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McKinsey on Finance

Perspectives on corporate finance and strategy

M&A: More really is more

Plus, why some large deals stall out, what drives industry multiples, and how red and blue teams can help you make better decisions

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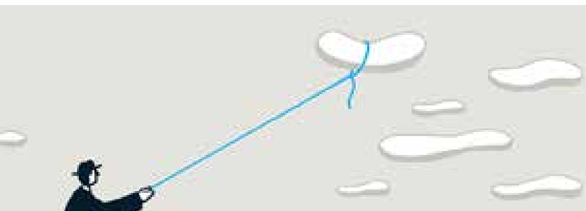

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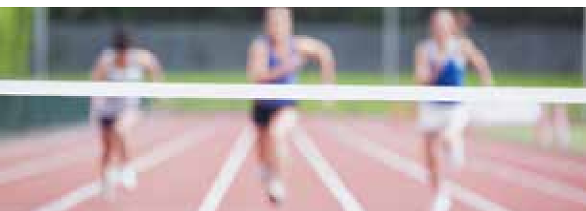

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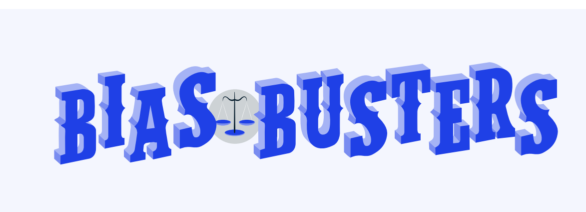

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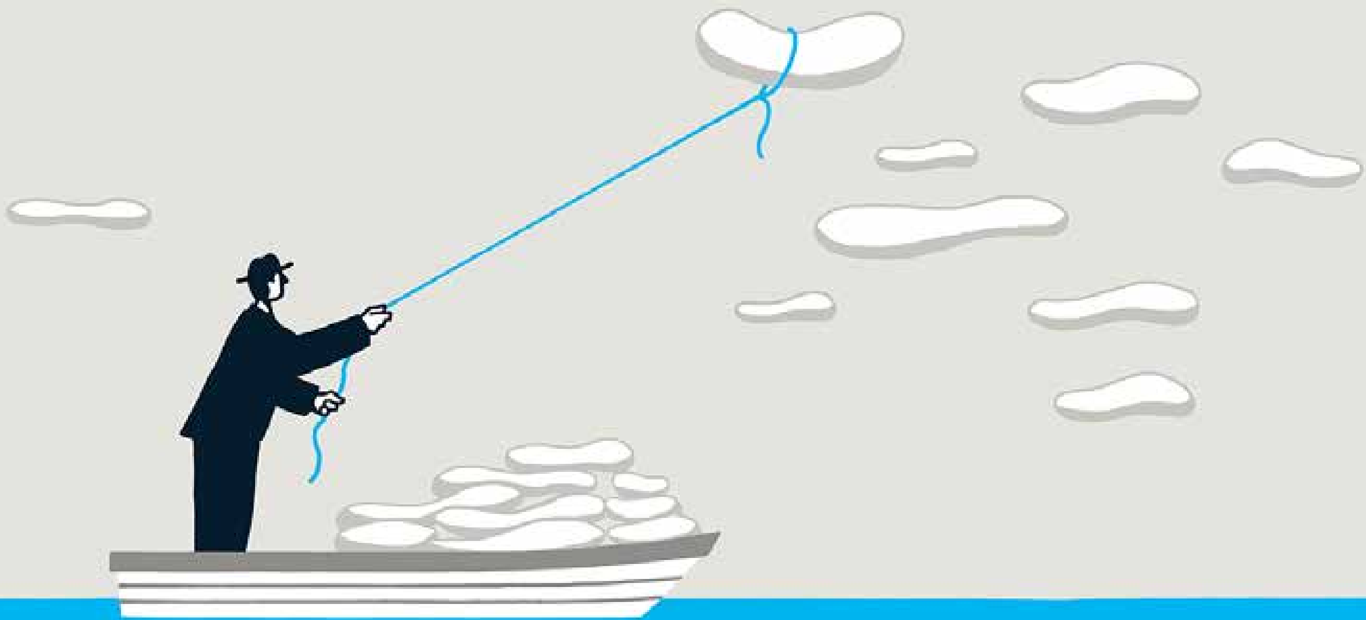
How lots of small M&A deals add up to big value

New research confirms that companies that regularly and systematically pursue moderately sized M&A deliver better shareholder returns than companies that don't.

by Jeff Rudnicki, Kate Siegel, and Andy West



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Nearly a decade ago, we set out to answer a critical management question: What type of M&A strategy creates the most value for large corporations? We crunched the numbers, and the answer was clear: pursue many small deals that accrue to a meaningful amount of market capitalization over multiple years instead of relying on episodic, "big bang" transactions.[1] Between 1999 and 2010, companies following this programmatic approach to M&A generally outperformed peers.[2]

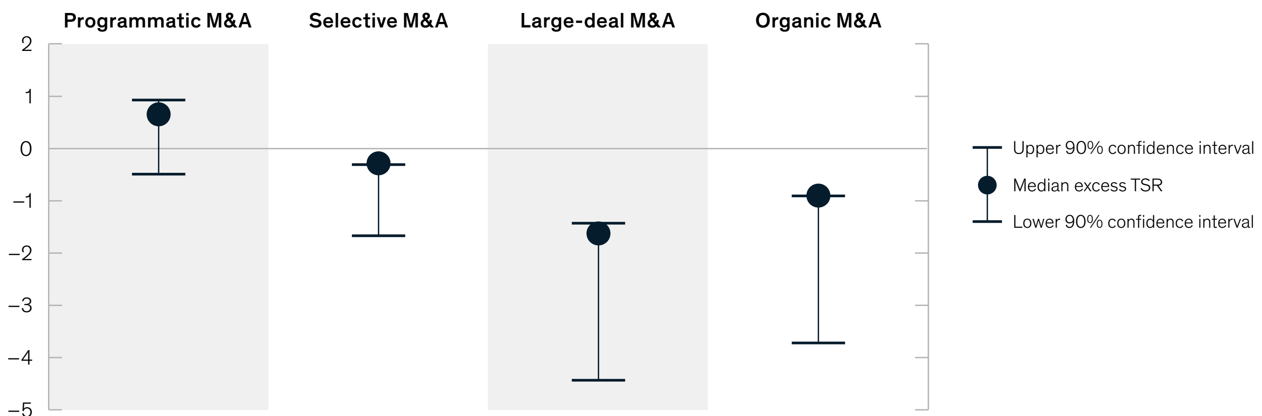
That pattern is even more pronounced in today's fast-moving, increasingly uncertain business environment (see sidebar, "The staying power of programmatic acquisition"). A recent update of our research reflects the growing importance of placing multiple bets and being nimble with capital: between 2007 and 2017, the programmatic acquirers in our data set of 1,000 global companies (or Global 1,000) achieved higher excess total shareholder returns than did industry peers using other M&A strategies (large deals, selective acquisitions, or organic growth).[3] What's more, the alternative approaches seem to have under-delivered. Companies making selective acquisitions or relying on organic growth showed, on average, losses in excess total shareholder returns relative to peers (Exhibit 1).

The data also confirmed just how challenging it is for individual companies to make the transition to programmatic M&A from any of the other models we identified. For instance, none of the companies that followed an organic approach between 2004 and 2014 had shifted to a programmatic model by the time we performed our latest analysis. And by

Exhibit 1

Programmatic acquirers achieved excess total shareholder returns that were higher than the median.

Median excess TSR for companies that remained in the Global 1,000 from Dec 2007 to Dec 2017,[1] %



[1] TSR = total shareholder returns. Global 1,000 comprises companies that are among top 1,000 by market capitalization; excludes companies headquartered in Africa and Latin America.

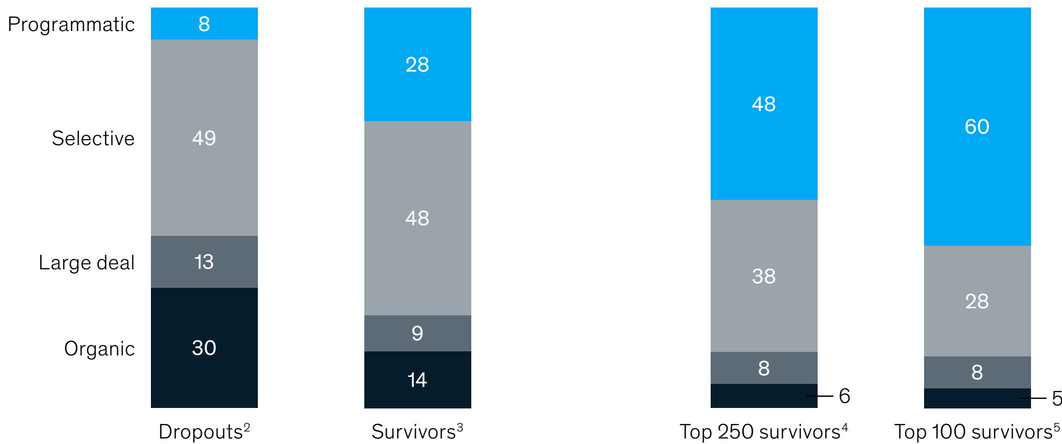
Source: Global 1,000, 2017; Thomson Reuters; Corporate Performance Analytics by McKinsey

[1] Werner Rehm, Robert Uhlaner, and Andy West, "Taking a longer-term look at M&A value creation," January 2012, McKinsey.com.
[2] The definition of programmatic M&A is when a company makes more than two small or midsize deals in a year, with a meaningful target market capitalization acquired (median of 15 percent).
[3] In the large-deal approach, a company makes one deal or more per year, and the target market capitalization is equal to or greater than 30 percent of the acquirer's market capitalization. In the selective approach, a company makes two or fewer deals per year, and the cumulative value of the deals is more than 2 percent of the acquirer's market capitalization. In the organic approach, a company makes one deal or fewer every three years, and the cumulative value of the deals is less than 2 percent of the acquirer's market capitalization.

Exhibit 2

Programmatic acquirers composed nearly one-third of the companies that remained in the Global 1,000 over ten years.

Distribution of 2007 Global 1,000 in 2017, %[1]



[1] Global 1,000 comprises companies that are among top 1,000 by market capitalization; excludes companies headquartered in Africa and Latin America. Figures may not sum to 100%, because of rounding.
[2] Companies in Global 1,000 on Dec 31, 2007, but not on Dec 31, 2017 (n = 178).
[3] Companies in Global 1,000 on both Dec 31, 2007, and Dec 31, 2017 (n = 686).
[4] Companies among top 250 companies in Global 1,000 on both Dec 31, 2007, and Dec 31, 2017 (n = 157).
[5] Companies among top 100 companies in Global 1,000 on both Dec 31, 2007, and Dec 31, 2017 (n = 65).

Source: Global 1,000, 2017; Thomson Reuters; Corporate Performance Analytics by McKinsey

2017, more than a quarter of those companies had dropped out of the Global 1,000 altogether because of takeovers and other factors. The story was similar among those companies we deemed selective acquirers (Exhibit 2).

When we looked even closer at the data, we saw some striking differences in what high-volume deal makers do relative to peers. For example, the programmatic acquirers were twice as likely as peers to estimate revenue and cost synergies at various stages of the deal-making process, and they were 1.4 times more likely than peers to have designated clear owners for each stage.[4]

These findings are consistent with our experience in the field, in which we see that programmatic acquirers have built up organizational infrastructures and established best practices across *all* stages of the M&A process—from strategy and sourcing to due diligence and integration planning to establishing the operating model. In this article, we will consider how programmatic acquirers typically manage each of these stages.

The programmatic model may not be the right fit for every company, of course. Some businesses may contend with organizational limitations or industry-specific obstacles (consolidation trends and regulatory concerns, for instance). Regardless, it can be instructive for companies with *any* type of M&A program to understand how some companies are taking advantage of the programmatic approach.

Strategy and sourcing

Most of the programmatic acquirers we interviewed said they work hard to connect their strategies with their M&A priorities. The hard work starts with a return to first principles: the development of a

[4] 2019 McKinsey Global M&A Capabilities Survey.

blueprint for bringing strategic goals into deal-sourcing discussions. An effective M&A blueprint delineates the limitations of pursuing certain deals and provides a realistic snapshot of market trends—for instance, “Which market-shaping forces are the most promising within our sector, and how are our competitors likely to evolve?” Additionally, the M&A blueprint can help programmatic acquirers identify whether or not they may be the best owner in any deal or transfer of assets—for instance, “What are our sources of competitive advantage, and what capabilities are we trying to acquire?” Finally, the blueprint can help companies assess how realistic it may be to expect success from a deal—for instance, “Are assets readily available, or are they overpriced? Do we have the relationships required to carry out this transaction? Are regulatory constraints too much to overcome?”

These were the kinds of questions senior leaders at one consumer-products company asked themselves as part of a recent deal. The leadership team strongly believed the company needed to expand its presence in China and asked the M&A organization to identify potential acquisition targets. The debate over which regions to focus on went on for several weeks, until senior leaders and the M&A team realized they needed to revisit the base strategy. In a series of fact-finding meetings that took place over an eight-week period—and referring back to their M&A blueprint—the senior leaders and the M&A organization

The staying power of programmatic acquisition

In our ongoing research, we track the largest (by market capitalization) 1,000 global companies, measure excess total shareholder returns they created compared with industry peers, and look at the type of acquisition strategy these companies deployed. The data confirm that programmatic acquirers continue to perform better than industry peers; indeed, the more deals a company did, the higher the probability that it would earn excess returns (exhibit). Precisely because these companies are doing deals systematically, we believe they are building lasting, distinctive capabilities in M&A.

Exhibit

Among programmatic acquirers, making more than five deals a year raised the probability of earning excess returns.

Median excess TSR for programmatic acquirers that remained in Global 1,000 from Dec 2007 to Dec 2017,[1] %

	Median excess TSR, %	**Standard deviation of excess TSR,** percentage points
2–5 deals per year	0.5	7.3
>5 deals per year	0.7	5.3

[1]TSR = total shareholder returns. Global 1,000 comprises companies that are among top 1,000 by market capitalization; excludes companies headquartered in Africa and Latin America.

Source: Global 1,000, 2017; Thomson Reuters; Corporate Performance Analytics by McKinsey

A programmatic approach won't work if you don't define the program and don't treat M&A as an enduring capability rather than a project or occasional event.

identified the amount of capital required to meet their goals, specific market trends and customer segments in China, and the potential advantages the company could confer to a target (primarily, its global distribution network). Once senior leaders at the consumer-products company had systematically explored such questions, they were able to gain quick agreement on a handful of potential targets in specific regions, several of which had not even been mentioned during the initial discussions.

Due diligence and integration planning

The programmatic acquirers we interviewed said they often tackle due diligence and integration planning simultaneously—holding discussions far ahead of closing about how to redefine roles, combine processes, or adopt new technologies. Having the right resources at the ready seems to be a key tenet for these companies. It was for one consumer-products company that, at the outset of its merger with a target, modeled the optimal sequence for migrating general and administrative tasks from both companies to a centralized shared-services group, thereby jump-starting the overall integration process.

Corporate culture and organizational health—of both the acquirer and target—also seem to be important concerns for programmatic acquirers. Our research shows that programmatic acquirers are more likely than peers to pay close attention to cultural factors during both diligence and integration processes.[5] For instance, the integration team at one technology company closely tracked the balance of employees who would be selected for the combined entity from across both the parent company and the target. If any area of the business was not achieving a balance that matched the relative scale of the merger, team leaders intervened. Additionally, employee selections could not be approved without ratification from the integration team. If two candidates were deemed equally suitable for a role, the team tilted its selection to the target-company candidate, recognizing that managers in the acquiring company likely already had a built-in unconscious bias in favor of the homegrown employee. If neither candidate was considered suitable, the team moved quickly to recruit externally.[6]

M&A operating model

A programmatic approach won't work if you don't define the program and don't treat M&A as an enduring capability rather than a project or occasional event. Our research shows that, compared with peers, programmatic acquirers often focus on building end-to-end M&A operating models with clear performance measures, incentives, and governance processes. For these companies, the devil is in the details. Potential acquisitions are not evaluated ad hoc, for instance. Instead all the decision makers and the criteria they are using are clearly defined and made transparent to all stakeholders. "If it's truly a

[5] Ibid.

[6] Becky Kaetzler, Kameron Kordestani, and Andy MacLean, "The secret ingredient of successful big deals: Organizational health," *McKinsey Quarterly*, July 2019, McKinsey.com.

program, then for each type of opportunity, you need to say, here are the targets that would constitute a doubling down, here are the targets or products we'd like to have, and here are the targets for the distribution we want," one partner at a private-equity company explained. "It has to be systematic."

To that end, one technology company treats M&A in much the same way it does customer acquisitions: it uses a customer-relationship-management-like tool to manage its M&A program. The tool is an online database of hundreds of companies that the technology company actively monitors as potential targets. Using a series of customizable dashboards, the corporate-development team updates the database and tracks statistics about acquired companies and which targets are in which phases of acquisition. (Business-unit leaders are also tasked with keeping this information up to date.) The corporate-development team generates reports, and the head of M&A analyzes the data and tracks progress on deals. The tool enables accountability across all phases of M&A; it is even invoked during executives' performance reviews.

A clear takeaway from our research is that practice still makes perfect. By building a dedicated M&A function, codifying learnings from past deals, and taking an end-to-end perspective on transactions, businesses can emulate the success of programmatic acquirers—becoming as capable in M&A as they are in sales, R&D, and other disciplines that create outperformance relative to competitors.

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Demystifying deal making: Lessons from M&A veterans

Two longtime experts in M&A describe what works—and what doesn't—in corporate deal making, including how to approach the role of activist investors.

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In M&A, nothing quite beats experience. This is particularly true of so-called programmatic M&A, a systematic approach to finding and transacting a steady stream of deals over time along a common theme.[1] To help demystify the deal-making process—including what works and what doesn't—we asked two seasoned executives: Michael Carr, the coleader of global M&A at Goldman Sachs, and Russell Fradin, an operating partner at private-equity firm CDR and former CEO and chairman of Aon Hewitt (and a McKinsey alumnus). Carr and Fradin spoke with McKinsey's Robert Uhlaner at a panel discussion at McKinsey's Global Business Leaders Forum in New York earlier this year. The following is an edited version of their conversation.

McKinsey: *What practical steps can business leaders take to make M&A more effective?*

Michael Carr: There's often a sense of mysticism about M&A, and the [pressures of M&A] can lead people to throw everything they've learned out the window. So first, lay out the rationale: Why are we doing this, and how does it fit within our business and our team? Next, lay out the steps, because there's always going to be disruption in the process, and it often comes from external forces like competition from other buyers, so you need to be ready to respond. Most importantly, make sure your people are prepared—that they know their roles and what the delivery is supposed to look like. Once you have that, more than half the battle is taken care of. After all, these are just companies, and companies are full of people and processes.

Russell Fradin: In terms of programmatic M&A, you have to answer the question "What's the program?"

Michael Carr

Education
Michael holds an MBA from the Wharton School at the University of Pennsylvania and a bachelor of arts degree from Wesleyan University.

Career highlights
Goldman Sachs
(2015–present)
Co-head of global M&A

(2011–15)
Co-head of M&A, Americas

(2004–11)
Co-head of industrials and natural resources

(2000–04)
Head of investment banking, Asia ex-Japan

(1998–2000)
Partner, M&A Department, Investment Banking Division (IBD)

Fast facts
A member of the Goldman Sachs's IBD operating committee and IBD client and business standards committee, Michael has also served on Goldman Sachs's partnership and Asia management committees. He is chairman of the board of trustees of Choate Rosemary Hall.

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[1] See Chris Bradley, Martin Hirt, Sven Smit, and Andy West, "Research shows that smaller M&A deals work out better," *Harvard Business Review*, May 9, 2018, hbr.org.

“I don’t want to say it’s never a good idea to buy capabilities, but, in general, if you’re looking at the latest blockchain start-up or the latest AI company or the best analytics company, you need those people to stay.”

And the program is you’re trying to do more of what you already do, you’re trying to buy a new product that you can leverage with your sales force or distribution, or you’re trying to buy distribution in new geographies. Then you need a strategy that says, “In terms of our category, here are the targets that would constitute a doubling down, here are the targets or products that we’d like to have, and here are the targets for the distribution we want.” Go about it in a systematic way.

Two other reasons to do M&A are diversification and capability building. [In my experience,] those two are likely to fail. Today, a lot of companies want to buy digital capabilities, and I’d be careful. I don’t want to insult anyone, but do you really think the hottest AI [artificial intelligence] start-ups are looking to become part of [a hundred-year-old company]? In other words, are you really going to get the best of the bunch? If you’re a strategic buyer, and capability building is the rationale, you need the people to stick around [after the deal], because what you’re really buying is people—it’s a mass-hiring situation. And then you get into questions like “Do I need retention bonuses? How do I teach them about the company?” Typically, if you’re buying like for like, or a product that’s in your industry, there is a greater likelihood of the cultures being a match. [Some companies are] just looking to cash out. I don’t want to say it’s never a good idea to buy capabilities, but, in general, if you’re looking at the latest blockchain start-up or the latest AI company or the best analytics company, you need those people to stay. If you’re looking at a company that just wants to cash out, it’s a good time to run for the hills.

Finally, I’ve found that having M&A strategy and business development reporting to the CFO is a bad idea. The CEO shouldn’t have that input filtered. I always kept the business-development function reporting directly to me. The CFO also had a key vote, but you don’t want all the good ideas killed before they get to you.

McKinsey: *How important is it for targets or potential targets to perceive a company as a good acquirer? And what, to your minds, does “good” look like?*

Michael Carr: In the M&A world, everybody develops a reputation, and unfortunately the reputation usually is built on the last bad transaction that they’ve executed or failed to do. As investment bankers, we spend a lot of time making sure the target knows what they’re getting into. This will sound like a cliché, but what is the acquirer’s ethos? Why are they who they are, and how do they operate? Are they honest people? Is this an organization that has a genuine culture? Of course, a lot of M&A is about earnings-per-share growth and other understandable and observable factors, but these

ephemeral topics, the human element, [also are critical].

McKinsey: *What are some ways that successful management teams create value from deals?*

Russell Fradin: First, a lot of what the market values is organic growth, so be careful not to think that M&A is going to solve all your problems. But M&A can accelerate organic growth if you do it right.

You have to have a clear strategy and be very well networked in your industry—and I don't mean just the CEO, but the entire management team. I used to include in all my regional managers' bonus plans that they had to raise [M&A] ideas, because the best ideas often come from the field.

McKinsey: *How would you describe the impact of activist investors on M&A velocity and decision making?*

Russell Fradin: Having come from the management side, my answer will probably surprise you. And that is that, more often than not, the activists are right, and management doesn't want to face it. When I recently joined the board of a public company, I asked them if they've looked at how an activist would attack them. If a company hasn't, that tells me it's not on their minds. What do you think the activists would be picking on? If management is not open to that alternative viewpoint, it's not a good thing. The CEO of one company where I'm a director simply published the cash [allocation] on their website—how much would go to stock buybacks, how much to dividends, how much to growth. An activist would look at that and say, "There's nothing to do here. They've already said they'll return the bulk of their cash to shareholders." But don't underestimate how smart these folks are. It's always the 20 percent where activists are wrong that management will pick on, not the 80 percent where the activists are right.

Russell Fradin

Education
Russell holds an MBA from Harvard Business School and a bachelor of science degree in economics and finance from the Wharton School at the University of Pennsylvania.

Career highlights
CDR
(2016–present)
Operating partner

SunGard
(2011–15)
President and CEO

Aon Hewitt
(2010–11)
Chairman and CEO

Hewitt Associates
(2006–10)
Chairman and CEO

Fast facts
An alumnus (former senior partner) of McKinsey, Russell is a board member of Capco and Sirius Computer Solutions. He is also an independent board member of Best Buy, Hamilton Insurance, and TransUnion. Additionally, he is a member of the board of governors of the International Tennis Hall of Fame.

Michael Carr: Everybody tends to forget that shareholder activism has been around for a long time: Carl Icahn is over 80 years old! Shareholder activism, like it or not, is just part of a very complex market; it's a part of how markets function.

But activism has changed a lot, and activism defense has changed a lot. We measure this very carefully. When the [US Securities and Exchange Commission filings] that list shareholder positions—including activist positions—are published, we see a series of activist cases develop. And within 40 to 50 days after the positions are published, there either will be a settlement—and that settlement usually entails changes at the board level—or a proxy fight starts. Over the past several years, 85 percent of companies that have encountered activist investors chose to settle, because shareholders don't like proxy fights; [they] are very expensive and time consuming.

Many shareholder activists make a living out of criticizing companies' portfolios of businesses, and there are times when they're absolutely right. It's extremely disruptive to your organization when you sell a business, but everybody has to make those hard decisions. The best CEOs have the guts and the ability to sell businesses that aren't earning their cost of capital. The private-equity model is interesting because they have the luxury to choose when to sell, and the best investors are those who have the discipline to sell. Companies often don't have that luxury, and they also have to address the perceived stigma of selling a business.

However, if you feel that your business is starting to degrade, or the market in which it operates has some structural challenges, you will need to act. You need to be your own activist. Get ahead of it, because otherwise you won't have enough time to put together the necessary effort to beat the clock.

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Done deal? Why many large transactions fail to cross the finish line

Our research shows that many large M&A transactions are abandoned before closing because of value-creation, regulatory, and political issues. Here's how to improve the odds of success.

by Dariush Bahreini, Roerich Bansal, Gerd Finck, and Marjan Firouzgar

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Our research shows that in any given year, about 10 percent of all large M&A deals are canceled—a significant number when you consider that about 450 such deals are announced each year.

The consequences of deal abandonment can be severe, affecting both the reputation and share price of the parties involved. Besides companies incurring the obvious one-off costs like advisory and termination fees, senior managers in these businesses are often perceived as having wasted precious time and resources pursuing a strategic path that turned out to be a dead end.

Clearly, teams don't go into such transactions expecting or wanting them to fail—so what happens? What are the common characteristics of such terminations, and what can companies do to make such abrupt endings less likely to happen?

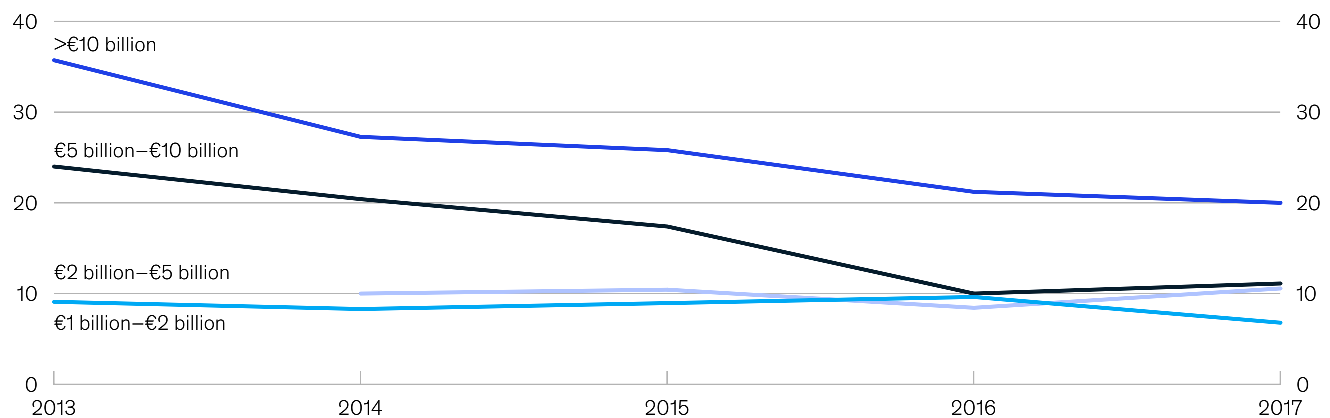
To help answer these questions, we reviewed more than 2,500 deals that were announced between 2013 and 2018 and valued at more than €1 billion, seeking to identify the types of deals that would be less likely to close once announced.[1] From that data set, we found 265 canceled deals of varying sizes, industries, and geographies.

Specific reasons for termination of these 265 deals were varied: there were instances of cold feet—shareholders backing out of what they perceived to be a problematic deal (about 6 percent of the deals)—and of interference from activist investors (about 3 percent of the deals). But the obstacles cited most often were mismatched expectations concerning synergies and value creation (hence, other companies sometimes swooped in with better offers), regulatory concerns (such as too much market concentration), and political issues (such as the introduction of new laws that directly or indirectly affected the businesses involved).

Exhibit 1

The larger the transaction, the more likely it is to fail.

Share of large M&A deals terminated/canceled, 2013–17,[1] %



[1] Deals >€1 billion. Data for 2018 have been collected but are not reflected here, as reviews are still pending and deals may still be canceled. Data for 2015 onward may also include transactions that are still pending.

Source: S&P Capital IQ; McKinsey analysis

[1] We considered a deal "canceled" or "terminated" if it was announced (for example, after signing or the launch of a takeover offer) but did not reach closing. Our data set included deals in Asia–Pacific, Europe, Latin America, North America, and the Middle East.

In this article, we explore our findings and suggest ways executives can sidestep the three most common obstacles and improve the odds of getting large M&A deals over the finish line.

Terminations: By the numbers

The larger the transaction, the more likely it is to cancel before close—at least that's what our analysis showed. Deals of €10 billion or more were terminated more than twice as often as deals between €1 billion and €5 billion (Exhibit 1). What's more, the average value of the canceled deals was approximately twice as high as that of the completed deals.

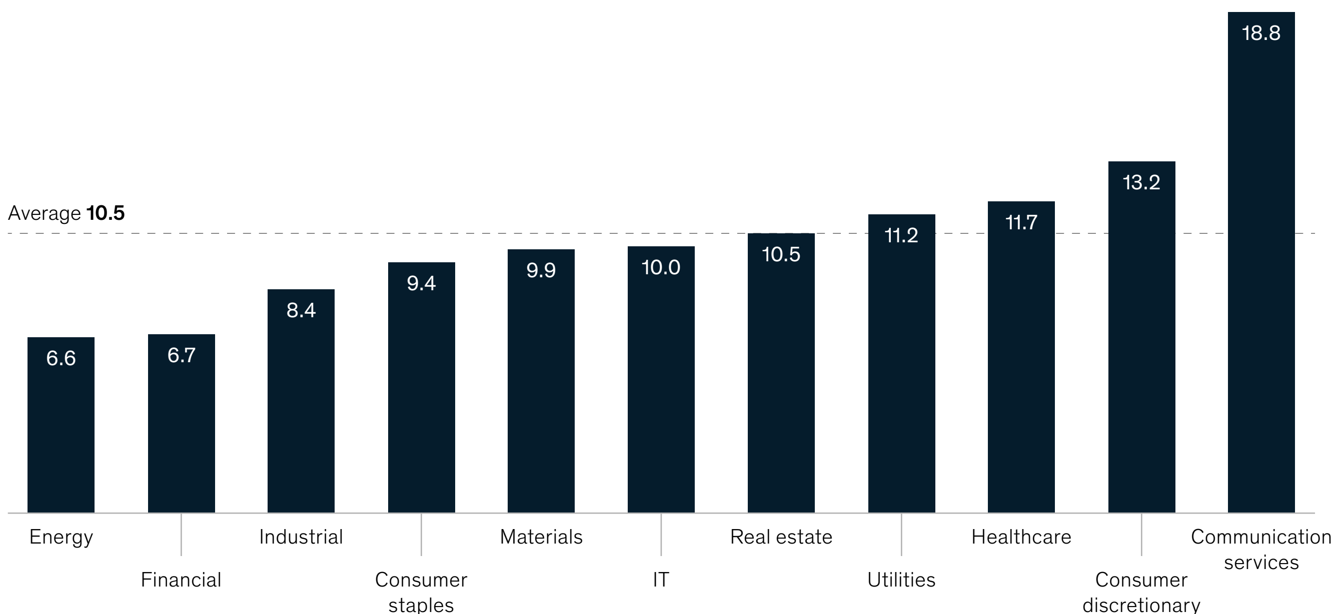
Our analysis also revealed that mixed-offer deals, consisting of both cash and stock, were more likely to get canceled than pure cash or pure stock transactions were—specifically, 17 percent of all the deals in our database that offered mixed consideration did not close. (Cash-only deals had the lowest termination rate, and stock-only transactions had only a slightly higher termination rate.) Clearly, simpler deal structures win the day, as they mitigate shareholders' uncertainties about potential premiums, taxes, and other investment factors.

A closer look at sector-level data showed that the cancellation rate in most industries fluctuated from year to year. The communication-services sector proved to be the only outlier; in each of the five years we studied, more than 15 percent of all deals announced in this sector were canceled (Exhibit 2). Of course, the communication deals we analyzed were substantially larger than transactions in other industries, often coming in above the €10 billion threshold and often negotiated in a highly regulated sector. They were also twice as likely as deals in the other sectors we studied to face antitrust challenges.

Exhibit 2

Communication-services deals are more likely to be canceled than deals in other sectors.

Cancellation rate of large M&A deals,[1] by sector, 2013–18, %



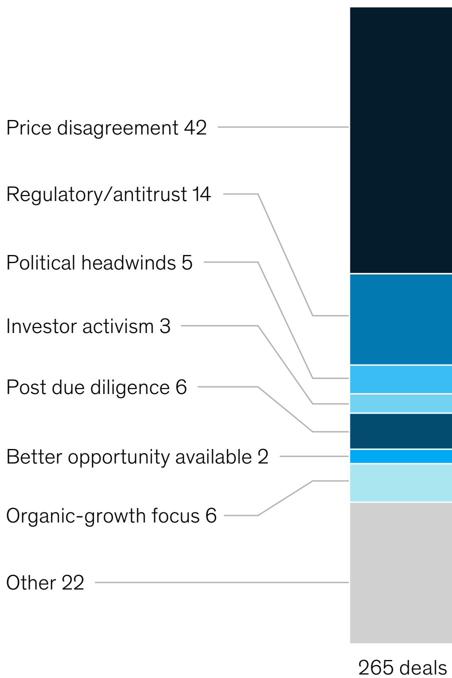
[1] Deals >€1 billion.

Source: S&P Capital IQ; McKinsey analysis

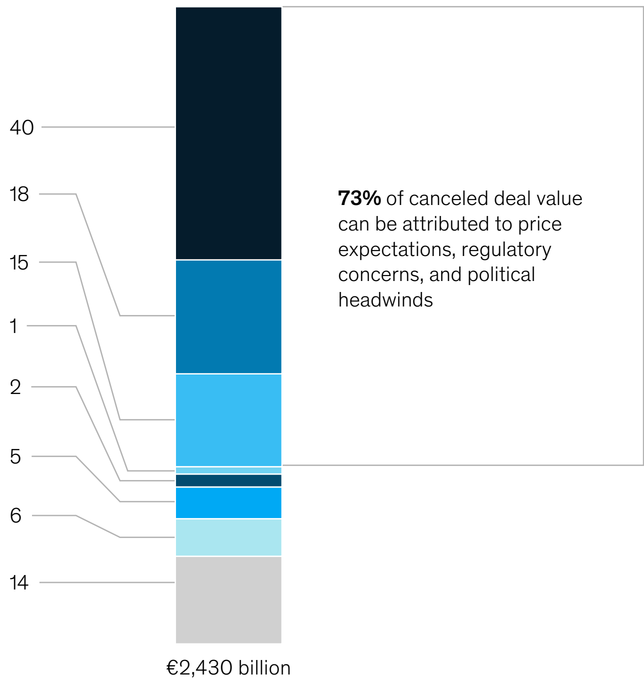
Exhibit 3

Deals are canceled for a range of reasons.

Share of large M&A deals[1] terminated/canceled, by reason, 2013–18, %



Share of large M&A deals[1] terminated/canceled, by deal value, 2013–18, %



Note: Figures may not sum to 100%, because of rounding.
[1] Deals >€1 billion.
Source: S&P Capital IQ; McKinsey analysis

Perhaps most telling, of the deals over €1 billion that were canceled between 2013 and 2018, we found that about 73 percent (by deal value) were abandoned because of companies' disagreements over valuation, regulatory concerns, or political headwinds (Exhibit 3). A good example of the latter is the change in tax rules issued in 2016 by the US Department of Treasury and the US Internal Revenue Service to end so-called tax inversions. The announcement was one of the factors prompting two pharmaceutical giants to abandon their deal even as they were in final negotiations. They had intended to combine their businesses and move corporate headquarters to Ireland to lower their tax rate, effectively—a move that would have put them in the crosshairs of this rule change.

Getting deals over the finish line

The fact that those three forces played a big part in quashing deals is perhaps not so surprising, and the truth is that executives can control only so many of the variables we've identified as being associated with abandonment of large M&A deals. There's no way they can pursue deals *only* under the €10 billion threshold, for instance, and political headwinds aren't always driven by business interests, nor are they always driven by numbers.

But our data on the most common pitfalls are instructive. They can help executives plan and pursue transactions more systematically, with three core principles in mind: be more transparent in deal communications, anticipate trade-offs coming out

of regulators' concerns, and actively monitor the political landscape. Our data and work with companies pursuing large deals suggest that too many executives neglect even these basics.

Be transparent

The misunderstandings and miscommunications that can sink the completion of large transactions most often appear just before or during the due-diligence stage, when buyers and sellers are still setting price expectations and everyone else in the market is watching intently to see how it will all shake out. Transparent and frequent cross-company dialogue is the only way to get all parties aligned and all motivations accounted for. And, as our data suggest, whenever possible, simpler structures for transactions should be favored over more complex ones—either all cash or all shares.

Transparency was critical to the success of a takeover offer made in 2015 by a large European oil and gas company to acquire another large industry peer. Its offer, at a premium of about 50 percent, was considered high given turbulent times in the industry. The offer was attractive to the target company, but leaders in the acquiring company understood that their own shareholders could have perceived it differently and could have disagreed with the transaction. They took care to share with both sets of stakeholders detailed calculations of the potential synergies among the two organizations and the strategic rationale for the move. They offered real-time updates on the closing process, which took ten months from the time of announcement. During that period, the company frequently published on its website updates on all major antitrust clearances and shareholder approvals—about 15 media releases between announcement and close. Because every step of the process had been handled straightforwardly, and was clearly explained and presented, the offer was quickly approved by important shareholders of both companies, with acceptance rates of well over 80 percent.

Anticipate trade-offs coming out of regulatory concerns

Transactions involving companies that have substantial market shares and that own important industry-standard-setting licenses, permits, processes, and technologies will inevitably attract close attention from regulatory agencies. Indeed, according to our research, about one-third of the deals valued at greater than €10 billion announced between 2015 and 2017 ended up being challenged by the European Commission or cleared with conditions.

Companies, of course, have legal teams and lobbyists at the ready when pursuing large deals, and most do their homework ahead of time, analyzing market scenarios and looking at how

Whenever possible, simpler structures for transactions should be favored over more complex ones—either all cash or all shares.

regulators have treated similar industry deals in the past. What's often missing from deal discussions, however, is an explicit consideration of trade-offs that might need to be made given regulators' suggested remedies and interventions. A drug company identified opportunities it could seize only if it started the integration process sooner rather than later, so it agreed to divest according to regulators' requests rather than negotiate with the regulator for an additional six to 12 months and the opportunity to divest fewer assets. How was it able to anticipate this trade-off? By engaging marketing, sales, and other functional leaders in due-diligence processes, alongside representatives from legal and finance. In the trade-off between speed and cost, speed won out.

Actively monitor the political landscape

Big deals often involve blue-chip companies that are firmly plugged into local and national economies. Think of a company like Amazon or General Motors that is a central source of employment in a large city, for example, or that leads the industry in technology innovation and market share. Governments may use their powers to block transactions involving such companies for any number of reasons—among them, national-security issues (particularly in sensitive industries, such as defense) and financial concerns (for instance, keeping a large employer in a structurally weak region).

For these reasons, it pays for acquirers to undertake a formal "market intelligence scan" early in the life cycle of the deal to get a sense of key issues relating to jobs, taxes, and investment trends in relevant regions or countries. This process should be jointly managed by the M&A organization and the external-communications and investor-relations professionals in the company. In a Chinese manufacturer's takeover of a German company, for instance, the bidder stated publicly that no plant closures or layoffs would occur within five years of closing. The company made this explicit statement because it wanted to address proactively the concern that it was raiding the target for technology. By committing to long-term job preservation and keeping production and headquarters in Germany, it was able to steer clear of political intervention and complete the deal.

Obviously, the faster that deals get approved, the faster that companies can move into the integration process, and the more likely it is that they will meet their acquisition objectives (greater production efficiencies, cost reductions, and so on). But, as our data suggest, unless executives tackle pricing, regulatory, and political challenges with greater forethought and confidence, abandonment will be the more likely outcome.

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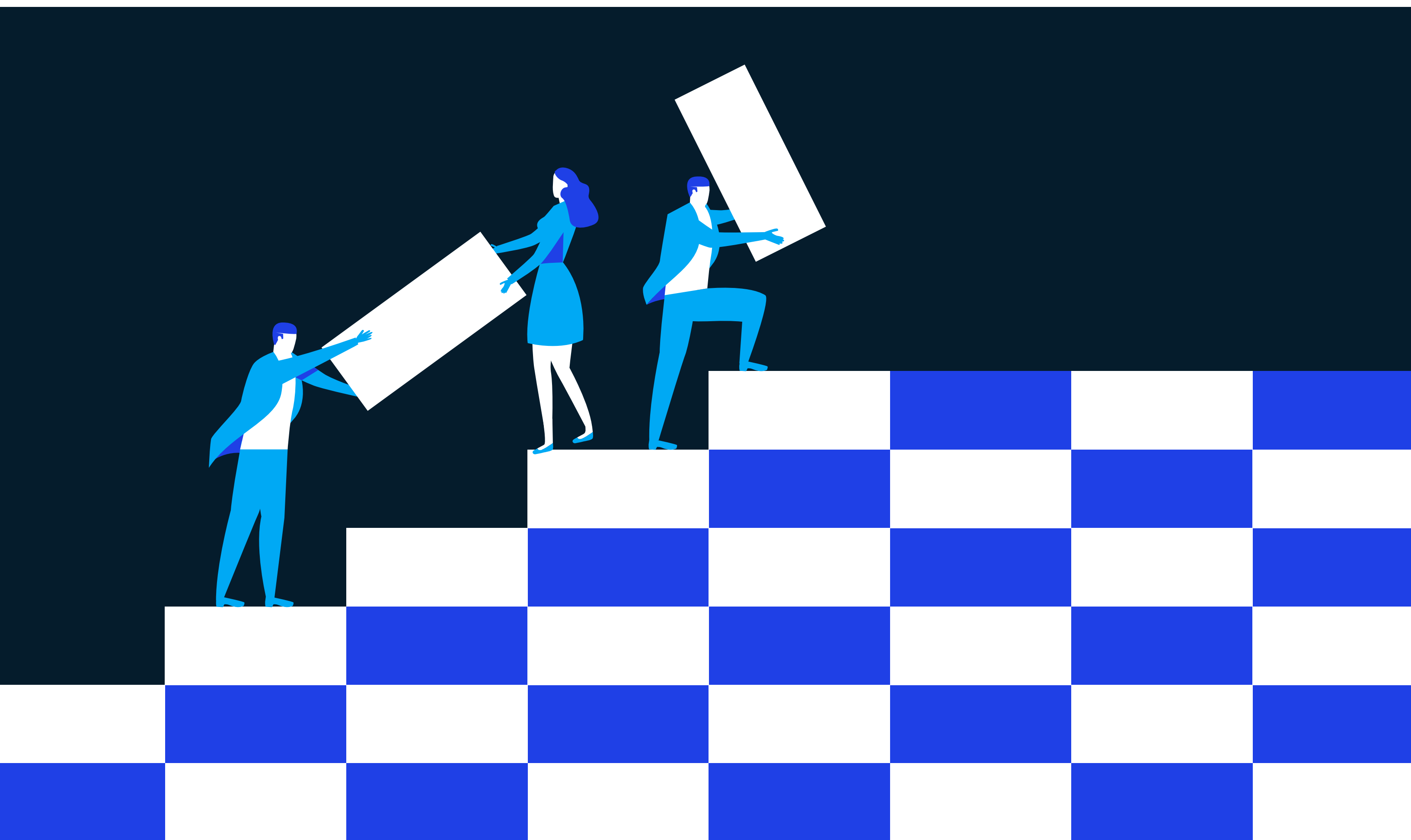
Multiples analysis: Industry labels don't matter, performance does

Our research highlights the variability of multiples within and across industries and refutes the idea that there is a shortcut to higher valuation.

by Alok Bothra and Zane Williams



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We hear executives theorize all the time about whether a change in industry classification[1] could boost their companies' valuation, even if underlying performance didn't change very much. For instance, if an insurance company were classified as a "wealth manager" rather than an "insurer," it could trade at higher multiples, and its valuation would increase. Right?

Not so fast.

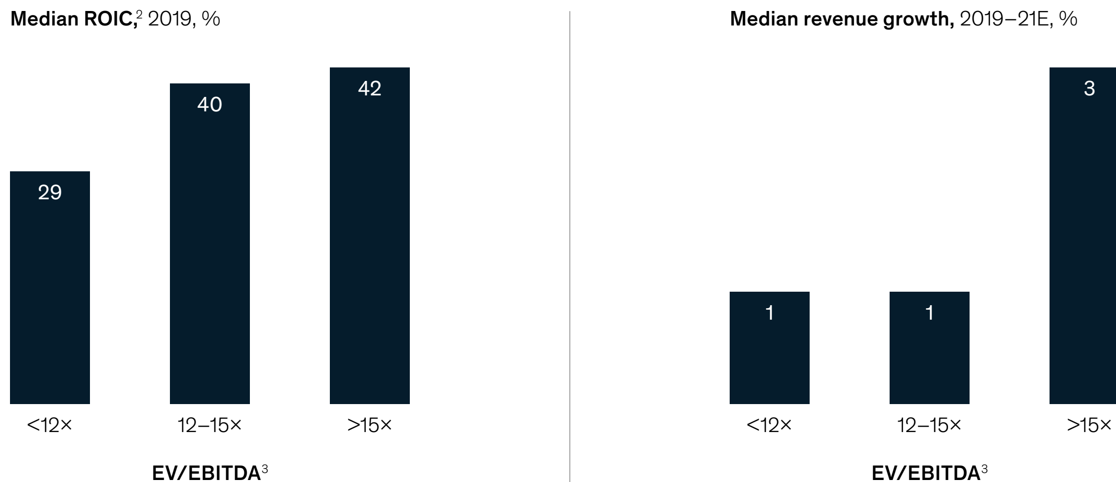
Our research underlines the degree to which corporate performance and multiples are inextricably linked. Companies in the packaged-food-and-meat industry, for instance, generally trade at multiples lower than 15 times EV/EBITDA.[2] But the higher performers—those companies that consistently deliver superior returns on invested capital and revenue growth—steadily trade at a multiple of more than 15 times EV/EBITDA (Exhibit 1). What's more, multiples are highly variable within industries themselves, reflecting the differing growth rates and profitability of different parts of the economy (Exhibit 2).

The numbers suggest that there are no shortcuts to higher valuation.[3] For a company to realize the industry-average multiple, it must match the industry-average expected performance. There's not much executives can do to affect

Exhibit 1

Underlying performance drives variation in multiples.

Industry example: Multiples used in packaged food and meat[1]



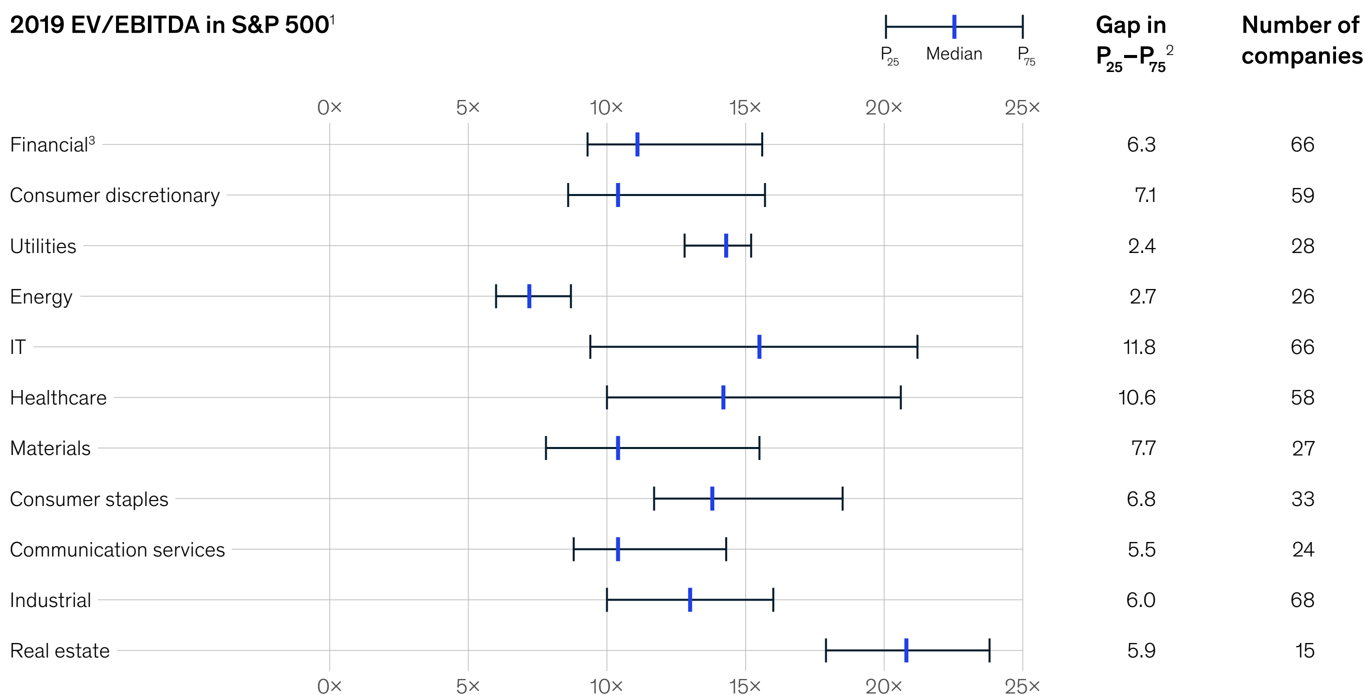
[1] Based on a sample of 19 US-based packaged-food-and-meat companies with a market cap of ≥$1 billion.
[2] Return on invested capital. Excludes goodwill and nonoperating intangibles.
[3] EV = enterprise value; EBITDA = earnings before interest, taxes, depreciation, and amortization. Based on EV and analysts' consensus EBITDA estimate as of June 7, 2019.

Source: S&P Capital IQ; McKinsey analysis

[1] Industry classifications group companies together based on an economic taxonomy that considers similarity of products, processes, behaviors, and other factors.
[2] "EV/EBITDA" refers to the ratio of enterprise value to earnings before interest, taxes, depreciation, and amortization. This is a measure of the cash flow available to a company.
[3] Susan Nolen Foushee, Tim Koller, and Anand Mehta, "Why bad multiples happen to good companies," May 2012, McKinsey.com.

Exhibit 2

Multiples vary significantly within different sectors.



[1] EV = enterprise value; EBITDA = earnings before interest, taxes, depreciation, and amortization. Based on EV and analysts' consensus EBITDA estimates as of June 7, 2019. S&P 500 companies with meaningful P/E multiples (470 in total) divided by sector.
[2] Difference between 75th percentile and 25th percentile values.
[3] Using 2019 estimates of P/E multiples for financial companies.

Source: S&P Capital IQ; McKinsey analysis

industry classifications and market variability directly, but they can control their companies' efforts to create more growth, higher margins, and greater capital productivity. Business leaders must do the hard work of revising business strategies, reallocating resources, monitoring outcomes, and otherwise enhancing corporate performance over the long term. Doing so will steadily improve a company's share price, even if it doesn't immediately result in higher multiples.

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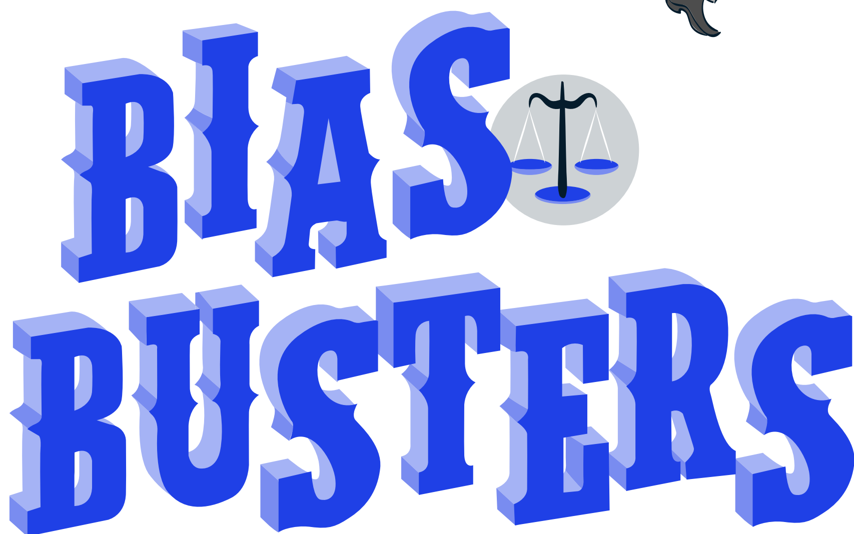
Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

Getting both sides of the story

by Aaron De Smet, Tim Koller, and Dan Lovallo



The dilemma

The CEO of a large, multinational industrial feels the company may no longer be the best owner of at least two financially lagging business units (valves and injection molding) acquired in the past decade. The CEO shares with the board a lengthy and detailed case for spinning off these assets. When he's clicked through his last slide, he asks for input, particularly from the heads of the two business units involved. Predictably, the business-unit heads advocate for staying the course. Even if profits and performance are down, they argue, the overall portfolio remains strong, so why break up the band? Almost everyone else in the boardroom, however, remains silent. How can the CEO get the critical input he needs to ensure he's making the right moves and creating the most value for the company?

The research

Research indicates that having leaders who can generate rigorous discussion in team meetings is what sets the best-performing companies apart from competitors.[1] Colleagues in these companies challenge one another, listen to minority views, and scrutinize assumptions. Recent McKinsey research also suggests that, particularly in "big bet" scenarios, the most significant predictor of successful decision making is the quality of the discussions and debate.[2]

But, as we've all witnessed, in most meetings, people rarely speak up until after the senior leader has spoken. Even then, they usually feel more comfortable following rather than challenging the leader. Compounding this "sunflower bias" is business leaders' tendency to continue advocating for ideas, even in the face of negative information. In the case of the multinational company, the CEO's voice became the loudest in the room, and, despite falling profits, the business-unit heads could not fathom the need for change, let alone begin to consider an alternate future for their ventures.

The remedy

One effective way to circumvent these biases is to assign two independent groups or individuals (a red team and a blue team) to represent opposing sides on a decision being considered. The teams present their arguments to relevant stakeholders—in a mutually agreed-upon format and time frame—and *only then* do decision makers voice their opinions. That's the approach Warren Buffett uses. When considering his biggest acquisitions, he routinely hires two investment advisers: one to make a case for the deal and the other to make the case

An effective way to circumvent biases in decision making is to assign two independent groups or individuals to represent opposing sides of the decision being considered.

1 Morten T. Hansen, *Great at Work: How Top Performers Do Less, Work Better, and Achieve More*, first edition, New York, NY: Simon & Schuster, 2018.

2 See "Decision making in the age of urgency," April 2019, McKinsey.com, and Aaron De Smet, Gregor Jost, and Leigh Weiss, "Three keys to faster, better decisions," *McKinsey Quarterly*, May 2019, McKinsey.com.

against it. Buffett listens to arguments from both sides, and the advisers are rewarded based on the final decision.

This vetting process is not just useful for getting to “yes” or “no.” It can also shift the very nature of the debate, thereby improving the quality of the decision. In the case of the industrial company, the CEO was advised by the business-unit heads to convene red and blue teams of outside experts to explore the factors associated with spinning off the business units in question. The teams’ research and presentations pointed to several options no one had considered at the outset, including spinning off the valves business but pursuing a joint venture for the injection-molding business, given projections of increased demand for injection-molded plastics in a range of industries.

Of course, convening truly independent teams can take time and effort. You will need to identify staffers who are either impartial to or very passionate about a particular course of action and assign them accordingly to the red or blue side. You may also want to pull in perspectives from outside the company, rewarding teams in the same way Warren Buffett does. Regardless, the effort will be worth it if you can change the dynamics in the board or strategy-planning room and bring multiple narratives to bear in your decision making.

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