MEMO TO THE CEO

Winning in Turbulence

Pursue Game-Changing M&A and Partnerships

By

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Previews the forthcoming book

Winning in Turbulence

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Pursue Game-Changing M&A and Partnerships

For many executives, doing a deal in a downturn seems risky and impractical. Credit markets aren't functioning normally, so financing is expensive and hard to come by. Cash reserves need to be guarded as a safety net in case the economy stays bad. Equity markets are depressed, so acquirers and targets alike are wary of stock-based transactions. A major deal could distract management from strengthening the core business and bring unforeseen hazards.

Acquisitions are certainly more challenging in a downturn. The number and value of deals tend to drop dramatically during and immediately after a recession. The aggregate value of deals in 2002, for instance, right after the 2001 recession, came to only about $1.2 trillion. That was less than half the aggregate deal value four years earlier and about one-third of the value four years later. Government-brokered mergers aside, the current recession may end up provoking an even more dramatic drop in deal value.

These constraints make it impossible or imprudent for some companies to enter the deal market. But for companies that are relatively strong strategically and financially, recessions present rare opportunities to improve their competitive position through acquisitions and partnerships. According to our analysis of more than twenty-four thousand transactions between 1996 and 2006, acquisitions completed during and right after the last recession (2001–2002) generated almost triple the excess returns of acquisitions made during the preceding boom. ("Excess returns" is defined as shareholder returns from four weeks before to four weeks after the deal, compared to peers.) This finding held true regardless of industry or the size of the deal. Overall, research shows, companies that acquire in bad times as well as in good outperform boom-time buyers over the long run. General Dynamics, Johnson & Johnson, and JPMorgan Chase have all built strong competitive positions by buying throughout the business cycle.

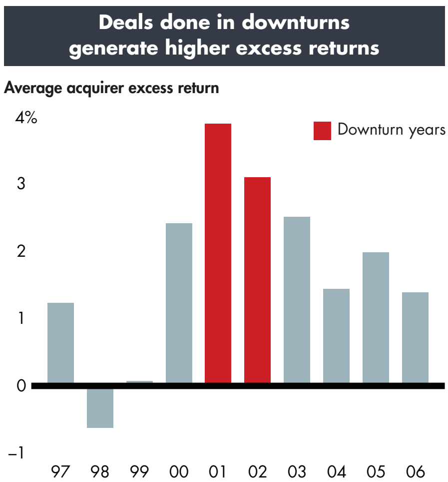
So what kind of approach makes sense? The most important objective of mergers and acquisitions in any economic environment is to help execute a company's strategy. In a downturn that strategy will almost certainly focus on strengthening the core business. No company can hope to weather the downturn without a strong core, and M&A can be a valuable tool for reinforcing it. In a recession, M&A serves another purpose as well: creating strategic options. The postrecession landscape, after all, is going to look very different from the one we have been operating in for the past twenty years. No one really knows, for instance, how supply chains may be forced to change, what the financial system will look like, or whether consumers have changed their spending patterns for a generation to come. As companies ride out the storm, they need to position themselves to emerge from the downturn both as strong and as flexible as possible (see figure 1).

Some have the resources to expand their strategic options through acquisitions, in spite of the obstacles presented by the downturn. Pfizer's agreement to acquire Wyeth, for example, buys some time for Pfizer as the patents expire on several of its leading medicines. Other industries are likely to consolidate as market leaders attempt to increase their options by expanding in scale or scope—wireless phone companies, for example, adding content and software capabilities. The equity market isn't necessarily an obstacle to stock-based deals in any of these cases, since both the acquirer's and the target's shares are likely to be equally depressed.

Partnerships, joint ventures, and strategic alliances will be a more likely course for many companies to create the right options, given the risks and fi-

FIGURE 1

Game-changing acquisitions and partnerships: Deal-making opportunities for strong companies in downturns



- Have a **corporate strategy** that defines their core and allows them to **invest with a thesis**
  - Buy assets that **reinforce their core business**
  - **"Prune" their non-core businesses** through divestitures
- Buy and divest **frequently and consistently through cycles**
- **Tailor merger integration efforts to their deal thesis** and the sources of value

Source: Thomson DataStream, Thomson Financial, Bain analysis.

nancing constraints on deal making in a downturn. Alliances give companies the opportunity to compete under a number of different scenarios without the inflexibility or expense of an acquisition. The 2008 deal between Morgan Stanley and Smith Barney, for example, was structured as a joint venture rather than a merger. Nokia recently established a joint venture with the Indian company HCL Infosystems to offer services such as navigation and music for mobile phones. These kinds of partnerships are likely to become more common in the coming months and may lead to mergers or acquisitions down the road.

Of course, acquisitions can be disastrous in a downturn if companies go about them the wrong way. One key to avoiding traps is having a clear strategy. A company with a well-thought-out strategy for taking advantage of the changing environment is likely to avoid being drawn into poorly considered acquisitions. Instead, M&A becomes a tool for executing its strategy. That requires an investment thesis tailored to its strategic priorities, the right list of targets, and a well-prepared team ready to act quickly when the time is right.

Investment Thesis: Strengthening Your Base of Competition

The vital discipline for strategic M&A in any economic environment is the investment thesis—a statement that articulates why buying an asset or business will make your existing business more valuable. Broadly speaking, companies create and sustain strategic advantage through some combination of five factors: cost position, brand strength, customer loyalty, ownership of a distinctive set of assets, and government protection. Procter & Gamble, for example, is built mainly on brand power and customer loyalty; the cable company Comcast is built primarily on asset ownership (local cable networks) and government protection (local rules granting it monopoly status). Advantages in any area constitute a company's basis of competition. Understanding that basis of competition—and how a proposed transaction will strengthen it—is the starting point for any successful deal.

Companies fail to understand the importance of an investment thesis even in good times—one reason that so many deals lead to buyers' (and shareholders') remorse. A few years ago, Bain surveyed two hundred fifty senior executives who had been involved in sizable acquisitions. More than 40 percent admitted they had *no* investment or strategic thesis behind their transactions. But when companies make deals that do strengthen their basis of competition—in good times or bad—they increase their long-term earnings potential. In one survey of acquirers involved in both successful and unsuccessful deals, for instance, we found that about 80 percent of successful transactions were based on a clear investment thesis. For failed deals, the proportion was only about 40 percent.

In a downturn, deals are riskier and harder to pull off, which makes it all the more important that each transaction strengthen a company's basis of competition. Verizon Wireless, for instance, has spent millions to strengthen its brand in the minds of consumers: virtually everyone in the United States has seen the ads asking, "Can you hear me now?" and touting the "power of the network." But in wireless telecommunications, a brand's strength depends not just on name recognition and warm feelings on the part of consumers; it depends on state-of-the-art technology and continually expanding geographic coverage.

Those imperatives don't change whether the economy is booming or slumping. That's why Verizon Wireless has kept up a steady stream of acquisitions designed to bolster its brand on these fronts, including forty deals during the period from 2004 to 2007. And that's why it has continued on the acquisition trail even in the downturn, closing a deal to buy Alltel for $28.1 billion in January 2009. The Alltel acquisition gives Verizon Wireless access to additional territories, including fifty-seven rural markets that the company does not yet serve. Verizon Corp., majority owner of Verizon Wireless, reported a 16.4 percent increase in earnings for 2008 compared to 2007. That increase is fueled by continuing growth in the wireless unit, which in turn has been fed by the unit's focus on using acquisitions to build brand strength.

For Lafarge, the world's largest cement company, the purchase of Egypt's OCI Cement Group, a unit of Orascom Construction Industries, in December 2007 was intended primarily to reinforce its cost position. Lafarge's long-term strategy is to increase its presence in emerging markets; to do so, it needs to stay price competitive. By buying OCI Cement, Lafarge acquired a well-regarded firm in a region where there are massive building projects going on—all of which, of course, require cement. It also gained additional scale, which should help it keep costs and prices low.

What's unusual is that the shares of the acquirer rose markedly (11 percent) after news of the deal broke. Though Lafarge's stock has since been battered by the general slump, its operating income rose more than 50 percent in the first half of 2008. Margins also increased. Most of the credit for that performance goes to the company's emerging markets operations, which accounted for about two-thirds of earnings. The deal has yet to be tested over time, but Lafarge appears better positioned than before to handle the current conditions.

Danaher Corporation has built its acquisition strategy around the investment thesis of strengthening its base of real assets. Danaher owns a large number of highly specialized, niche-oriented manufacturing businesses and operates them according to a distinctive philosophy and set of processes known as the Danaher Business System. It has maintained a rapid pace of acquisitions through good times and bad, and has been largely successful at incorporating the newly acquired companies into its business model. During the last downturn, for instance, it made ten significant acquisitions, including buying Marconi Commerce Systems, now known as Gilbarco Veeder-Root. Gilbarco is a leading global supplier of fuel-dispensing equipment; it recently introduced a dispenser with a live Internet connection, allowing motorists to view Google maps, search Google's local business listings, and then print out directions. Gilbarco was part of Danaher's third-most profitable product line in 2008. This 2001 acquisition contributed to its parent's stellar performance during the subsequent recovery, in which Danaher's shares outperformed the S&P index by a factor of three.

Preparation Leads to Success

Too often, an acquisition begins when an investment banker calls the CEO with a potential target and a deal book. Corporate development staffers quickly give the book a cursory review and do a superficial industry overview. If the deal looks interesting, they construct a valuation model and conduct financial and legal due diligence.

But this approach delivers mixed results at best. If an acquisition team is reacting rather than acting, it's likely to pursue deals with prices below the valuation model, deals with limited upside and almost unlimited downside, and deals whose numbers can be massaged until they meet corporate hurdle rates. The team will turn down transactions that appear to be too expensive but actually are not in terms of their long-term strategic benefits. And it will fail to uncover opportunities it might have turned up on its own if it had followed a strategic road map.

In contrast, seasoned deal makers such as Cintas, the uniform manufacturer, know their basis of competition and are always thinking about the kinds of deals they should be pursuing. Their corporate M&A teams work with individuals who are closer to the ground in the line organizations to create a pipeline of priority targets, each with a customized investment thesis. They systematically cultivate a relationship with each target so that they are positioned to get to the table as soon as (or even better, before) the "For Sale" sign goes up. By this stage, savvy acquirers are likely to have months or even years invested in the prospective deal. As a result, they're often willing to pay a premium or act more quickly than rivals because they know what they can expect to achieve through the acquisition. Acquisitions on this basis have helped Cintas sustain its sales growth for thirty-nine consecutive years.

In a deep downturn, resources are scarce and the cost of a wrong move may devastate the acquirer. To go into a deal without this kind of preparation is like jumping into a lake blindfolded—you don't know whether there's a rock right under the surface. Of course, a steep downturn can also present sudden buying opportunities to a well-prepared acquirer, as we noted earlier. In February 2008, JPMorgan Chase had told investors it needed investment-banking capabilities, like those of Bear Stearns, to meet its growth goals. In March, Bear Stearns suddenly became available in a government-brokered deal. Because JPMorgan already knew exactly what it needed, it was quickly able to commit to acquiring an incremental $1 billion in earnings capacity, even after meeting shareholder demands to raise the price once the initial deal was signed.

Getting the Deal Done

Turbulence brings deal-making opportunities, but the obstacles presented by a downturn can stall even a well-prepared company. Focusing on three practices can help guide companies to get deals done.

First, ratchet up the level of diligence you expect from your M&A team. Some of the deals on Wall Street, for example, have turned out to be less attractive than the acquirers initially believed and may cost the acquiring CEOs their jobs. Corporate buyers seeking targets in the same industry are particularly likely to fall into the trap of inadequate diligence because executives believe they know the industry. They often conduct a quick and sometimes cursory regulatory review while failing to ask the big strategic questions—and then they are unpleasantly surprised when the target turns out to be more liability than asset. Private-equity buyers, by contrast, rarely make that mistake: they know what they don't know and so are careful to uncover any hidden traps.

Second, tailor your list of targets to the new valuations. Many companies are relatively cheap in a downturn because their shares are trading at low levels. But some companies are cheap for good reason, and the adage that you get what you pay for applies to deals as much as it does to anything else. It is possible to strengthen your company's core business or create new strategic options at a reasonable price. A target that has seen its stock decline, for instance, may quickly agree to be acquired by a stronger company whose stock has also declined. It seems like a fair exchange of assets rather than a predatory raid, and it is more likely to lead to synergies in the future. This is why the most common near-term deals are likely to be consolidations or other intra-industry transactions.

Third, update the target list to reflect the changing environment. The business climate in the future is likely to be less freewheeling, more tightly regulated, less leveraged, and more risk averse. Some of the large banks that recently acquired mortgage companies or investment houses may never be able to return those businesses to their previous levels of growth and profitability, simply because the environment in those industries is likely to be so different. There are plenty of other unanswered questions about the future as well. Once-successful business models may no longer work. Onetime market leaders may be permanently compromised. Yet you may want to add businesses to your list that you think are likely to thrive in a different environment. A clear investment thesis reflecting the new reality is more important than ever.

Can a company's portfolio actually emerge stronger from the kind of economic hurricane we're seeing right now? In many cases, yes, as long as the deals the company makes are based on sound assessment of the new conditions. Don't assume that things will return to "normal." Don't assume that conventional mergers and acquisitions are your only options; the scarcity of capital is likely to make joint ventures and alliances increasingly popular. Above all, don't use deals to reshape your company's competitive foundation. Use them instead to strengthen it, to do what you do better. Acting on these principles is the first step toward M&A success, in turbulence as well as in calm weather.