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Who Says M&A Doesn't Create Value?

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For years, we've heard that a majority of acquisitions fail to create value for the buyer. However, every year, companies pour considerable time, effort and capital into just that – making acquisitions. What would cause so many companies to pursue a strategy that research has repeatedly said doesn't work? Could it simply be management hubris – 'My Company's different… I'll make it work'?

Our findings in the Industrial Machinery industry suggest that in fact a *strategy* of pursuing and executing acquisitions can set you apart as a value creator over the long term.

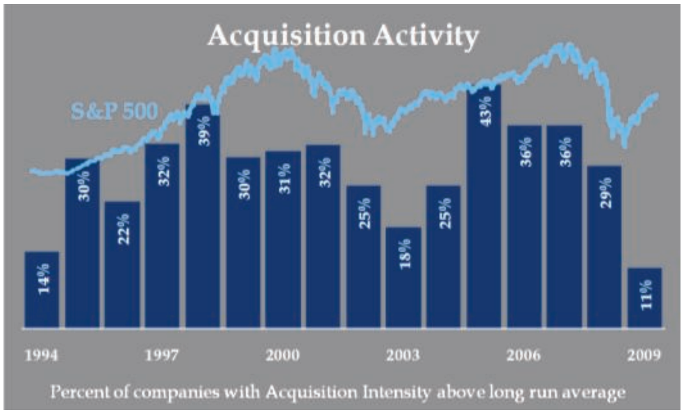
We focused on the Industrial Machinery industry, a collection of 37 companies including well known acquisitive companies such as Danaher, IDEX and Dover, as well as less acquisitive companies such as Lincoln Electric, Donaldson and Tecumseh. We reviewed the acquisition history of each company from 1994 through 2009 and compared this to the total shareholder returns (TSR) over the period.

Tests were conducted with and without the companies that ceased to exist during the study period and the results were substantially the same, so this summary of our findings includes all companies that were public for even part of the study period.

While this is a relatively small study and care should be taken to not extrapolate these findings across all industries at all points in time, it does provide some interesting perspectives that may have applicability in other situations.

Empirical Findings in Industrial Machinery

In an average year, these companies invested 6.8% of their revenue in acquisitions. We've classified companies as 'acquisitive' in a given year, based on whether their aggregate acquisition intensity, or dollars spent on acquisitions as a percent of revenue, exceeded this industry average.

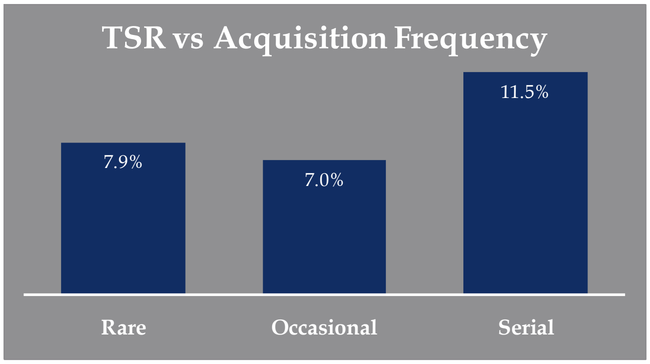


Next, the companies were divided into three equally sized groups based on the frequency of "acquisitive years". For companies with the same number of years, they were ranked based on average acquisition intensity. Companies were classified as:

- Rare Acquirers
- Occasional Acquirers
- Serial Acquirers

The results show that the Serial Acquirers generated the highest total shareholder returns by a fairly wide margin, with the other groups being very similar.

While this research suggests that Serial Acquirers create more value for shareholders than companies that make rare or occasional acquisitions, the question is, "how did they do it?"



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Our client work over the years suggests that much of the value creation by Serial Acquirers is derived from having more established processes for identifying targets, performing due diligence, pricing the transaction and integrating the business after the acquisition. In fact, for many of these companies, M&A itself has become a core competency.

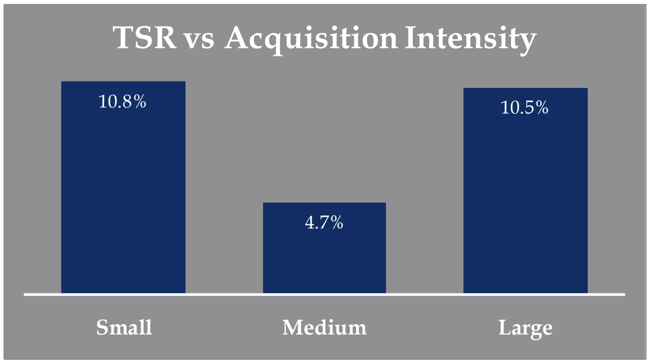
When reviewing the data on frequency, we found there were Rare, Occasional and Serial Acquirers that invested in very large deals, but there were companies in each category without any blockbuster years as well. So does transaction size affect success?

To address this, we examined average acquisition intensity, or the average annual acquisition investment as a percent of revenue over the full study period. We again formed three equally sized groups.

- Small Acquirers
- Medium Acquirers
- Large Acquirers

The results show that the Small Acquirers (bolt on acquisitions) and Large Acquirers (transformational acquisitions) generated the highest total shareholder returns and the poorest performers were the Medium Acquirers.

Why? Perhaps these medium sized acquisitions are harder to integrate than bolt on acquisitions yet are not large enough to transform the business and add adequate value.



Lessons Learned: M&A Strategy & Planning

These findings should be very encouraging to those executives who have always suspected that M&A could deliver value. The ultimate question is. "how you are going to build the competencies necessary to succeed in M&A?"

It starts with strategy and planning:

- What direction is my product market going? Are there trends emerging that we can't fulfill as efficiently or in sufficient time to remain competitive?
- What are our investor's expectations for our business? Can we deliver this performance on our own or do we need to seek outside opportunities to close gaps?
- What list of companies could close these product and capital market gaps?
- What expectations are currently priced into their share price (or asking price if it's a private company)?
- Could I deliver sufficient synergies to justify a premium above that level of performance or are the expectations already too high?

Start by asking the above questions and developing a target list of opportunities. Then, begin a formal ongoing process of monitoring performance, valuation and expectations. By taking these steps, management will be better prepared to take advantage of opportunities when they arise. As with many aspects of business, a proactive strategy can deliver more value in the long-term.

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