Masters of the Deal: Part 2

Learning from the best performers

A study by the M&A Research Centre at Cass Business School and Intralinks | **May 2015**

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Executive summary

This research study seeks to investigate two separate but related areas. Masters of the Deal: Part 1, whose findings are described in a report released in November 2014, identifies the relationships between shareholder value creation and the merger and acquisition (M&A) activity of an extremely large global sample of publicly listed companies over the past 20 years. Masters of the Deal: Part 2, whose findings are described in this report, examines the M&A strategies of an elite group of corporate outperformers – companies that have demonstrated sustained, above-average shareholder value creation from M&A (referred to in this report as "Excellent Corporate Portfolio Managers" or ECPMs) – to determine if the M&A strategies of the ECPMs share common attributes that are statistically significantly different from the M&A strategies of other firms, and to identify those common attributes. 1,469 firms are identified as ECPMs out of a total of over 25,000 firms in the entire study - the ECPMs thus comprise less than 6% of the sample, making them a truly unique group.

In conjunction with this research, interviews with 30 C-level and senior executives working for ECPMs were conducted by Remark. These professionals offer their expertise and provide context to the findings.

Key findings of Masters of the Deal: Part 2 include the following:

Excellent Corporate Portfolio Managers have bolder M&A strategies, with greater execution risk

ECPMs engage in a higher proportion of riskier deals, such as cross-border and hostile acquisitions, than other firms. Cross-border deals account for 38% of the value of all acquisitions by ECPMs compared to 28% of the value of all acquisitions by other firms. ECPMs make 4x as much hostile acquisitions as other firms, with hostile takeovers accounting for 0.8% of the value of all acquisitions by ECPMs compared to 0.2% of the value of all acquisitions by other firms.

Excellent Corporate Portfolio Managers achieve faster deal completion

ECPMs have a lower proportion of deals that are slow to complete than other firms. 33% of the value of all acquisitions and 33% of the value of all divestments by ECPMs are slow to complete, whereas 34% of the value of all acquisitions and 39% of the value of all divestments by other firms are slow to complete.

Excellent Corporate Portfolio Managers have greater engagement with financial sponsors and public companies

ECPMs engage in a higher proportion of deals where the counterparty is a private equity firm or a public company, than other firms. 7% of the value of all acquisitions and 12% of the value of all divestments by ECPMs are with a financial sponsor, compared to 5% of the value of all acquisitions and 9% of the value of all divestments by other firms. 48% of the value of all acquisitions and 50% of the value of all divestments by ECPMs are with another public company, compared to 40% of the value of all acquisitions and 47% of the value of all divestments by other firms.

Excellent Corporate Portfolio Managers employ more all-cash consideration for acquisitions

ECPMs have a higher proportion of acquisitions with all-cash consideration than other firms. 38% of the value of all acquisitions by ECPMs are all-cash, compared to 30% of the value of all acquisitions by other firms.

Excellent Corporate Portfolio Managers undertake smaller acquisitions, relative to their own size, than other firms

The study finds a significant difference in the relative size of acquisitions made by ECPMs compared to other firms. The average value of acquisitions by ECPMs is 0.18x their own sales, whereas the average value of acquisitions by other firms is 0.26x their own sales.

Excellent Corporate Portfolio Managers make a significantly greater value of acquisitions than divestments, compared to other firms

ECPMs make over three times as many acquisitions, by value, than divestments: the average ratio of the value of acquisitions to divestments by ECPMs is 3.4x, compared to 1.0x for other firms.

Excellent Corporate Portfolio Managers make significant adjustments to their M&A strategies to take account of market conditions and take advantage of valuation opportunities

The study finds evidence that ECPMs are more willing to engage in market timing, compared to other firms, by significantly reducing the value of acquisitions relative to divestments during periods when M&A markets and valuation levels are increasing strongly and may be overheating, and significantly increasing the value of acquisitions relative to divestments immediately following sharp market downturns.

Introduction and methodology

This study is unique in two ways. First, its size and scale, in terms of the number of global companies and M&A transactions that are analysed (25,000+ firms and 265,000+ deals), over a very long-term time series (1994–2013: 20 years), make the results robust and unlikely to be affected by sample bias – not least because the size of the sample makes it much more reflective of the total population of global companies than previous studies. Second, unlike many previous research studies that have attempted to investigate shareholder value creation from M&A by assessing the impact of individual transactions over relatively short time periods, we believe that this is the first comprehensive study which combines emerging thinking in M&A research of analysing the effect of M&A on companies' performance in the context of their overall programme of M&A activity over different time periods.

The sample of firms in this study comprises the entire global dataset of publicly listed companies with a market capitalisation of at least $10m, whose public equity was actively traded between 1994 and 2013. The firms and their associated data were obtained from Thomson Reuters Datastream®. The M&A activity (both acquisitions and divestments) of these firms during the study period was obtained from Thomson Reuters SDC Platinum®, with a restriction on the minimum transaction value of $1m (for US and UK targets only) and the maximum percentage ownership by the acquirer before announcement of 49%. The raw performance of the firms is defined as their total shareholder returns (share price performance plus dividends) measured over rolling three-year periods beginning in 1994 until 2013 (for example, 1994-1996, 1995-1997, 1996-1998, and so on). These raw figures are then adjusted by the equivalent three-year total return index growth for the primary equity market index of the firms' listing location, and the resulting statistic is then expressed as an annually compounded growth rate per three-year period – thus generating a consistent way to compare the performance of the firms on the basis of a market-normalised annual percentage growth in total shareholder return.

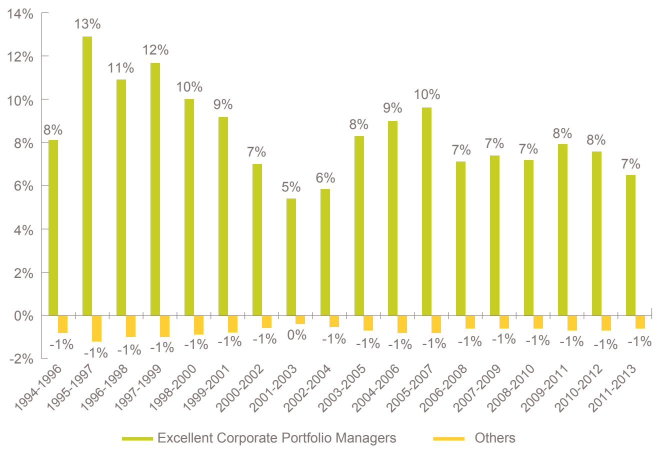
The firms are further classified according to their frequency of M&A activity within each three-year period and by their maturity, based on the period of time since their first public listing. The frequency of M&A activity for each period is defined as either "inactive" (no deals announced in a three-year period), "active" (one to two deals announced, and subsequently completed, in a three-year period), "very active" (three to five deals announced, and subsequently completed, in a three-year period), or "extremely active" (six or more deals announced, and subsequently completed, in a three-year period). The maturity of a firm within each three-year period is defined as either "young" (listed for a maximum of three years), "medium" (listed for more than three but less than 10 years), or "mature" (listed for 10 or more years).

These classifications enable the performance of firms to be analysed along the twin dimensions of M&A frequency and firm maturity.

To qualify as an ECPM, a firm has to have a high level of M&A activity - defined as announcing at least one new acquisition or divestment in at least 75% of the periods for which the firm is listed in the study. An ECPM also has to have an annual normalised total shareholder return which is above the average of its maturity peer group in more than 50% of all the periods for which the company is listed in the study.

Chart 1 shows the average annual normalised total shareholder returns of ECPMs compared to other M&A-active firms for the periods covered by the study. The average annual normalised total shareholder return for ECPMs for the entire period is 8.3%, compared to -0.7% for other M&A-active firms.

Chart 1. Average annual normalised total shareholder return of ECPMs vs. other firms



Transaction strategies of Excellent Corporate Portfolio Managers

The findings of the first part of this research study, which were discussed in Masters of the Deal: Part 1, suggest that firms can achieve superior total shareholder returns with an M&A portfolio management programme which includes several acquisitions per year on average, while simultaneously conducting a limited number of divestments (one to two divestments every three years) once they have been publicly listed for at least three years.

Given these findings, can we identify any common attributes of the M&A strategies of consistently high-performing companies that may be leading indicators of their outperformance, and to what extent do these strategies differ from those of the majority of firms that conduct M&A?

To answer this question, an elite group of M&A-active corporate outperformers, referred to in this report as "Excellent Corporate Portfolio Managers" or ECPMs, is defined based on their frequency of M&A activity and their ability to consistently outperform their maturity peer group in terms of shareholder value creation (see Introduction and methodology, page 5). The deals done by this high-performing group of firms are analysed to identify key variables which are statistically significant when compared to the group of non-ECPM firms ("others"), thus enabling robust conclusions to be drawn regarding the common factors that are associated with being an "excellent" corporate portfolio manager firm.

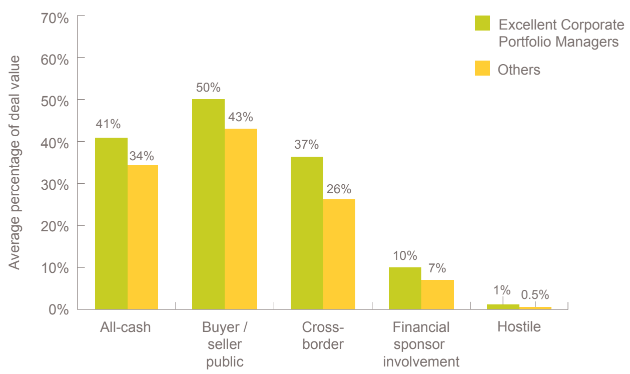
Excellence requires risk

One key finding is that ECPMs have bolder M&A strategies, with greater execution risk, than other firms. When looking at total M&A activity (including both acquisitions and divestments) ECPMs undertake a greater value of both cross-border and hostile deals as a proportion of their total M&A activity than other firms.

"M&A is now a well-exploited strategy. The opportunities have therefore shrunk and risk-free deals are unlikely to yield the desired results."

Looking at these results in further detail, as **Chart 2** shows, the study finds that cross-border deals account for 37% of total M&A activity by deal value for ECPMs, compared to 26% for other firms. The results in relation to hostile deals are even more pronounced, with hostile transactions accounting for 1% of total deal-making by value for ECPMs – double the 0.5% seen for other firms.

Chart 2. Statistically significant deal attributes of ECPMs vs. others: **acquisitions and divestments**



Taken together, these findings suggest that ECPMs are willing to engage in a greater degree of risk taking in their M&A strategies, which can lead to higher performance, rather than focusing on the simplest deals that are easiest to achieve. The vice president of corporate development at a UK engineering ECPM agrees with this result: "M&A is now a well-exploited strategy. The opportunities have therefore shrunk and risk-free deals are unlikely to yield the desired results. In the current environment, portfolio managers therefore have to take risks."

As **Chart 2** shows, ECPMs are also more engaged with private equity firms and public companies when buying and selling assets than other firms. 10% of the value of ECPMs' acquisitions and divestments are with a private equity firm, versus 7% of the value of other firms' acquisitions and divestments. 50% of the value of ECPMs' acquisitions and divestments are with another public firm versus 43% of the value of other firms' acquisitions and divestments.

Keep all options open

Further insights into the deal characteristics of ECPMs can be obtained by decomposing the previous analysis (which considers total deal activity, including both acquisitions and divestments) into separate analyses of acquisition and divestment activity.

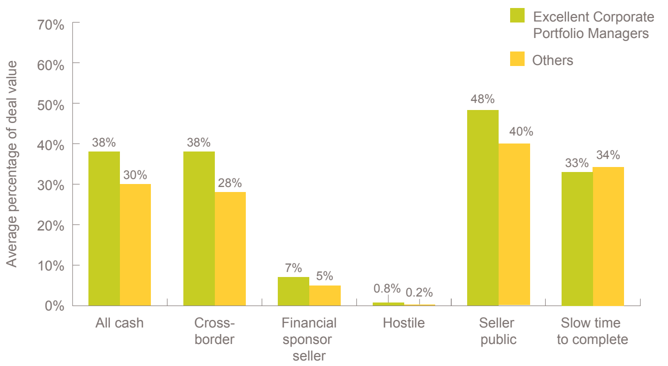
As **Chart 3** shows, when considering acquisition activity alone, ECPMs engage in riskier deals, with a higher percentage of cross-border and hostile acquisitions, than other firms.

The tendency for the best-performing firms to engage in cross-border acquisitions is over a third higher than for other firms, with cross-border acquisitions making up 38% of the value of all acquisitions by ECPMs compared to 28% of the value of all acquisitions by other firms. ECPMs also make 4x as much hostile acquisitions as other firms, with hostile takeovers accounting for 0.8% of the value of all acquisitions by ECPMs compared to 0.2% of the value of all acquisitions by other firms.

The head of strategy at a Dutch engineering ECPM elaborates on these results: “The M&A market is now very competitive and there are fewer opportunities. This means that portfolio managers have to think outside of the box and become innovative. They need to look at a diverse range of opportunities to achieve the best outcomes, even if this means taking higher risks.”

“More risks will mean more scope for targets and those portfolio managers who take such risks can better exploit the available opportunities,” adds the chief strategy officer at a US computer programming ECPM.

Chart 3. Statistically significant deal attributes of ECPMs vs. others: **acquisitions**



As **Chart 3** also shows, several additional factors are found to be statistically significant - compared to other firms, ECPMs acquire a greater percentage of their targets from private equity firms (7% of the value of ECPMs’ acquisitions are from a financial sponsor vs. 5% of the value of other firms’ acquisitions) and are also more willing to offer all-cash as consideration than other firms (38% of the value of ECPMs’ acquisitions involve all-cash consideration vs. 30% of the value of other firms’ acquisitions).

Among the best-performing firms there is also evidence of better execution, with ECPMs achieving faster deal completion than other firms. Specifically, other firms are found to have a higher percentage of deals with a slower time to completion (defined as taking longer than the median time to completion for all acquisitions in the sample) than ECPMs. 34% of the value of all acquisitions by other firms are found to be slow to complete versus 33% of the value of all acquisitions by ECPMs.

ECPMs are also more likely than other firms to acquire targets from other public companies. 48% of the value of all acquisitions by ECPMs are from a public company seller versus 40% for other firms.

“Portfolio managers have to think outside of the box and become innovative. They need to look at a diverse range of opportunities to achieve the best outcomes, even if this means taking higher risks.”

As **Chart 4** shows, the study also finds that ECPMs undertake acquisitions which are significantly smaller in comparison to their own size than other firms. ECPMs have an average ratio of the value of acquisitions to their own sales of 0.18x, compared to an average ratio of the value of acquisitions to their own sales of 0.26x for other firms. Thus, while the previously discussed findings indicate that ECPMs are engaging in bolder, more risky acquisition strategies, they appear to prefer to avoid large transformational acquisitions, which could suffer from execution or integration risk, and instead are more likely to be focused on targeting more reasonably sized "strategic" acquisitions that fill product, technology, or market gaps in their businesses.

Chart 4. Average acquisition value/sales of acquirer*

*Last 12 months sales prior to year of acquisition, calculation winsorized at 95th and 5th percentiles to remove outliers

This view is supported by the executive vice president of global corporate development at a US professional services ECPM: "It is critical to be confident in the initial selection itself. Our primary selection criterion is how well the target will be able to meet the strategic goals of our company."

The chief operating officer at a Chinese hotel and hospitality ECPM explains how this works in practice at his company: "First, we identify the reasons for making an acquisition and the specific enhancements we are seeking to our strategic competencies. Then our first stage of acquisition screening involves creating a list of potential acquisition targets. During this stage, we focus on whether the targets can be acquired or not and then whether their strategic resources include the desired assets or competencies we are seeking in our acquisition."

Stay strategic

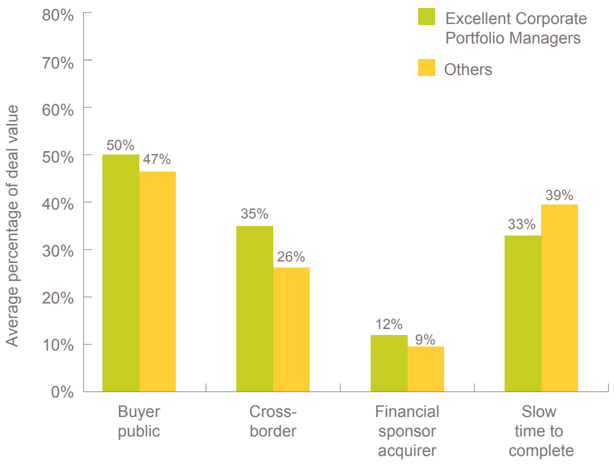
As shown in **Chart 5**, when considering divestment activity alone the study finds that, compared to other firms, ECPMs sell more to foreign buyers, with cross-border deals accounting for 35% of the value of all their divestments, compared to 26% of the value of all divestments for other firms. Compared to other firms, ECPMs also sell more to private equity buyers, with financial sponsors on the buyside for 12% of the value of their divestments compared to 9% for other firms. Compared to other firms, ECPMs sell more to public companies, with public buyers involved in 50% of their divestments by value, compared to 47% for other firms. These results point to the ability of ECPMs to exploit a wider range of strategic options when selling assets.

On the execution side, there is again evidence that, compared to other firms, ECPMs get their deals over the line quicker, with only 33% of their divestments by value classified as slow to complete compared to 39% for other firms.

"Our primary selection criterion is how well the target will be able to meet the strategic goals of our company."

The attitude of ECPMs to divestments can be summarised by the comments from a senior vice president of corporate development at a US manufacturing ECPM: “Our primary objective for divestments is to sell non-core assets and focus on core competencies. In the current market, we will be looking to divest an asset or part of a business that is not a part of the core business and is not bringing any value to us.”

Chart 5. Statistically significant deal attributes of ECPMs vs. others: **divestments**



Get the timing right

The timing of the deals done by ECPMs also provides insights into what separates the best-performing companies from the rest. As shown in **Charts 6** and **7**, the study finds evidence that ECPMs are more likely to adjust their acquisition and divestment activity depending on the level of markets and other timing factors than other firms.

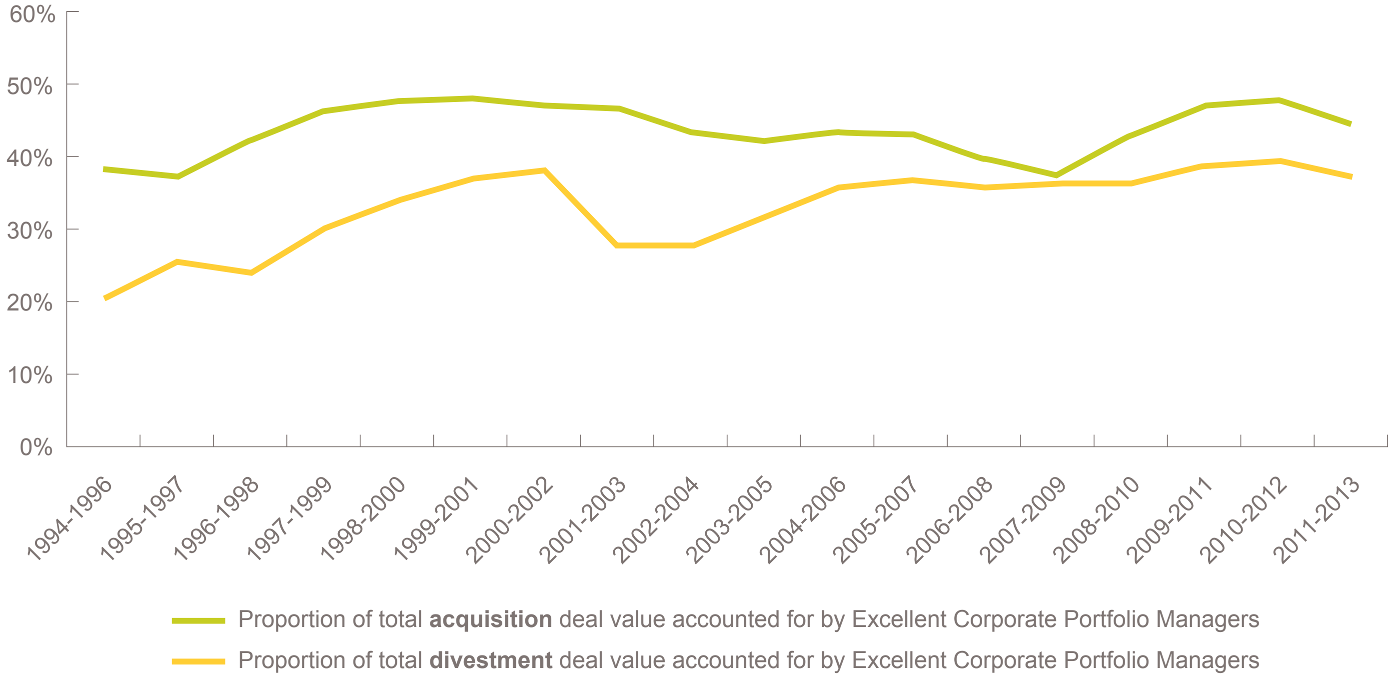
For example, as shown in **Chart 6**, the study finds that the relative proportion of all acquisitions accounted for by ECPMs fell steadily to below 40% during the last M&A boom of 2003-2007 (when asset prices became inflated) before picking up sharply following the start of the global financial crisis in 2007/2008 (when buyers were scarce and asset prices fell steeply). For divestments, the opposite is true, with ECPMs increasing their share of the value of total announced divestments during periods of rising markets, such as from 1993-2000 and again from 2003-2007.

The head of strategy at a Dutch engineering ECPM supports these findings: “The level of competition is a critical factor when it comes to M&A as it directly influences valuations. When competition intensifies then valuations surge and at a point we often decide that deals do not make sense.”

> “When competition intensifies then valuations surge and at a point we often decide that deals do not make sense.”

“We always consider the market condition and a market that has very high valuations is not good for buying,” adds the head of mergers and acquisitions at an Italian rubber and plastic products ECPM.

Chart 6. Proportion of total acquisition and divestment deal value accounted for by ECPMs



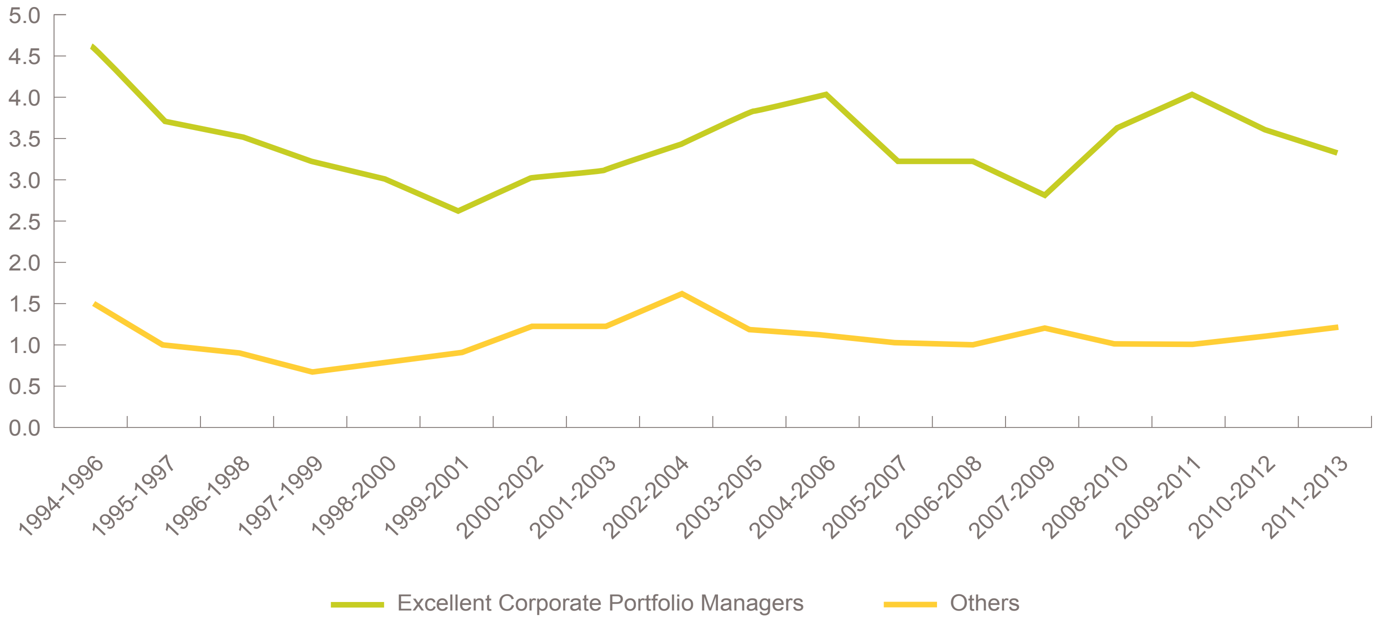
Although the relative proportion of total acquisition deal value of ECPMs compared to other firms may decrease during market peaks, as shown in **Chart 7** these high-performing firms do continue to acquire significantly more than they divest and they also have a significantly higher acquisition value to divestment value ratio than other firms. The chief financial officer at a UK chemical manufacturing ECPM points out that strategy still needs to be considered before price: "For us, it will depend on the asset and its strategic importance to our company. If the asset is very strategically important then market conditions will not matter."

"If the asset is very strategically important then market conditions will not matter."

The importance that the best-performing firms place on the relative value of acquisitions compared to divestments, and on timing, can be seen by looking at the history of the ratio of acquisition to divestment transaction value for ECPMs in comparison to other firms, as shown in **Chart 7**. For ECPMs, the study finds that the average value of this ratio is around 3.4 over the 20 year period, compared to an average value of 1.0 for other firms, meaning that the best-performing firms are making acquisitions worth over three times as much as their divestments.

As shown in **Chart 7**, for ECPMs this ratio falls rapidly during the period leading up to the collapse of the internet/dotcom bubble in 2000, to a low of 2.6, after which the ECPMs sharply increase the value of their acquisitions relative to divestments to a high of 4.0 until the middle of the M&A boom of 2003-2007, after which the ratio falls again to a low of 2.8 at the start of the global financial crisis in 2007/2008. By contrast, the ratio of acquisitions to divestments of other firms increases over the period 1997-2003 to a high of 1.6, before falling to 1.0 in the period leading up to 2007.

Chart 7. Acquisition to divestment ratio of ECPMs compared to other firms



However, following the start of the global financial crisis in 2007/2008, in contrast to other firms, the ECPMs rapidly increase the value of their acquisitions relative to divestments - back to the last high of 4.0 seen in the period 2004-2006, taking advantage of opportunities to make acquisitions during a period of unprecedented market turmoil, falling asset prices and a sharp fall in global M&A activity as buyers disappeared from the market. These findings point to the increased willingness and ability of ECPMs, especially over the last economic cycle, to engage in market timing compared to other firms (reducing the value of acquisitions relative to divestments during periods when markets become overheated and increasing acquisitions immediately following sharp market downturns).

"We never want to divest when the valuations are weak and below our expectations."

"Conditions such as valuations, demand, and stock performance matter a lot. We never want to divest when valuations are weak and below our expectations," reveals the head of corporate development at a US waste management ECPM.

"If a company is in dire need of cash to survive then regardless of the valuations they will have to divest to raise cash. But it is important to divest when market valuations are high," suggests the chief operating officer at a Chinese hotel and hospitality ECPM.

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