Where's the Value? Strategies for Successful Acquisitions: Part 2

We are living in an M&A world where many acquisitions fail to create value. The corollary, of course, is that some acquisitions DO create value, and the obvious question is why. In the current environment, where companies are relying more heavily on M&A to drive revenue growth, that's a significant "why", so we went looking for an answer.

We've discussed post-merger integration (PMI) as a critical factor in any successful M&A transaction. But a recent McKinsey article, The Six Types of Successful Acquisitions, takes a front-end perspective. The authors suggest that successful deals are initiated with specific and detailed value creation strategies, typically fitting with at least one of six archetypes. In last week's article, we covered the first three archetypes. This week we discuss the remaining three, along with an overarching value creation principle.

Successful Acquisitions: Value Creation Strategies

As a reminder, last week we talked about the following strategies:

1. Improving the target company's performance

2. Accelerating market access

3. Acquiring skills/technologies faster or at lower cost than building from scratch

4. Exploiting Economies of Scale

While economies of scale can be a significant source of value creation, it is important to ensure that the potential for cost savings is substantial enough to justify an acquisition.

When the cost of adding on incremental capacity is large and sector specific, as in the auto industry, economies of scale represent a compelling source of value. The McKinsey authors point to the combination of Volkswagen, Audi and Porsche, where the three auto companies share underlying platforms for several of their car models. By minimizing the number of platforms that they need, the companies enjoy material economies of scale, as the cost of developing a new car platform is substantial.

On the other hand, generic cost savings like those generated by combining back office operations are unlikely to yield significant value creation.

5. Acquiring companies early and helping them develop

The McKinsey authors acknowledge that this strategy requires a disciplined approach to be effective. Prospective acquirers should:

- Be willing to invest early, before competitors see the potential;
- Make multiple investments, as some will fail; and
- Have the necessary skills and patience to nurture the business.

We would add that acquirers pursuing this strategy should heed advice from Harvard Business Review (HBR) article, M&A: The One Thing You Need to Get Right: Target early stage companies only where you (acquirer) can provide something that renders your target more competitive, whether that something is better management, additional capital, a strong distribution network, or industry expertise.

6. Consolidating to remove excess capacity from industry – Value creating but not necessarily for the acquirer

We've moved this strategy to last place, as much of the value created here will accrue to other industry stakeholders.

Where excess capacity has developed in an industry, reducing that excess by acquiring competitors and closing inefficient or obsolete plants across the consolidated entity will likely create value. In this scenario, however, while the acquirer may realize some value, value will also accrue to the seller and to other industry competitors who benefit from the reduced capacity (without having had to take any action of their own).

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We want to add one additional acquisition principle: "stick to adjacent spaces", from the HBR article, *Rules to Acquire By*. As an analogy, the author recalls Michael Jordan's folly: attempting to compete in major league baseball after retiring from an incredible basketball career. That was a non-adjacent space for Jordan, and a distinctly unsuccessful career move. So acquirers, take note… evidence suggests that adjacent acquisitions, that is, acquisitions that are extensions of a company's current business, are more likely to create value than acquisitions in non-related areas.

The McKinsey archetypes neatly describe successful acquisition strategies. But the additional principles that we've described underpin the actual success of any one of these strategies. In your pursuit of acquisition targets, you can look for economies of scale or seek out early stage companies. But don't forget to think about what you've got to offer your target, and whether that target represents the equivalent of a leap from NBA basketball to major league baseball, in which case, it's probably time to reconsider.