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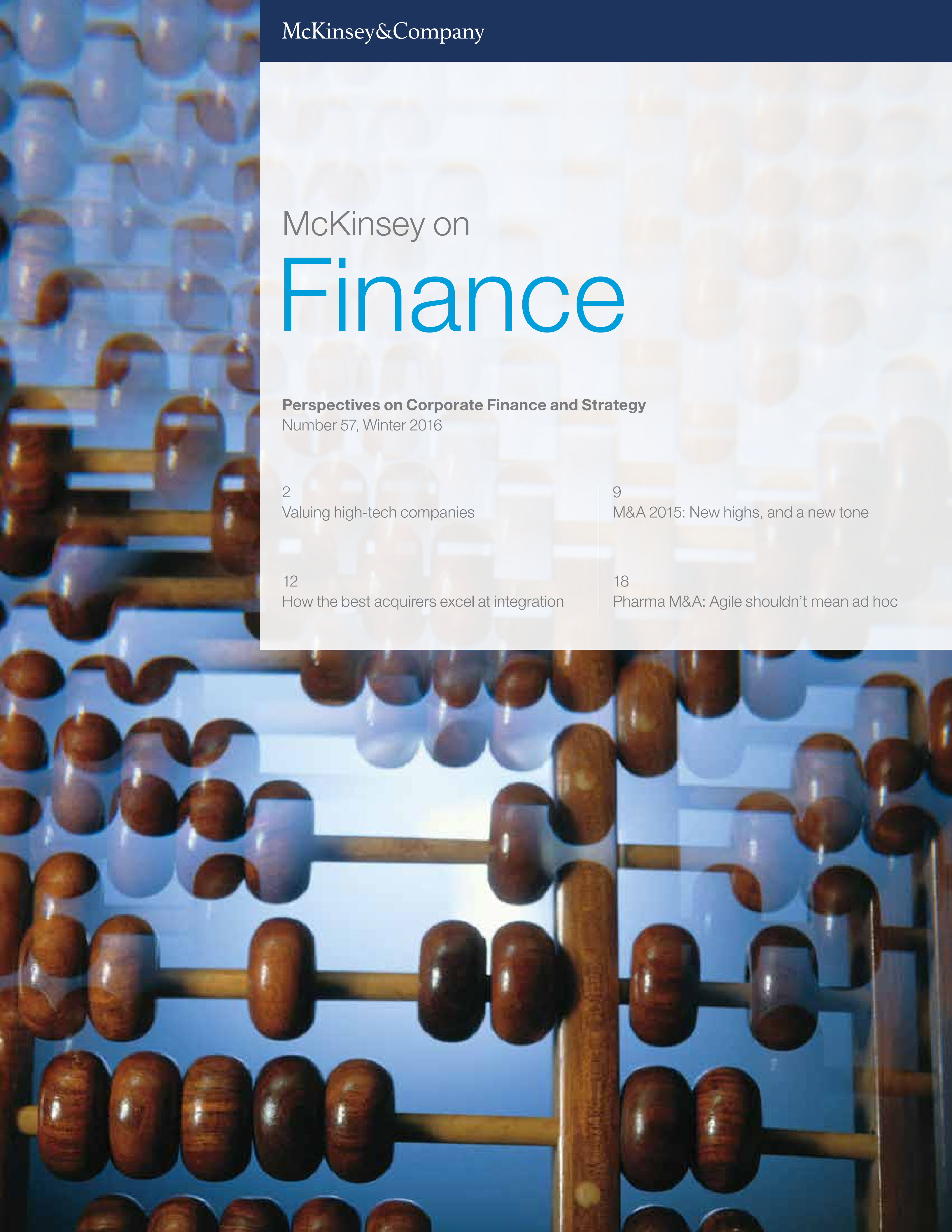

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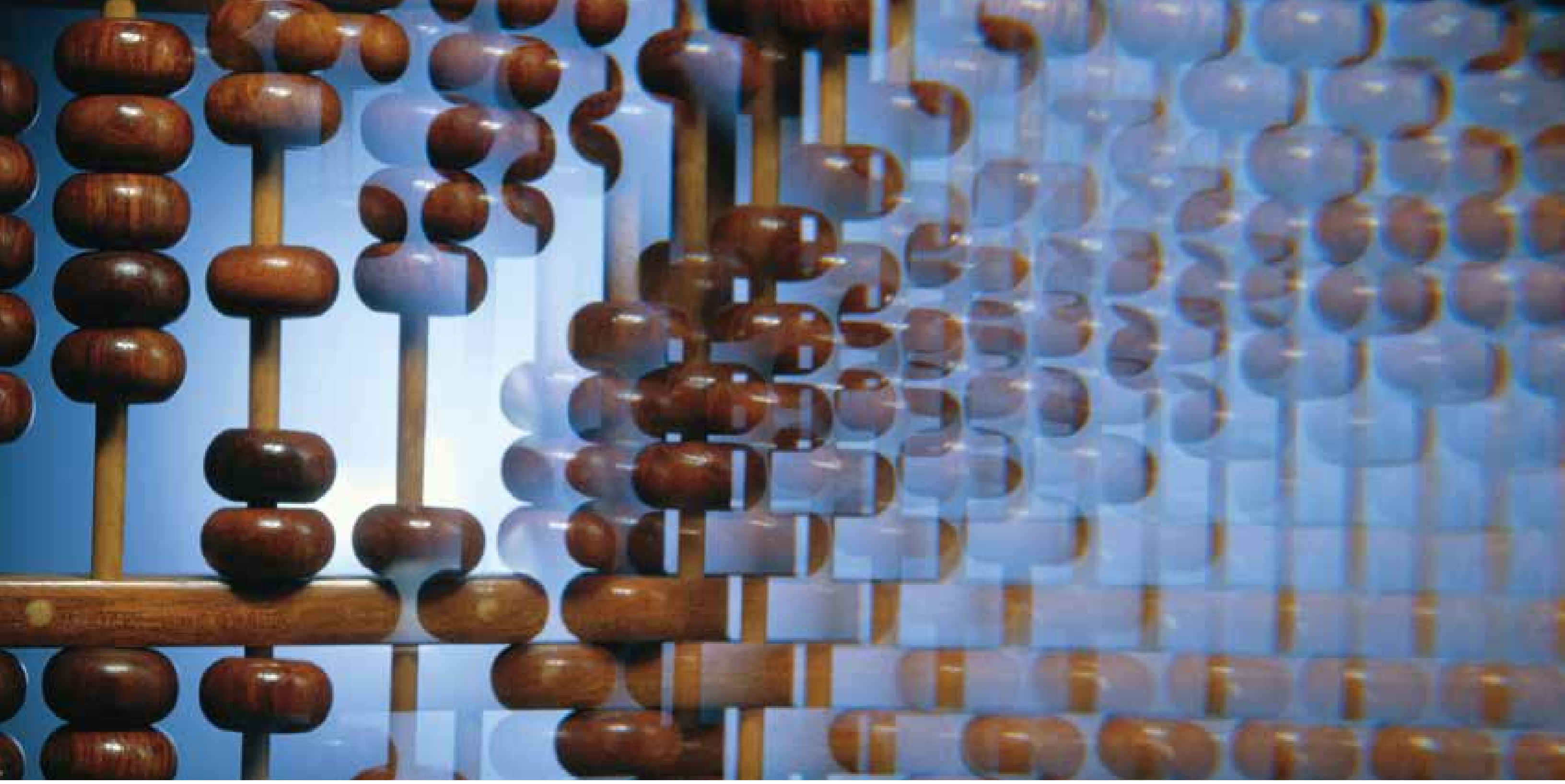

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Valuing high-tech companies

It might feel positively retro to apply discounted-cash-flow valuation to hot start-ups and the like. But it's still the most reliable method.

Marc Goedhart, Tim Koller, and David Wessels

For the past several years, investors have once again been piling into shares of companies with fast growth and high uncertainty—especially Internet and related technologies. The rapid rise and sudden collapse of many such stocks at the end of the 20th century raised questions about the sanity of a stock market that appeared to assign higher value to companies the more their losses mounted. Now, amid signs that the current tech boom is wobbling, even the US Securities and Exchange Commission is getting into the act, announcing in late 2015 its plans to investigate how mutual funds arrive at widely varying valuations of privately held high-tech companies.

In the search for precise valuations critical to investors, we find that some well-established principles work just fine, even for high-growth companies like tech start-ups. Discounted-cash-flow valuation, though it may sound stodgily old school, works where other methods fail, since the core principles of economics and finance apply even in uncharted territories, such as start-ups. The truth is that alternatives, such as price-to-earnings or value-to-sales multiples, are of little use when earnings are negative and when there aren't good benchmarks for sales multiples. More important, these shorthand methods can't account for the unique characteristics of each company in a fast-changing environment, and they provide little insight into what drives valuation.

Although the components of high-tech valuation are the same, their order and emphasis differ from the traditional process for established companies: rather than starting with an analysis of the company's past performance, begin instead by examining the expected long-term development of the company's markets—and then work backward. In particular, focus on the potential size of the market and the company's market share as well as the level of return on capital the company might be able to earn. In addition, since long-term projections are highly uncertain, always value the company under different probability-weighted scenarios of how the market might develop under different conditions. Such techniques can help bound and quantify uncertainty, but they will not make it disappear: high-growth companies have volatile stock prices for sound reasons. What follows is an adaptation of analysis we published in 2015, using public data from 2014 and 2015.[1] The analyses herein are presented as an exercise to illustrate the methodology. They are not meant as a commentary on the current market situation and should not be used as the basis for trading in the shares of any company.

Start from the future

When valuing high-growth companies, start by thinking about what the industry and company might look like as the company evolves from its current high-growth, uncertain condition to a sustainable, moderate-growth state in the future. Then interpolate back to current performance. The future state should be defined and bounded by measures of operating performance, such as customer-penetration rates, average revenue per customer, sustainable margins, and return on invested capital. Next, determine how long hypergrowth will continue before growth stabilizes to normal levels. Since most high-growth companies are start-ups, stable economics probably lie at least 10 to 15 years in the future.

To demonstrate the valuation process for high-growth companies, let's walk through an abbreviated, potential valuation of Yelp, a popular online site for reviewing local businesses, using public data about the company. In 2014, approximately 545 million unique visitors wrote 18 million reviews on 2 million businesses. As the company explains in its annual report, "These reviews are written by people using Yelp to share their everyday local business experiences, giving voice to consumers and bringing 'word of mouth' online."

Originating in San Francisco, the company now serves around 150 cities around the world. Yelp's revenues between 2009 and 2014 grew more than tenfold from just under $26 million to $378 million, representing a compound annual growth rate of 71 percent. (Revenues in 2015 were up 48 percent over the previous year as of the third quarter.) To estimate the size of the potential market, start by assessing how the company fulfills a customer need. Then determine how the company generates (or plans to generate) revenues.

Understanding how a start-up makes money is critical. Many young companies build a product or service that meets the customer's need but cannot identify how to monetize the value they provide. Yelp provides end users with an extensive online forum to review the experiences of other customers when selecting a local business. Although Yelp provides a convenient service to the customer, today's Internet users often do not pay for online reviews.[2]

Instead of charging the end customer, Yelp sells local advertising to businesses that register on the website. A basic listing is free, but the company offers paid services, such as enhanced listings with photos and video, a sponsored search (where the company appears early in the consumer's search results), and a "call to action," which allows the consumer to schedule an appointment or the business to provide a coupon. In 2014, that local advertising contributed $321 million of the company's $378 million in revenues. Two other sources of revenues, brand advertising and other services, allow companies to purchase general advertisements and conduct transactions. Both are growing rapidly, but they continue to be a smaller part of annual revenues. Using these revenue drivers as a guide, start your valuation by estimating the potential market, product by product.[3]

Size the market

Although Yelp management rightfully touts its unique visitors and growing base of customer reviews, what really matters from a valuation perspective is its ability to convert local businesses into Yelp clients. Start with estimating how many local businesses are in Yelp's target markets, how many businesses will register with Yelp, and how many of those businesses will convert to its paid services. There are approximately 66 million small and midsize businesses in Yelp's target markets.[4] As of 2014, the company had registered 2 million businesses on its site. Of the businesses that registered, only 84,000 were paying clients. With 1 percent market penetration, there is plenty of room for growth (exhibit).

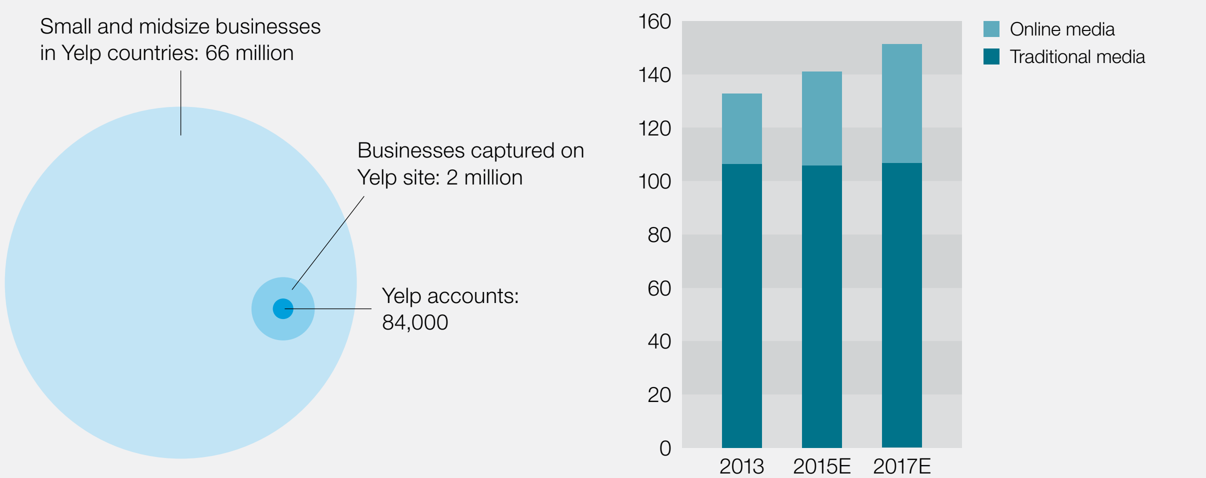
To build a revenue forecast, first estimate the number of business that might register with Yelp. We estimate both historical and future registration rates by analyzing Yelp's historical data. Since registration is free and Yelp is well known, we model penetration, for this exercise, to reach 60 percent. That translates to 8.5 million registered businesses by 2023. For most start-ups, forecasting a 60 percent share is extremely aggressive, since additional competition is likely to enter the market.[5] For this business, however, it is reasonable to assume that the largest company is

Exhibit

Yelp has potential to increase its market penetration.

Number of local businesses, 2013

US local-ad spending, $ billion



Source: BIA/Kelsey; Yelp 10-K, 2014; Yelp investor deck, Mar 2014 likely to capture a significant portion of the online market—since businesses desire an advertising partner that generates the most traffic, and consumers desire a website with the most reviews. In that way, this business is similar to others with a community of users that reinforces the use of the product, such as Microsoft's Windows operating system, which still retains more than 80 percent of its market.

With registered businesses in hand, next estimate the conversion rate from basic (free) to enhanced (pay) services. To estimate this number, we analyzed data from cohorts of Yelp's markets based on entry dates to annual conversion rates the company has reported. Based on historical data, we project that Yelp's penetration rate will grow from 4 to 5 percent as the cohorts mature. This number is quite conservative, but historical data have not pointed to much movement over time, even for Yelp's earliest markets.

Complete the forecast by estimating revenues per client. Again, data from early markets are relatively stable, averaging near $3,800 per business. Assuming average revenue per paying business increases at 3 percent per year leads to revenue of $5,070 per business by 2023. Multiplying the number of paying clients in 2023 (423,000) by the average revenue per business leads to estimated total local-advertising revenue of $2.2 billion in 2023. Adding estimates of revenues for brand advertising and other services yields an estimate of total 2023 revenues of $2.4 billion.

Next, we test our revenue estimate by examining potential market share in 2023. BIA/Kelsey, a research and advisory company that focuses on local advertising, estimated that local businesses spent $132.9 billion on advertising in 2013, of which $26.5 billion was placed online.[6] Between 2013 and 2017, the research company expects online advertising to grow by 14 percent per year, to $44.5 billion. Assuming that number grows by 5 percent per year, we estimated total online-advertising revenues will come to $60 billion in 2023. Although search engines such as Google are likely to continue to capture the lion's share of this market, there is still room for Yelp to capture a portion of local advertising. Our estimate for Yelp in this exercise translates to a potential market share of 4 percent by 2023.

Estimate operating margin, capital intensity, and return on invested capital

With a revenue forecast in hand, the next step is to forecast long-term operating margins, required capital investments, and return on invested capital (ROIC). Since Yelp's current margins as a fast-growing start-up are not indicative of its likely long-term margins, it is important to examine the fundamentals of its business model and look to companies with similar business models. OpenTable is another high-growth company actively serving businesses in local markets. OpenTable provides reservation services for restaurants. Similar to Yelp, the company generates revenue by deploying a dedicated sales team to local restaurants to encourage enrollment. OpenTable's management forecast that, when mature, it would reach operating profit margins of about 25 percent. Combined with our revenue forecast, this margin projection would translate to a potential growth in operating profit from a loss of $8.1 million in 2013 to a profit of $619 million in 2023.

But are these forecasts realistic? To address this question, examine other software companies that provide a similar conduit between consumers and businesses, funded by businesses. The key value drivers for Google, LinkedIn, and Monster Worldwide, though not a perfect comparison, offer some insight into what is possible.

If Yelp can match Google, perhaps 25 percent operating margins are not unrealistic. But not every business-to-business Internet company has been able to maintain such healthy margins. For instance, Monster Worldwide generated operating margins near 30 percent prior to 2010, but it has watched margins erode under competitive pressure. In 2013, domestic margins hovered near 15 percent, and the company's overall margin declined below 10 percent. Success with consumers by no means assures ongoing success with the businesses and, by extension, with financial results.

To estimate future cash flow, we also had to forecast capital requirements. Most businesses require significant capital to grow. This is not the case for many Internet companies. In 2014, Yelp required only $92 million of capital on $378 million of revenues, or 24 percent. Unlike traditional companies, which often consume significant capital as they grow, Internet companies require little fixed equipment; most of the capital resides in short-term assets such as accounts receivable. To create cash flow for Yelp, we maintained this percentage of invested capital to revenue, which is also in line with Google, LinkedIn, and Monster Worldwide. With high operating margins and little invested capital, ROIC is so high that it is no longer a useful measure. But what about the competition? If ROIC is so high, shouldn't competitors enter and eventually force prices down? Perhaps, but Yelp's real capital resides in intangibles such as brand and distribution capabilities, and these are not easily captured using today's financial statements.

Work backward to current performance

Having completed a forecast for total market size, market share, operating margin, and capital intensity, it is time to reconnect the long-term forecast to current performance. To do this, you have to assess the speed of transition from current performance to future long-term performance. Estimates must be consistent with economic principles and industry characteristics. For instance, from the perspective of operating margin, how long will fixed costs dominate variable costs, resulting in low margins? Concerning capital turnover, what scale is required before revenues rise faster than capital? As scale is reached, will competition drive down prices?

Often the questions outnumber the answers. To determine the speed of transition from current performance to target performance, we examined the historical progression for similar companies. Unfortunately, analyzing historical financial performance for high-growth companies is often misleading, because long-term investments for high-growth companies tend to be intangible. Under current accounting rules, these investments must be expensed. Therefore, accounting profits are likely to be understated relative to the true economic profits. With so little formal capital, many Internet companies have high ROIC figures as soon as they become profitable.

Consider Internet retailer Amazon. In 2003, the company had an accumulated deficit (the opposite of retained earnings) of $3.0 billion, even though revenues and gross profits (revenues minus direct costs) had grown steadily. How could this occur? Marketing- and technology-related expenses significantly outweighed gross profits. In the years between 1999 and 2003, Amazon expensed $742 million in marketing and $1.1 billion in technology development. In 1999, Amazon's marketing expense was 10 percent of revenue.

In contrast, Best Buy spends about 2 percent of revenue for advertising. One might argue that the eight-percentage-point differential is more appropriately classified as a brand-building activity, not a short-term revenue driver. Consequently, ROIC overstates the potential return on capital for new entrants because it ignores historically expensed investment.

Develop weighted scenarios

A simple and straightforward way to deal with uncertainty associated with high-growth companies is to use probability-weighted scenarios. Even developing just a few scenarios makes the critical assumptions and interactions more transparent than other modeling approaches, such as real options and Monte Carlo simulation.

To develop probability-weighted scenarios, estimate a future set of financials for a full range of outcomes, some optimistic and some pessimistic. For Yelp, we developed three potential scenarios for 2023. In our first scenario, revenues grow to $2.4 billion on roughly 423,000 converted accounts with margins that match Google's. In our second scenario, we assume that Yelp progresses much better than expected. Registrations for free accounts follow the base-case scenario, but the company doubles its conversion rate from 5 to 10 percent, leading to nearly a half million accounts and approximately $4.6 billion in revenue. In this scenario, the company continues its path to profitability, with margins comparable to Google's. This is an optimistic estimate based on past performance, but a 10 percent conversion rate is by no means implausible. The last scenario assumes that Yelp generates less than $1.2 billion in revenue by 2023 because the international expansion goes poorly. Without expected revenue growth, margins grow to just 14 percent, matching Monster Worldwide's domestic business.

To derive current equity value for Yelp, weight the intrinsic equity valuation from each scenario ($5.0 billion for the high case, $3.4 billion for the base case, and $1.3 billion for the low case) by its estimated likelihood of occurrence, and sum across the weighted scenarios. Based on our illustrative probability assessments of 10 percent, 60 percent, and 30 percent, respectively, for the three scenarios, we estimate Yelp's equity value at $2.9 billion and value per share at $39.[7] Whether this price is appropriate depends on your confidence in the forecasts and their respective probabilities. Were they too optimistic, too pessimistic, or just right?

Scenario probabilities are unobservable and highly subjective. If the probability of occurrence for the most pessimistic scenario were ten percentage points higher, Yelp's estimated value would be more than 10 percent lower. For start-up companies with promising ideas but no actual businesses, the sensitivities can be significantly higher. Take, for example, a start-up company that needs to invest $50.0 million to build a business that could be worth $1.2 billion with a probability of 5 percent and completely worthless otherwise. Its estimated value today would be $10.0 million. But if the probability of success were to fall by just half a percentage point, its value would decline by more than half. It should be no surprise that the share prices of start-up and high-growth companies are typically far

> Understanding what drives the value of the underlying business across the scenarios is more important than trying to come up with a single-point valuation.

more volatile when compared with companies with mature businesses.

As a result, understanding what drives the value of the underlying business across the scenarios is more important than trying to come up with a single-point valuation. A careful analysis of Yelp's business following the lines laid out above helps. For Yelp, the growth of the advertising market and the market share it could attain are important—but they can be forecasted within a reasonable range (and don't differ that much across scenarios). More critical—and harder to predict—are the conversion rates to paid-service accounts and the average revenues per account that Yelp realizes in coming years. Conversion rates and revenues per account are the key value drivers for Yelp. ■

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1 Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, sixth edition, Hoboken, NJ: John Wiley & Sons, 2015.

2 Although free reviews are commonplace today, this has not always been the case. As of this writing, professional reviewers such as the magazine *Consumer Reports* (for products) and Zagat (for restaurants) still charge for their service.

3 For the purpose of exposition, this article examines only one source of revenues for Yelp in detail: local advertising, which generates the bulk of the company's revenues.

4 Yelp investor presentation, 2014.

5 One piece of data pointing to the potential of a 60 percent share is the restaurant-reservation company OpenTable. Before being acquired by Priceline.com in 2014, OpenTable reported that it had exceeded a 60 percent share in San Francisco.

6 "BIA/Kelsey forecasts overall US local media ad revenues to reach $151.5B in 2017, lifted by faster growth in online/digital," November 19, 2013, biakelsey.com.

7 During the first half of 2015, when this example was updated, Yelp's shares were trading between $40 and $50 per share. In the second half of the year, one of the cofounders announced his departure, and Yelp announced that growth would be slower than anticipated, leading to a substantial drop in the share price. As with any valuation of fast-growing companies, markets are volatile and susceptible to the mood of the market.

This article is excerpted from Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, sixth edition, Hoboken, NJ: John Wiley & Sons, 2015. The book can be ordered at wiley.com.

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M&A 2015:
New highs, and a new tone

Deal activity surged again—especially big deals and those in the United States.

Werner Rehm and Andy West

M&A activity reached a new high in 2015, both globally and in the United States—with large deals leading the way. Asia also reached a new record, with activity for the first time virtually tied with Europe as the second-busiest region for M&A.

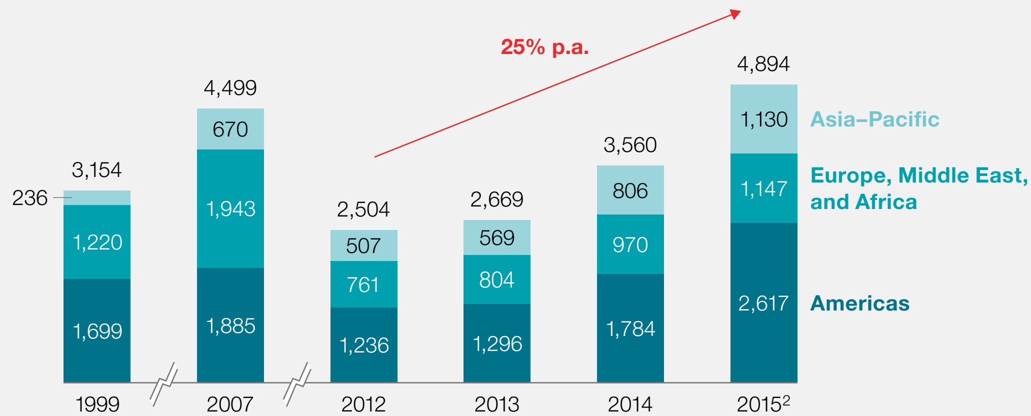
By the numbers, more than 7,500 deals with a combined value of over $4.5 trillion had been announced as of this writing (Exhibit 1)—on track to exceed 2014 deal volume by 8 percent and deal value by 37 percent, and eclipsing the record of activity set in 2007. North American acquisitions accounted for more than 50 percent of global deals by value, while year-on-year growth of deal value in Asia over the first 11 months of 2015 exceeded the previous 11 months by nearly 60 percent.

But the big story in 2015 is around big deals. Megadeals—those valued at more than $10 billion—were up by nearly 130 percent by value year on year during the first 11 months of the year. Large deals, with a value between $5 billion and $10 billion, were up 24 percent, while small deals increased by about 10 percent. Announcement effects for acquirers in large deals, which went positive in 2013 for the first time in our records, dipped only slightly in 2015 as many investors continued to welcome announcements of large deals (Exhibit 2). Traditionally, such announcement effects have been a poor indicator of a deal's eventual value. For instance, our analysis of past deals has found no correlation between share-price movement in the days after a deal is announced

Exhibit 1

Global M&A sets a new record.

Value of announced deals,[1] $ billion



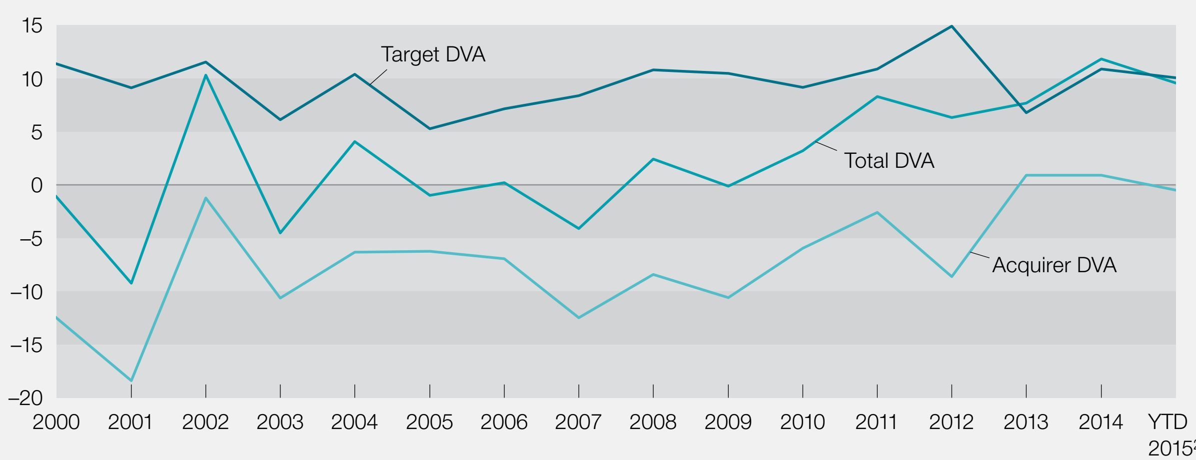
[1] Includes deals with value of more than $25 million only. Figures may not sum, because of rounding.
[2] Data extrapolated to show expected results for entire year based on announced activity (not withdrawn) through Nov 30, 2015.

Source: Dealogic; McKinsey analysis

Exhibit 2

Many investors continue to react well to large deals.

Deal value added (DVA),[1] target and acquirer, large deals ≥$5 billion, %



[1] For M&A involving publicly traded companies; defined as combined (acquirer and target) change in market capitalization, adjusted for market movements, from 2 days prior to 2 days after announcement, as % of transaction value.
[2] Based on large-deal data from Jan 1 to Nov 30, 2015.

Source: Datastream; Dealogic; McKinsey analysis and a company's excess total return to shareholders two years after a deal, when most synergies are captured.

Why do many investors continue to applaud big deals? It could be a change in the types of deals. In the past, big deals were often seen as tactics to address cost reduction and industry consolidation—and many still are. But today we also see deals where managers and boards are talking about diversification and, for the first time in a long time, about revenue—about cross-selling and creating new customer opportunities, and about transformation. Some of that has always been part of the rationale for big deals, but given continuing strong announcement effects, it may be that investors are more receptive to it. Companies may also be getting better at integration and capturing deal synergies. In our observation, the discipline, professionalism, and capabilities around integration have certainly improved. ■

The authors wish to thank Roerich Bansal for his contributions to this article.

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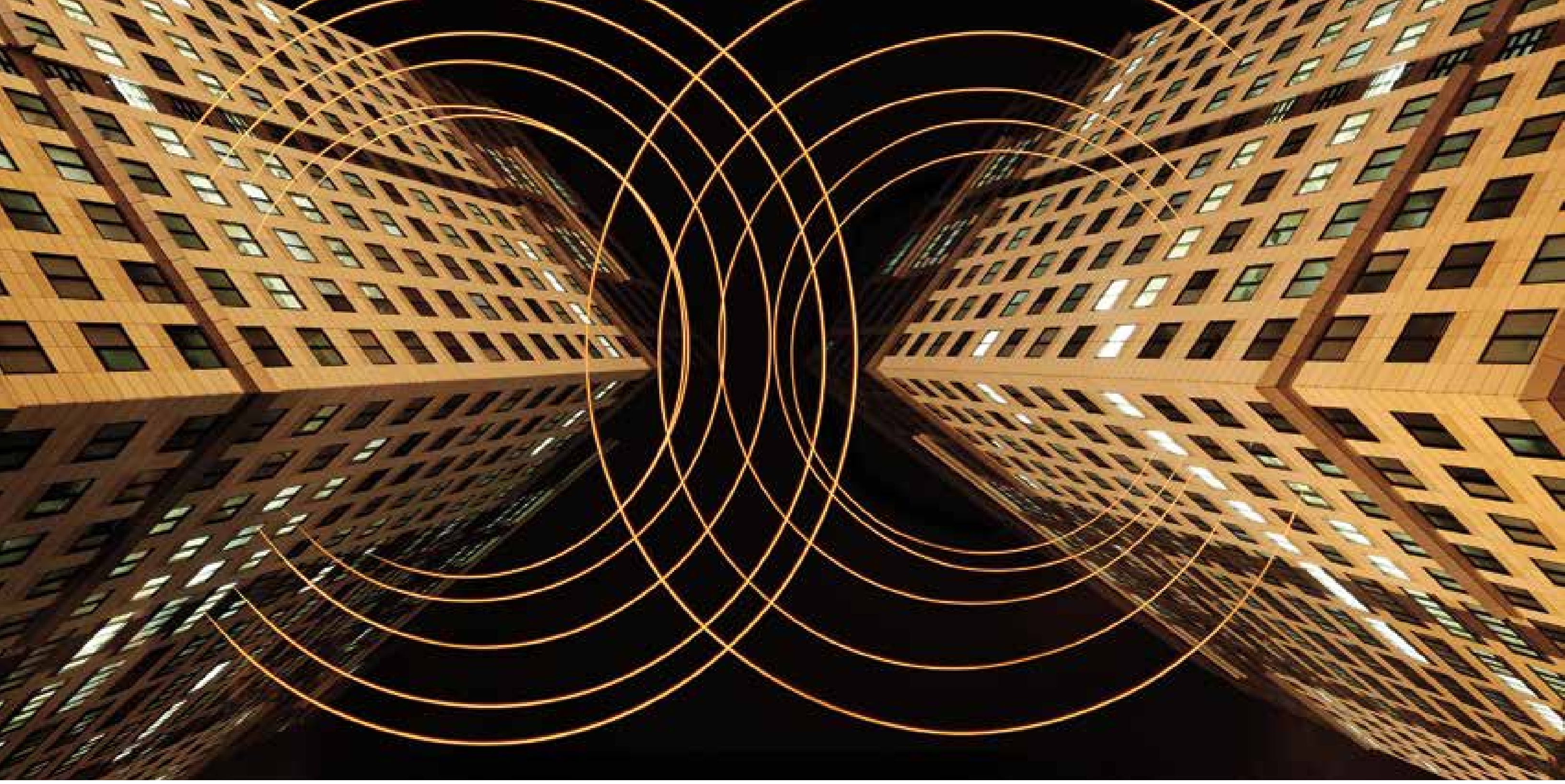

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How the best acquirers excel at integration

The same handful of integration challenges vex companies year after year. New survey data suggest how high performers stay on top.

Rebecca Doherty, Oliver Engert, and Andy West

Integrating merging companies requires a daunting degree of effort and coordination from across the newly combined organization. As the last step in an M&A process that has already been through many months of strategic planning, analysis, screening, and negotiation, integration is affected both by errors made in earlier stages and by the organizational, operational, finance, cultural-alignment, and change-management skills of executives from both companies. Those that do integration well, in our experience, deliver as much as 6 to 12 percentage points higher total return to shareholders than those that don't.

The skills and capabilities that companies need to improve most when they integrate are persistent and, for many, familiar. Grounding an integration in the objectives of the deal, bringing together disparate cultures, setting the right performance goals, and attracting the best talent are frequently among the top challenges that bedevil even experienced active acquirers.[1] They're also the ones that, according to our experience and survey research,[2] differentiate strong performers from weaker ones.[3]

Ground integration in the objectives of the deal

The integration of an acquired business should be explicitly tailored to support the objectives and sources of value that warranted the deal in the first place. It sounds intuitive, but we frequently encounter companies that, in their haste, turn to off-the-shelf plans and generic best practices that tend to overemphasize process and ignore the unique aspects of the deal.

Since the deal rationale is specific to each acquisition, so is the integration approach, and it's important to think through the implications of the deal rationale and the sources of value for the focus, sequence, and pace of the integration. Consider, for example, the experience of two companies where R&D was a primary source of value for an acquisition. After prefacing their integration plans with a close review of their respective objectives, they each took a different approach to integration.

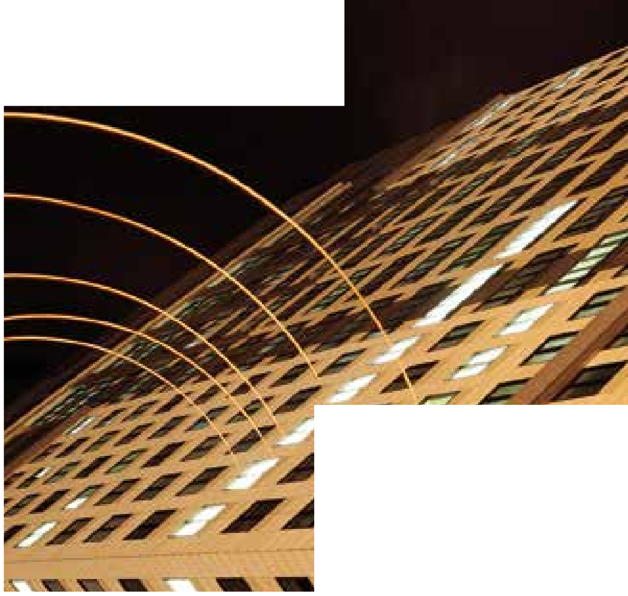
For the first, a technology company, the objectives of its deal were to build on the acquired company's R&D capabilities and launch a new sales channel in an adjacent market. Extrapolating from those objectives, the integration managers designed the integration around three core teams for R&D, sales, and back-office consolidation. By prioritizing these areas and structuring groups to tackle each one, the company ensured the proper allocation of talent, time, and management attention. Specifically, steering-committee time was regularly dedicated to these issues and ensured a proper focus on the areas likely to create the most value. As a result, the team quickly launched cross-selling opportunities to similar customers of the acquired company and deployed resources to accelerate ongoing development and merge R&D road maps.

The deal objectives also shaped the sequence and pace of the integration. On a function-by-function basis, managers determined where to accelerate, stage, or delay integration activities, by considering which created the most value while sustaining the momentum of the integration. Hence the company prioritized must-have functional areas to ensure compliance and business continuity—for example, ensuring that the finance group was ready to support month-end close procedures—and accelerated value-creating activities in sales and R&D. Year-on-year revenues were up well over 10 percent as of the last quarter for which figures were available.

In the second company, a key player in the pharmaceutical industry, R&D again was a primary source of value. But because the acquired biopharmaceutical business was in an emerging area that required different capabilities and entrepreneurial thinking, the acquiring company's managers decided that the acquisition's culture and processes would be a critical aspect of its value. While they would reevaluate whether to integrate more fully once products cleared development and were ready for market, they decided that it would be best in the short term to integrate only select back-office functions to take advantage of the combined company's scale. They would ensure the proper linkages with legal, regulatory, and financial-compliance activities, but to protect the target's business momentum, the acquiring company's managers allowed the target's managers to retain their local decision rights. The acquirer also provided resources, such as capital, to help the business grow—and rotated managers into the business to learn more about it and its market.

Tackle the culture conundrum

Culture isn't about comparing the mission and vision of two companies—which on the surface can often appear very similar. And culture is much deeper than a good first impression, a sense that you share the same values, or the more trivial practices of, say, wearing jeans on Fridays. Instead, the essence of culture is reflected in a company's management practices: the day-to-day working norms of how it gets work done, such as whether decisions are made via consensus or by the most senior accountable executive. If not properly addressed, challenges in cultural integration can and often do lead to frustration



among employees, reducing productivity and increasing the risk that key talent will depart, hampering the success of the integration.

Companies often struggle to assess and manage culture and organizational compatibility because managers focus on the wrong things. Too often, they revert to rites, rituals, language, norms, and artifacts—addressing the most visible expressions of culture rather than the underlying management practices and working norms. Managers often return from initial deal interactions convinced that the cultures of the companies involved are similar and will be easy to combine.[4] As a result, they almost always apply too few resources to the cultural side of the integration, often leaving it to human resources to lead.

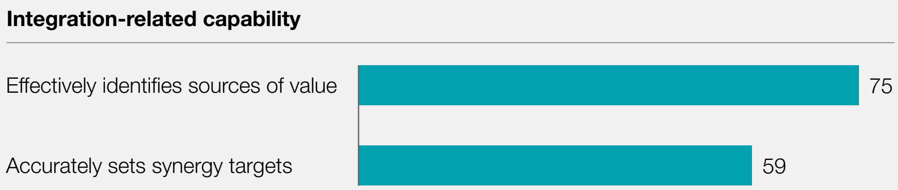
For cultural integration to be successful, employees must view it as core to the business. That may not happen if business leaders are not visibly leading and prioritizing the cultural integration. Culture is also difficult to address because it permeates everything—spanning levels, geographies, and organizations. Therefore, addressing it just at headquarters or a few key sites is insufficient; real cultural integration needs to be addressed in a distributed fashion across geographies and at all levels in the company. It should also be treated seriously at all stages of the acquisition process: due diligence, preclose integration planning, postclose integration, and ongoing operations.

For example, in one healthcare deal, the acquirer began its assessment of culture during the due-diligence process. Managers took an outside-in look at the likely culture of the target company and used this input to shape the initial approach to due diligence, top-management meetings, and early integration planning. They even used the insights for more tactical decisions, such as limiting how many people attended initial meetings. Specifically, rather than bringing dozens of finance professionals to assess synergies, the company started with a smaller group to understand the target better. Then, at the integration kickoff, they built in an explicit discussion of working norms, so integration leaders could begin identifying, understanding, and addressing some of the differences head-on.

Maintaining the momentum of cultural integration well into the integration process is equally important. In an integration of two European industrial companies, managers identified and evaluated ten potential cultural goals as joint areas for improvement, joint areas of strength, or areas of difference. The managers weighed these potential goals against the sources of value in the deal, deciding to focus on four that were most closely linked to this value and that struck a balance between areas where the two companies were similar, as well as areas where they were different. Quickly achieving the benefits of their similarities created the momentum and trust required for addressing many of the thornier issues the managers faced. To ensure that cultural integration would be linked to and led by the businesses, not just by human resources, the company assigned a senior-executive sponsor from each business to tackle each goal. Every sponsor then created and implemented a plan that managers could monitor well past the close date and into ongoing operations—including specific consistent metrics, such as achieving a certain score on an ongoing employee survey.

Exhibit 1 **Companies face challenges in translating sources of value into synergy targets.**

% of respondents (n = 1,841) who "strongly agree" or "agree" that their companies have each integration-related capability



Source: McKinsey survey on global M&A capabilities, May 2015

Translate sources of value into quantifiable performance goals

The results of our global M&A capabilities survey suggest that companies are significantly better at identifying sources of value than they are at translating those sources of value into quantifiable performance goals (Exhibit 1). The explanation is intuitive: understanding the theory behind how two companies can come together and brainstorming revenue-synergy opportunities are exciting, but operationalizing the ideas is more complicated.

Companies find this work to be challenging. The value-creation process requires setting a granular baseline; setting targets; putting together detailed, milestone-driven plans; making tough decisions and trade-offs; and visibly tracking progress over time. The first step alone is daunting, since setting an objective baseline requires an apples-to-apples comparison of each company's costs and revenues, and that means preparing financials in a way that's usually foreign to both the acquiring and the target company.

One best practice we observe is that managers, before setting detailed performance goals (and the actions to achieve them), update expectations on synergies after the due-diligence phase by looking more broadly at capital productivity, revenue enhancement, and cost efficiency, as well as transformational opportunities. By this point, the acquirer will know a lot more about the target than it did during due diligence and may even have a different purpose and mind-set. In fact, in our experience, the best acquirers revisit value creation in a very formal way several times during the integration, both encouraging and resetting the expected synergy results to higher and higher levels.

To do so, managers at one industrial company brought key employees from both sides of the deal together in separate cost and revenue value-creation summits, where they were tasked with identifying bottom-up opportunities to meet the aspirational goals that had been set from the top down. These summits were staggered, with costs coming first, followed by several rounds on revenues. The first summit, held before the deal closed, focused on only headquarters costs, which represented the most immediate cost synergy of the deal. During the summit, the participants—a mix of subject-matter experts, finance specialists, and members of the core value-creation integration team—brainstormed ideas and crafted initiatives to achieve performance goals endorsed by the CEO. Managers later held revenue value-creation summits in the countries with the greatest opportunities, holding each country leader accountable for regional targets. By creating a space away from the day-to-day business to brainstorm ideas, summit managers set a tone that encouraged collaboration and promoted creative thinking. Coming out of the summits, managers understood who was accountable for which targets and initiatives, as well as how progress against targets would be visible to the most senior executives of the company.

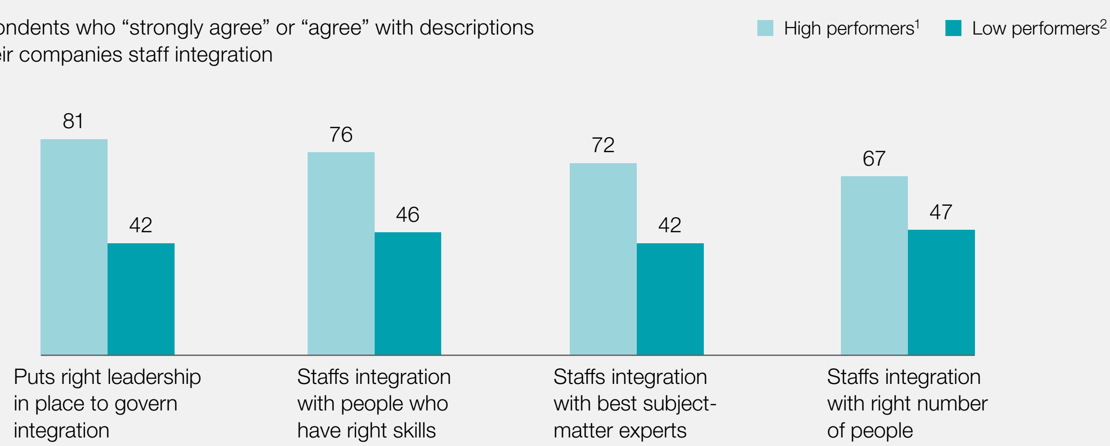
Promote until it hurts

Compared with other stages of M&A, integration is where companies perceive their capacities and capabilities to be the most deficient. Survey respondents were 12 to 18 percent less likely to report that their companies had the right capacities for integration than for any other M&A activity, and were 12 to 19 percent less likely to report that they had the right capabilities. This is probably because integrations require so many people with such diverse capabilities for a substantial period of time. Most companies have at least a few leaders who fit the bill, but some companies find it difficult to task enough people for an integration. That makes it challenging to build the right integration team with top-notch players—though this is one area where high-performing companies across the board distinguish themselves. Overall, 76 percent of respondents at high performers surveyed report that they staff an integration with people who have the right skills, versus 46 percent of respondents at low performers. The contrast is even starker in staffing different aspects of the integration with the right talent (Exhibit 2).

Exhibit 2

Companies that meet or surpass their M&A objectives are more effective than others at staffing integration.

% of respondents who “strongly agree” or “agree” with descriptions of how their companies staff integration



[1] Companies where respondents to a survey on global M&A capabilities report that those companies have met or surpassed their cost- and revenue-synergy targets in their transactions (n = 464).

[2] Companies where respondents report that those companies have achieved neither their cost- nor revenue-synergy targets in their transactions (n = 302).

Source: McKinsey survey on global M&A capabilities, May 2015

From a CEO's point of view, it can initially appear risky to move a top performer out of the day-to-day business and into integration. In some cases, key business leaders should be kept running the business, but in others, there is an opportunity for companies to backfill the position and move a high performer into integration. If it's not a hard personnel decision, it's probably not the right one. There are instances where we see companies do this well. In one retailer, a top-performing business-unit head was assigned to lead the integration full time. In a medical-device company, a celebrated COO was relieved of his day-to-day duties and appointed lead manager of integration.

Moreover, uncertainty about the career implications for employees can make it difficult to attract the right talent, since employees may be hesitant to move into an integration role they see as a temporary gig. To address this, managers of one global diversified food company assigned a midlevel manager to run a multibillion-dollar integration, hoping it would prove his potential to be a business-unit leader. Eighteen months later, they elevated him to the leadership of a business unit. The visible career trajectory of this individual helped improve the perception of integration roles for subsequent acquisitions. Integration is increasingly perceived as a career accelerator, which is attracting more talent within the organization to integration. In another example, a major technology company takes this even further and makes rotations through material integrations a prerequisite to becoming a company officer.

■ ■ ■

High-performing acquirers understand the complexity and importance of getting all aspects of integration right. Companies that apply best practices tailored to deal objectives have the best chance of delivering on the full potential of the deal. ■

[1] An annual barometer of more than 700 integration managers attending the Conference Board's Merger Integration Conference since 2010 identifies similar needs year after year.

[2] For more, see Rebecca Doherty, Spring Liu, and Andy West, "How M&A practitioners enable their success: McKinsey Global Survey results," *McKinsey on Finance*, October 2015, mckinsey.com. The online survey on global M&A capabilities was in the field from May 19 to May 29, 2015, and garnered 1,841 responses from C-level and senior executives representing the full range of regions, industries, company sizes, and functional specialties.

[3] "High performers" are defined as companies where respondents to the global M&A capabilities survey report that their companies have met or surpassed cost- and revenue-synergy targets in transactions (n = 464). "Low performers" are defined as companies where respondents report that their companies have achieved neither cost- nor revenue-synergy targets in transactions (n = 302).

[4] For more, see Oliver Engert, Neel Gandhi, William Schaninger, and Jocelyn So, "Assessing cultural compatibility: A McKinsey perspective on getting practical about culture in M&A," *Perspectives on merger integration*, June 2010, mckinsey.com.

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Pharma M&A: Agile shouldn't mean ad hoc

Under pressure to be active acquirers, some pharmaceutical and medical-products companies may be neglecting best practices. Here's where they can most improve.

Ankur Agrawal, Ruth De Backer, and Spring Liu

The spate of recent megamergers among both pharmaceutical and medical-products (PMP) companies has made for eye-opening headlines, not just for the supersizing of these industry-consolidating deals, but also because it seemed to mark a break from the industry's usual pattern of M&A. In the background, though, most PMP companies continued their usual focus on the rapid completion of many smaller deals to acquire innovation and fill selected portfolio and capability gaps.[1]

That's been a good approach for them. Analysis of global 1,000 companies[2] over the past decade shows that PMP companies with high-volume M&A programs reliably outperform peers with respect to excess total return to shareholders—which is consistent with the results from other industries. So it's no surprise that many executives in the industry expect an uptick in smaller deals, according to McKinsey's latest survey on M&A.[3] Nearly three-quarters of respondents from PMP companies report that they expect the number of deals to increase in 2016 and the size of deals to be the same as or smaller than in 2015. That's also consistent with what we've historically seen outside of megamerger booms.

For some, it also marks a moment to revisit best practices. As essential as agility is for the fast-paced acquisition of programmatic M&A, it's not an excuse for the kind of ad hoc approach we've encountered in far too many deal teams. And even otherwise-strong performers will benefit. When we examined the survey for insights from PMP respondents, we found three areas in particular where companies could be doing better: keeping the right level of CEO involvement, standardizing the process wherever practical, and reinforcing feedback mechanisms.

Keep the CEO involved

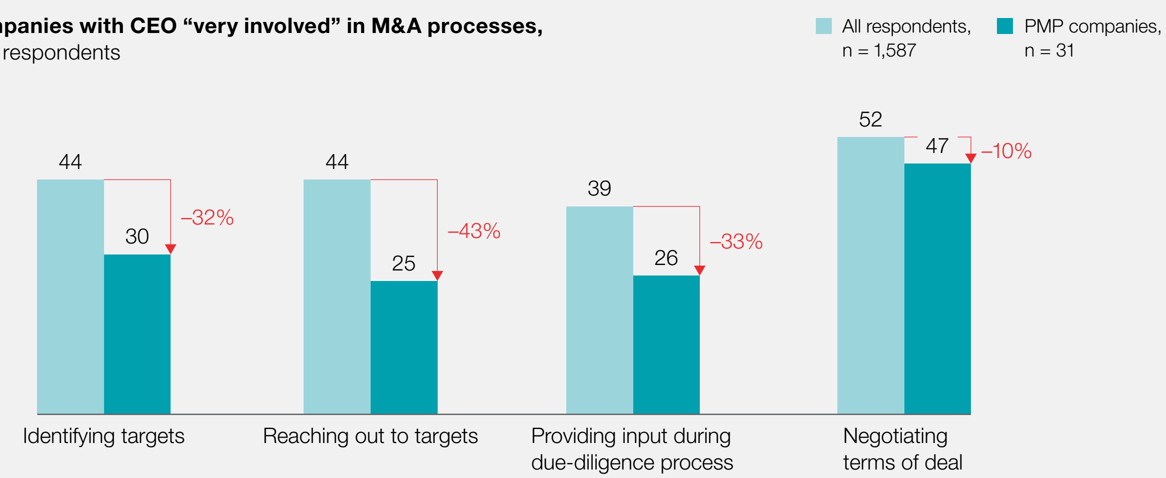
Because of the high volume and relatively low value of deals, PMP companies often entrust M&A work to lower levels of the organization than companies do in other industries, especially in the earlier phases of the deal funnel. In many companies, we encounter periodic business-development processes where the CEO and CFO don't review and approve or kill deal proposals until the end. As such, they forgo involvement in shaping target identification and diligence during the formative stages of a deal. For identifying targets, reaching out to targets, and conducting due diligence on targets, PMP companies are roughly one-third less likely to report their CEO as being "very involved" in the process (Exhibit 1). The role of senior leadership is much more focused on setting the high-level, strategic direction of the business-development team and checking in on the last stages of asset deals. Such delegation is consistent with the targeted nature of these acquisitions, in which the deal model may be concerned with as little as a single molecule or medical device that requires deep expertise on the part of the acquisition team, as opposed to the need for a broad consensus.

It's true that the fast pace and high variability of subject-matter-specific inputs for due diligence demand flexibility. And the reality on the ground often doesn't neatly fit a rigid set of processes in which the same functions are brought into the deal analysis the same way each time. But when the amount of senior-management involvement in the

Exhibit 1

Pharmaceutical and medical-products companies pursue M&A with less senior involvement.

Companies with CEO "very involved" in M&A processes, % of respondents

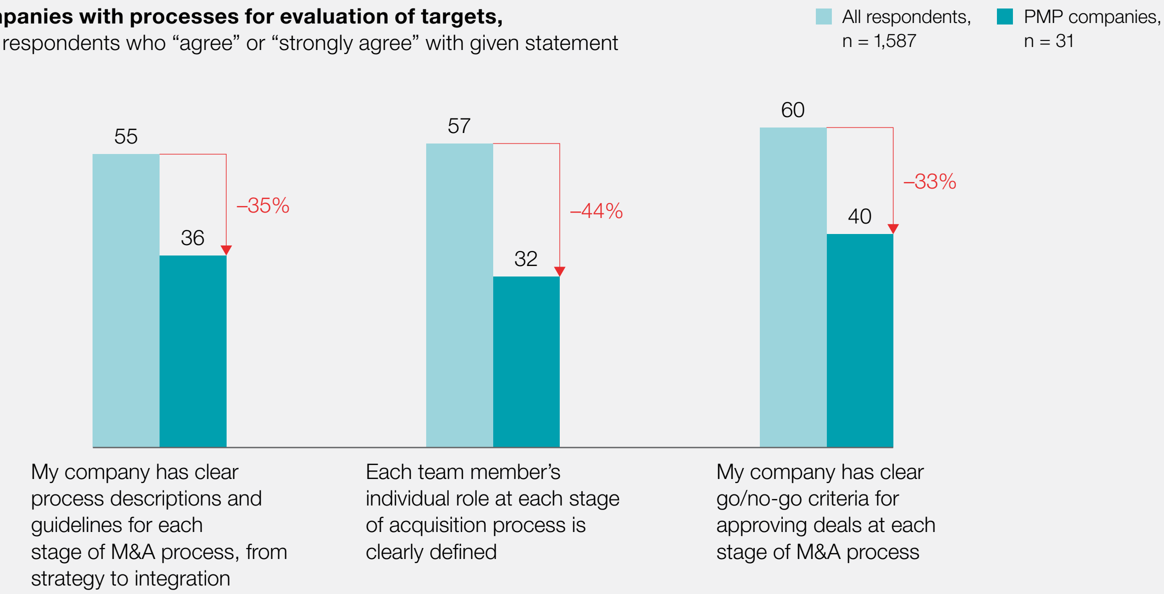


Source: McKinsey survey on global M&A capabilities, May 2015

Exhibit 2

Pharmaceutical and medical-products companies rely less on standardized processes and guidelines.

Companies with processes for evaluation of targets,
% of respondents who "agree" or "strongly agree" with given statement



Source: McKinsey survey on global M&A capabilities, May 2015

M&A recipe is reduced, the result is often looser definition of the deal-making processes, roles, and criteria than in other sectors (Exhibit 2).

Standardize the process wherever practical

Consistency and standardization may look different for PMP companies, but these qualities can still be practical—and worthwhile. Our analysis finds that companies taking a systematic approach perform better over time, which is consistent with the cross-industry trends.

Deal managers can establish a playbook of repeatable end-to-end processes for specific deal types, such as acquisitions of companies with products on the market, takeovers of companies with preapproved products, or licensing deals for products or intellectual property. A playbook would include, for example, stage gates, role descriptions, descriptions of deal owners and cross-functional deal teams, and common tools. And even with some standardization, managers still have the option of pulling in appropriate subject-matter experts from across the organization.

The lack of standardization is apparent in how M&A practitioners in PMP companies perceive their performance in discrete M&A-related activities. When looking across the target-sourcing process, the survey finds that PMP companies see themselves as outperforming the cross-sector average in activities that are more execution oriented, but not in activities more closely oriented to defined processes or playbooks. While this could be the result of either fewer attempts to standardize processes or less success when attempting to do so, the relative lack of standardization is clear.

Reinforce feedback mechanisms

The asset-based nature of many healthcare-manufacturer deals may limit the opportunity to perform the traditional postintegration analysis, with many companies merely aggregating it into the budget process without breaking out results for particular deals. Yet some forms of retrospective analysis and performance feedback are critical to consolidate deal lessons and build institutional capabilities over time. These feedback loops add the kind of transparency and accountability that establish M&A as a competitive advantage.[4]

Based on the survey data, this may be an area that offers PMP companies significant opportunities for improvement. Survey respondents, all of whom claim to be knowledgeable about their companies' M&A activity, are more than twice as likely to report not knowing how deals in the past five years have performed relative to plans as they are to report knowing.

Senior managers at leading PMP companies typically review performance with deal teams to reassess their target evaluation, deal execution, and integration processes for lessons learned. Managers at one medical-device manufacturer, for example, typically organize structured postdeal review sessions to discuss successes and areas for improvement, with an eye on improving future deals and building their team's capability. Each session usually includes a thorough analysis of how different elements of the deal process contribute to the company's ability to capture revenue and cost synergies, for example, and can highlight

strengths and weaknesses in the team's ability to track and measure discrepancies in the investment thesis to improve future performance.

The PMP industries seem destined to renew their focus on frequent, smaller acquisitions as a main source of innovation. Whether or not the wave of megamergers is over, a high volume of small deals will require M&A teams to act quickly with the right balance between flexibility and consistency.

[1] These types of deals we've described elsewhere as comprising a tactical or programmatic approach to deal making. See, for example, Werner Rehm, Robert Uhlaner, and Andy West, "Taking a longer-term look at M&A value creation," *McKinsey Quarterly*, January 2012, mckinsey.com.

[2] Companies that were among the top 1,000 companies by market capitalization as of December 31, 2004 (market caps greater than $6.5 billion), and were still trading as of December 31, 2014; excludes companies headquartered in Africa and Latin America.

[3] For more, see Rebecca Doherty, Spring Liu, and Andy West, "How M&A practitioners enable their success," *McKinsey on Finance*, October 2015, mckinsey.com. The online survey was in the field from May 19 to May 29, 2015, and garnered 1,841 responses from C-level and senior executives representing the full range of regions, industries, company sizes, and functional specialties. This article looks more closely at the responses of executives in the pharmaceutical and medical-products sectors.

[4] For more, see Cristina Ferrer, Robert Uhlaner, and Andy West, "M&A as competitive advantage," *McKinsey on Finance*, August 2013, mckinsey.com.

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