fit is the main driver of a successful deal. Most other factors are considered much less important, including the financial attractiveness of the target (cited by 49 percent of companies) and its cultural fit (35 percent).

These findings underscore our earlier results, which showed that most companies view deals through a long-term strategic lens, even during difficult periods. The belief that deals will grow in importance in the long run also implies that many companies are already anticipating an upswing in M&A activity. Inevitably, there will be an upturn, since deals have always occurred in waves. (See Exhibit 10.) But it is unlikely to happen in the near term, and it would be unwise for any company to wait on the sidelines for this moment to arrive. Today’s crisis presents unique M&A opportunities and threats that all companies must address. Every firm needs to systematically assess its predator-prey position, bullet-proof its cash flows to seize opportunities and ward off attacks, and craft an appropriate strategy, taking into account competitors’ positions and possible responses.

The M&A market might be down, but it’s not out. The question is who will be able to capitalize on the opportunities of a downturn and who will be the victims. Looking further ahead, we are convinced that M&A activity will rise substantially in the medium term, possibly reaching heights that few today can imagine.

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**Exhibit 9. Companies Believe M&A Will Become Increasingly Important over the Next Five to Ten Years**

<table>
<thead>
<tr>
<th>Importance of M&amp;A for surveyed companies over the next five to ten years</th>
<th>Key factors in a successful transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>More Important</td>
<td>Strategic logic and fit of target (80%)</td>
</tr>
<tr>
<td>Same</td>
<td>Financial attractiveness (deal economics) (49%)</td>
</tr>
<tr>
<td>Less Important</td>
<td>Cultural fit (35%)</td>
</tr>
</tbody>
</table>

More than 90 percent see a continuing or even an increasingly important role for M&A in corporate strategy.

**Source:** UBS and BCG CEO/Senior Management M&A Survey of 164 publicly listed European companies.

**Note:** Answer option “Don’t know” has been omitted in left-hand graph; multiple answers allowed in right-hand graph.
Exhibit 10. Like the Economy, M&A Has Always Been Cyclical—and Will Definitely Rebound in the Medium Term


Note: 2008 values based on figures through September extrapolated to year-end.
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