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Creating Value Through Acquisitions When Capital Isn't Free

How a company defines success influences whether acquired targets check boxes or create value.

By Frank Hopson

In March 2022, the Federal Open Market Committee (FOMC) took a significant step to curb inflation in the United States by raising interest rates for the first time in three years. The S&P 500 closed that day at 4,358, but struggled to meaningfully surpass that level in the following 18 months. The message was clear: the era of free money was over, and capital costs were back in play.

Low capital costs fuel speculative growth because, with minimal discounting, a dollar a year from now holds nearly the same value as a dollar today. However, as capital costs rise, each extra year needed to generate revenue significantly diminishes the investment's ultimate value.

The Shift in Market Dynamics

Between March 2022 and January 2024, the FOMC raised interest rates 11 times, creating shockwaves in U.S. markets. Companies and investors had to adjust to the new reality, which saw a dramatic decline in IPOs, from $338.7 billion in 2021 to just $26.2 billion in 2023, according to Bloomberg. Acquisitions also took a hit, with the value of deals involving U.S.-listed companies falling to $963 billion in 2023 from $1.8 trillion in 2021.

However, this reset on speculative growth can be beneficial. Fear of missing out (FOMO) can lead to poor capital allocation, diverting funds from strong business lines to speculative ventures. In contrast, a more value-based approach balances existing business investments and disruptive innovation.

Rebounding Momentum in M&A Activity

By April 2024, M&A activity rebounded as announced deals involving U.S.-listed companies increased by more than a quarter to $345 billion, up from $270 billion in the same period the previous year. While it's uncertain if this momentum will continue, companies now need to rigorously evaluate their acquisition strategies to ensure success.

Crafting a Winning Acquisition Strategy

Identifying a promising target is just the first step in a successful acquisition strategy. Companies need a clear intent for how an acquisition will enhance their broader strategic goals, rigorous due diligence processes that emphasize people and culture, and post-acquisition integration focused on accountability.

Strategic Intent and Self-Assessment

Higher costs of capital are prompting management teams to scrutinize their acquisition targets more carefully, but they must also regularly assess their organization's values, processes, and ability to scale. Acquisition strategies should align seamlessly with resource allocation processes that aim to close product, service, and capability gaps. How your organization defines success sets the standard for prioritizing decisions and guides your resource allocation process. Economic profit serves as a valuable benchmark for success, balancing growth, profitability, and asset utilization into a single metric that empowers leaders to prioritize value creation regardless of the business model.

Due Diligence with a People-Centric Approach

With acquisitions shifting from scale to capability expansion, understanding a target's culture and values is critical. In the past, acquisitions often centered on resource accumulation for scale benefits, whether manufacturing facilities or customer bases. Over the last decade, however, acquisitions have increasingly focused on innovation, where value creation is rooted in people and processes. In this new landscape, disparate value systems between the target and acquirer could signal a need to operate separately rather than risk full integration, which may lead to value destruction. Having dedicated due

diligence team members focused on people and corporate culture can be the difference between a successful acquisition and one that disrupts the entire organization.

Consider the example of Kraft Heinz, one of Warren Buffett's most challenging investments. Clashing corporate cultures resulted in strategic missteps and a decline in brand value. Heinz' aggressive cost-cutting, guided by 3G Capital's management philosophy, conflicted with Kraft's emphasis on brand building investments. Dramatic cost reductions, including layoffs and product rationalizations, disrupted both employee morale and customer brand perceptions, as loyal customers experienced product discontinuations and quality declines. The merged company became slow to react to shifting consumer preferences for healthier foods, leading to further declines in perception and creating opportunities for new entrants to take market share. Had each company maintained its strategic direction independently, it might have more effectively navigated the changing market landscape.

Accountability-Driven Integration

Integration starts with realistic performance goals and price expectations established during due diligence. Warren Buffett's adage, "Price is what you pay, value is what you get," underlines the importance of assigning accountability early on to those who will oversee the acquisition. Involving these key players early enables realistic goal setting and seamless execution.

Aligning Financial Metrics and Long-Term Value Creation

How a company defines success influences whether acquired targets check boxes or create value. If a new opportunity requires additional investment that will temporarily reduce cash flows but promises long-term growth, how does this factor into the acquired company's performance evaluation within your organization? Economic profit offers a distinct perspective by spreading the investment cost over the expected return period, encouraging managers to adopt an owner's mindset. Management should prioritize business outcomes over rigid financial targets, allowing flexibility for significant investments while ensuring that smaller opportunities aren't overlooked.

M&A activity is likely to grow in the coming years as businesses realign their strategies in this evolving economic environment. But spreadsheets don't capture the nuances of strategic fit and value creation. Companies are collections of people whose actions drive success, guided by values that shape decision-making and processes that ensure flawless execution. By considering these factors, companies can build a strong, people-focused acquisition strategy that thrives in the current economic paradigm.

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