Done deals: How companies can make M&A a winning growth strategy

Last year's wave of M&A activity drove the volume and velocity of dealmaking to dizzying heights.[1] Yet finance leaders can still find themselves feeling stuck as to how best to execute such transactions. In what circumstances is an acquisition most likely to create value for both buyer and seller? Why do many consolidations appear to fall short on delivering on their promised synergies? What makes post-deal integration so fraught?

With performance and growth ranking among the drivers of The CFO Agenda,[2] finance leaders are eager to leapfrog competitors. They may risk getting ahead of themselves, however, given the complexities of M&A. Indeed, it's not uncommon for a buyer already mired in an acquisition to bring in an outside analyst for help, only to have that analyst ask how the deal ever got that far.

In *The Synergy Solution: How Companies Win the Mergers & Acquisitions Game* (Harvard Business Review Press, February 2022), we offer an integrated step-by-step approach to implementing a proactive M&A strategy. The book is aimed at helping company leaders, including CFOs, gain a clearer understanding of the ramped-up challenges they will inevitably face as a result of having paid a premium of, on average, 30%.

Such practical guidance is rooted not only in decades of experience—Mark Sirower previously authored *The Synergy Trap: How Companies Lose the Acquisition Game* (Free Press, 1997), which analyzed the drivers of acquisition performance—but also is based on our analysis of more than 1200 acquisitions during a 24-year period. Using publicly available databases, we examined about $5 trillion worth of deals.[3] Approximately half of those deals could be considered successful, as defined by relative total shareholder returns, challenging the oft-repeated statistic that 70% to 90% of acquisitions fail.[4] Still, for CFOs, the stakes of M&A remain daunting: unwinding a deal, especially after any attempts at post-close integration, is costly in both human and financial capital.

In this edition of *CFO Insights*, we'll explore the factors that contribute to making some acquisitions successful. What does it take to qualify as a "prepared acquirer?" What's the formula for calculating the value of vague-sounding synergies? And what makes M&A so uniquely challenging?

The deal with peer pressure

In an environment where the cost of debt still hovers around historical lows, and private equity firms have more than $1 trillion in dry powder,[5] companies can feel pressured not to be left behind. In Deloitte's North American "CFO Signals™" survey for the third quarter of 2021,[6] nearly three-quarters of CFOs said they expect M&A to fuel as much as 20% of their organizations' growth over the next three years.

The challenges of organic growth may prod some companies to turn to M&A, while others may be spurred on by the announcement of a big, consequential industry merger. Soon after, CFOs can receive a nudge from their bankers or other financiers: act quickly or risk having no dance partner. Lacking a well-developed growth thesis, companies respond by identifying acquisition targets. The absence of preparation can lead to overpaying, triggering a negative reaction from the market.

Such a reception can have significant repercussions. Indeed, our study found that those deals that initially met with negative market reaction (65%) were still negative a year later, with an average return of -26.7%. Companies on the positive side (57%) remained positive a year afterwards, with an average return of 32.7%—an enormous difference of nearly 60 percentage points. Put simply, a negative start is difficult to reverse—even more so if it's an all-stock transaction. Among those deals, the 71% that were greeted negatively were still negative a year later.[7] (See sidebar, "What really matters in boosting shareholder returns from M&A.")

A plan for preparedness

One of the central challenges acquirers face involves understanding and communicating the promised synergies that underlie the deal. It's easy to confuse synergies—defined as savings or profitable growth that can *only* be achieved as a result of the deal—with the kinds of performance improvements investors are already expecting. Possessing such strategic clarity characterizes those we call "prepared acquirers."

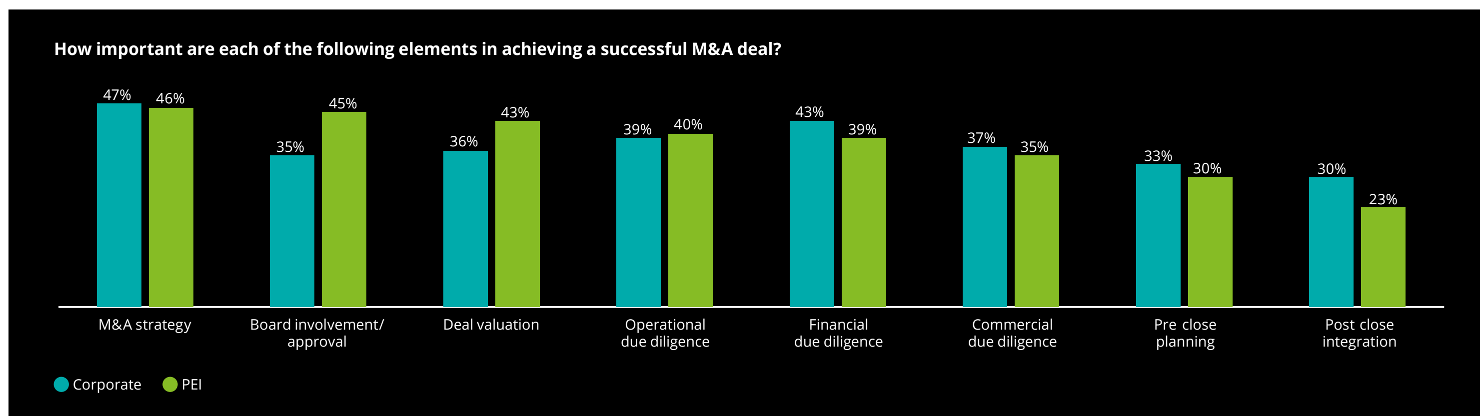
Before they even consider doing a specific deal, these companies decide how big a role M&A will play in their growth, which assets are most needed to exploit existing capabilities or close existing gaps, and where the most valuable targets reside along the pathway they intend to pursue.

Keeping and refreshing such a watch-list is key. In a survey of 1300 executives at corporations and private equity investors in Deloitte's 2022 M&A Trends Survey, nearly half of each chose M&A strategy—the highest proportion among eight choices—as an important component of a successful M&A deal, ahead of board approval and even due diligence (see Figure 1).[8]

Acquirers who succeed at M&A tend to follow specific practices, including:

- **Recognizing M&A as a unique business gamble.** Few corporate-resource decisions can alter the value of a company faster than a major acquisition. Yet M&A offers no opportunity for any trial-and-error, or even test runs. In addition, the upfront payment of a premium demands that acquirers have a detailed idea of the improvements they've committed to making.
- **Making hard decisions upfront.** The development of an M&A strategy requires management to tackle tough strategic choices early. Should the company, for example, prioritize targets that offer certain advantages in terms of geographical expansion, or technology or product offerings?
- **Using diligence to test assumptions and build an early integration plan.** Too often, acquirers view diligence as a step designed to boost their comfort level with making a decision. It's more effectively used to test strategic and operational assumptions about everything from revenue growth to sustainability of margins over time—data that can serve as inputs to drive both a valuation model and an initial integration roadmap.
- **Understanding the roles of different stakeholders and involving them at the right time.** This awareness and openness can be critical. Stakeholders, including the C-suite, investment committee, corporate development, and

Figure 1. Making a deal good



Source: *The future of M&A: 2022 M&A Trends Survey*, Deloitte Development LLC, January 2022

external advisors, can offer guidance to keep the focus on value creation.

A fistful of questions

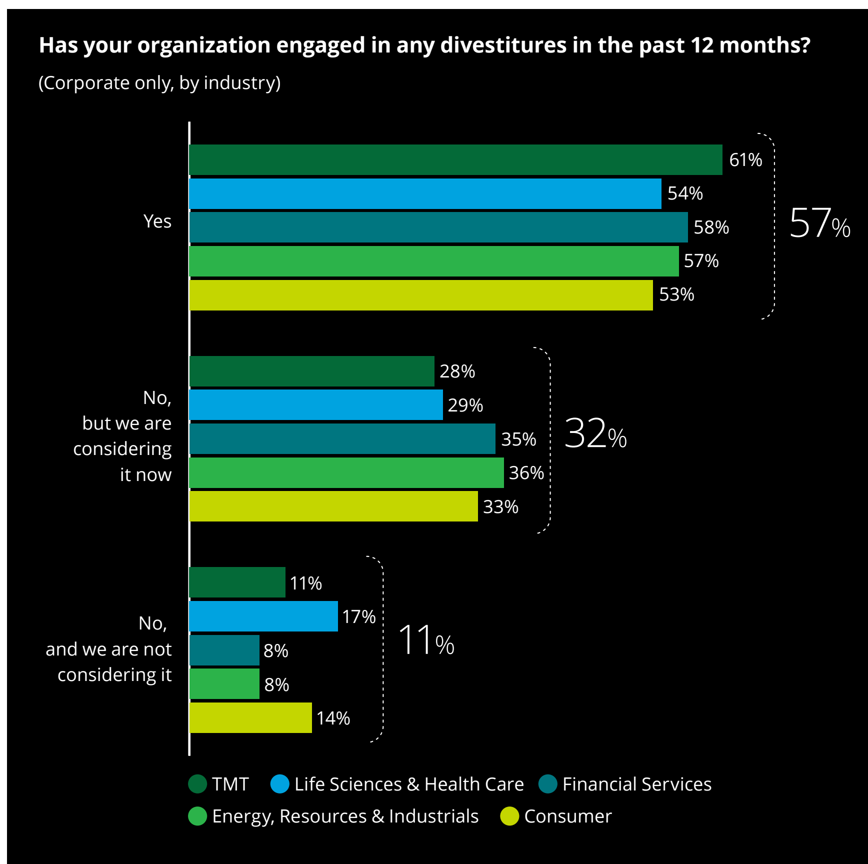
With the COVID-19 pandemic having entered a new phase,[9] some CFOs and boards have turned their attention to capital allocation (see "Capital allocation: Is it time for a refresh?" *CFO Insights*, October 2021). The goal: to position their companies as long-term winners.

Companies reviewing their portfolios are part of a crowded marketplace. For some, that means shedding noncore assets to generate capital for more fitting acquisitions. In the 2022 M&A Trends Survey,[10] more than half of responding executives (57%) said they had engaged in a divestiture in the past 12 months. Another third or so (32%) were considering one. Only 11% hadn't, and didn't, plan to join in (see Figure 2).

Heightened dealmaking activity can put a premium, so to speak, on speed. But no matter the pace, the kinds of questions that CFOs may want to make sure they make time to ask—both of themselves and of others—include the following:

1. **Why is now the time to do this?** Maybe it would have cost 20% less six months ago, but there's competitive pressure to do a deal ASAP. Instead of being forced into a reactive mode, it may be worth exercising the required discipline to create a deal-flow structure.
2. **Can we assemble a credible plan prior to any announcement?** Once the deal becomes public, any embedded assumptions turn into promises. Are there one-time costs that need to be factored in? How should cost-reduction initiatives be prioritized? If ERP systems will be consolidated, how long will that take?
3. **Can we give investors a reason to buy shares?** More than any road show, investor presentation, or conference call, an official announcement about a deal can roil a company's share price. It's critical to be able to explain, for example, why your company was willing to pay more than other potential acquirers.

Figure 2. Acquiring an urge to divest



Source: *The future of M&A: 2022 M&A Trends Survey, Deloitte Development LLC*, January 2022

4. **Can we foresee the necessary post-close transitions?** Once the deal closes, the integration management office should be dissolved, with the workstreams under it rejoining the business. The acquirer's efforts then turn to choosing leaders deeper in the organization who fit the new organizational design and new roles, as well as overseeing change-management and workforce transition issues.
5. **Have we retained any lingering delusions of synergy?** As magical as it can sound, synergy may be driven by upwards of a dozen major initiatives, broken down into projects and milestones.

The value of synergistic thinking

M&A strategy benefits by being approached meticulously—and holistically. In *The Synergy Solution*, we suggest that rather than accepting the received wisdom that most acquisitions are doomed, deal-makers reexamine their processes.

Each subprocess needs to be viewed as part of a greater whole. If due diligence isn't conducted properly, companies may overpay. Such miscalculations may also feed into unrealistic synergy targets, leading to missed milestones for investors and analysts to seize on. Those pressures make the job of building a new organization—while stabilizing the existing business—that much tougher.

Other external factors may come into play, as well. Rising inflation and global turmoil may slow the pace and volume of M&A transactions this year. But developing and maintaining a rigorous process for successfully making deals will surely assist in creating value over the long term.

What really matters in boosting shareholder returns from M&A

More findings from our study of more than 1,200 acquisitions in a 24-year period:

- **Initial market reactions count.** How much? To find out, we divided the transactions into those deals that were met with a positive reaction (508), and those that felt the sting of a negative reaction (759). A year later, those that had faced a negative reaction of, on average, 7.8% had earned an even stronger negative return of about 9.1%. The portfolio of deals that began with a positive return of 7.7% had risen to 8.4%. A closer look reveals that 65% of the initially negative deals were still negative a year later, while 57% of those with positive reactions stayed positive. Conclusion: while a positive start is no guarantee of future success, especially if companies do not subsequently deliver on their promises, a negative start is tough to overcome.
- **Acquisition premiums matter.** The average premium paid for targets across the entire sample was 30.1%, with an average premium of 32.2% paid by the initially negative portfolio and 26.9% paid by the initially positive portfolio. For companies that were persistently viewed negatively throughout the year, the average premium was 33.8%, compared to only 26.6% for their positive counterparts. The difference in premiums is even more pronounced for all-cash and all-stock deals for the persistently negative versus the persistently positive portfolios: 33.6% vs. 27.6% for all-cash deals and 32.8% vs. 22.5% for all-stock deals.
- **Cash deals outperform stock deals by a lot.** All-cash deals represented 20% of the transactions we analyzed, while all-stock deals comprised 36% of our sample. At announcement, the returns for all-cash deals beat all-stock deals by 4.7%. Moreover, 57% of cash deals receive positive market reactions as compared to only 35% of stock deals. The performance gap widened to 9.5% over the course of the year, as cash deals beat their peers by 3.8% while stock deals lagged their peers by 5.7%. Overall, 46% of stock deals received both initial and persistent negative returns versus 27% of cash deals. Among transactions combining a mix of cash and stock, only 36% received a positive market reaction.
- **Sellers are the biggest beneficiaries of M&A deals.** Shareholders of target companies earn an average 20% peer-adjusted return from the week before the deal announcement to the week after. Buyers, on average, lose 1.6%.
- **M&A transactions create value at the macroeconomic level.** Mergers create value for the economy. We calculated a measure for both buyers and sellers based on the 11-day peer-adjusted dollar return around deal announcement. The average total shareholder value added (TSVA) is the sum of those dollar returns for buyers and sellers. While buyers lost an average of $285 million, sellers gained an average of $469 million. That works out to a TSVA of $184 million for all deals.

End notes

1 "Global M&A volumes hit record high in 2021, breach $5 trillion for first time," *Reuters*, December 31, 2021.

2 "The CFO Agenda," CFO Program, Deloitte LLP.

3 The study also focused on deals in which both the acquirer and target were publicly traded in the U.S., were at least $100 million in size, and involved a target that was at least 25% of its acquirer's size.

4 "Don't Make This Common M&A Mistake," *Harvard Business Review*, March 2020.

5 "Opportunities for private equity post-COVID-19," *Deloitte Insights*, Deloitte Development LLC, May 2020.

6 CFO Signals™: 3Q 2021, CFO Program, Deloitte LLP.

7 Mark L. Sirower, Jeffery Weirens, *The Synergy Solution: How Companies Win the Mergers & Acquisitions Game*, Harvard Business Review Press, February 2022.

8 "The future of M&A: 2022 M&A Trends Survey," Deloitte Development LLC, January 2022.

9 "The US is in 'transition phase' of pandemic, Fauci says," CNN.com, April 27, 2022.

10 "The future of M&A: 2022 M&A Trends Survey," Deloitte Development LLC, January 2022

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