Strategic acquisition or merger, what value?

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Large external growth deals are back: AB InBev's public bid to take-over SABMiller in the beer industry, the acquisition of EMC by Dell in technology, the merger of Holcim and Lafarge in cement, ... These major acquisitions and mergers are often criticised for both the high price and the low probability of success of their synergies.

Why pursue such strategies? What is their value?

Lack of alternative

The first answer is most obviously the lack of alternative for most large Western groups operating in traditional sectors. These leaders experience (or have experienced) strong growth by consolidating their market. This growth explains both their high valuation and the value they have created over time. However, it has its own natural end: how to continue growing strongly with already more than 30% market share and/or more than double the revenue of competitors?

A strategy to accelerate organic growth (or small local acquisitions) is often not up to the task, at least in the short to mid-term. The more major groups have managed to deploy this strategy in the past, the more insurmountable the challenge turns out to be. The implementation of major organic growth levers (disruptive innovation, development in emerging countries, in the digital industry, offer extension and assortment levels, ...), where they exist, often takes too much time to change the pattern in the short/mid-term (unless your name is Apple).

The slowdown of historically strong growing companies thus leads to a major slowdown in value creation (see table 1). This was the case for L'Oréal in the years 2002 to 2006 with a TSR at nil during these four years of economic rebound (compared to + 6% p.a. for the CAC40), for Microsoft in the years 2003 to 2004 with a TSR at –5% p.a. for two years (versus + 11% p.a. for the S & P 500),... (see table 2).

Most often, only major acquisitions or mergers enable Western leaders to maintain (or improve) their growth, and hence their potential for value creation.

Not all strategic acquisitions are the same

Not all acquisitions provide the same benefits. The success of a major acquisition or a merger requires the identification and the successful implementation of good strategic levers.

The consolidation of mature markets necessitates the realisation of major synergies to create value and justify the acquisition premiums. An example of this is the ongoing consolidation of the cable industry in the United States (acquisitions of Cablevision by Altice, of Time Warner Cable by Charter Communications, ...). The benefit is however often not visible because the gains are likely to be transferred to customers (lower prices, ...) or dissipated by the costs of complexity. This strategy only has long term interest if the consolidation potential is deep enough and large mergers/acquisitions can accelerate this market concentration. In the case of a "one shot" strategy, the risk is to find oneself in a dead-end situation and to forego financial flexibility.

- Tableau 1 -

Example of a company going from a growth of 15% to 5% p.a.

	Year 1	Annual Growth Rate	Year 5	Annual Growth Rate	Year 10
Revenue (index)	100	+15%	200	+5%	255
Net result (index & % of revenue)	10	+15%	20	+5%	25
	10%		10%		10%
PER (price earning ratio)	25	0%	25	-10%	15
Market capitalization	250	+15%	500	-5%	385
Dividend yield		0%		5%	
TSR (1) (in % p.a.)		+15%		+0%	

Note: all else being equal (non-dilutive growth, excluding capital increase, excluding decrease in interest rates, over the period…)
(1) Total Shareholder Return : return to shareholders from gains and dividends
Source: Estin & Co

Geographic diversification is a strategy where the challenge is for a business to reposition itself significantly towards long-term growing markets and accelerate the development of the target acquisition by realising synergies (shared costs, financial resources, ...). This strategy was successfully implemented by many groups in consumer goods, in particular by the two major leaders in the beer industry, AB InBev and SABMiller. They have generated a TSR of respectively of 20% and 18% p.a. between 2005 and 2015 (compared with a TSR of 13% p.a. for Heineken and 10% p.a. for Carlsberg). The acquisition of SABMiller by AB InBev is the logical outcome of this consolidation trend, with a rationale for AB InBev of long-term growth in Africa and China. Geographical diversification strategies are nevertheless not without risks: inaccurate assessments in the growth potential of markets, choice of a non-competitive target, an overly-extensive integration of the target and its consequential dilution within the group, ...

Diversification into related businesses is another example of repositioning towards long-term growth markets. This strategy creates even more value when they transform the industry by implementing revenue synergies (joint customers with a one-stop shopping offer,...) or cost (streamlining of the steps of the value chain...). This is a classic strategy in technology industries, in particular for leaders who have saturated their historic market. Microsoft seeks to find growth outside its historic perimeter through major acquisitions in internet services and social networks (Skype, ...), in telephony (Nokia Handset), in digital marketing (AQuantive, ...). Traditional players in the pharmacy industry such as Roche and Sanofi players rely on acquisitions of biotechnology specialists to offset the slowdown in their historic activity. Here too, there are plenty of risks both upstream (selection of markets and targets) and downstream (integration, ...).

Finally, external growth through major acquisitions is crucial to portfolio management strategies. Thus conglomerates like Danaher, Jarden Corp. or even Valeant experienced TSRs higher than 13% p.a. over long period. The most emblematic example remains Berkshire Hathaway (acquisition of Precision Castpart in the aerospace industry, Heinz in the consumer goods market, Burlington Northern Santa Fe from the rail industry, ...). Integration and headquarter costs should be limited in this type of strategy. The disposal of mature assets most often accompany the development of new markets.

In any case, large acquisitions should accelerate the implementation of growth strategies without upsetting the financial position of the group. The challenge being the speed at which the strategy can be deployed. The principal issue is to identify markets and targets with a sufficient impact to analyse the extent and growth duration of these targets, and thus to promote this long growth and synergies. It is also to focus on the right levers for each type of strategy, to find the right ratio between integration and autonomy of the targeted acquisitions.

The issue of financing

The main obstacle to a growth strategy through acquisitions is financial capacity. If disposals and increased leverage are not enough, it may become a question of raising capital. In such a case, the trade-off for a major shareholder can be reduced to the dividend yield (and a risk of long term value destruction) or dilution, with, in the worst case, the merger of his company within a group which is more likely to grow in the long run (but with loss of control). The option to merge may be the most attractive when the increase in the market value of the capital outweighs the dilution. Moreover, it does not reduce the investment capacity of the group created through the acquisition as this avoids additional leverage.

- Table 2 -

Examples of emblematic companies having experienced a break in their dynamics

	L'Oréal		Walmart		Dell		Microsoft		Oracle	
	1992-2002	2002-2006	1993-2003	2003-2006	1995-2005	2005-2007	1992-2002	2002-2004	2002-2012	2012-2013
Annual Growth	10%	3%	19%	2%	30%	7%	30%	-1%	10%	5%
Annual TSR	24%	0%	16%	-5%	39%	-19%	25%	-5%	12%	1%
TSR of benchmark index[(1)]	-21%	6%	11%	9%	9%	0%	-22%	5%	5%	22%
TSR Difference	+45 pts	- 6 pts	+5 pts	-14 pts	30 pts	-19 pts	47 pts	-10 pts	7 pts	-21 pts

(1) Benchmark: CAC40 for French companies; S&P500 for US companies
Sources : Bloomberg, annual reports, Estin & Co analysis and estimates

In conclusion

There is no value creation over the long term without growth. In an environment with low interest rates, large acquisitions are an effective lever for major Western groups. Business leaders should therefore concentrate on sustainable sources of growth. If not, shareholders have the option to change management by merging into a group with more potential.

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Estin & Co is an international strategy consulting firm based in Paris, London, Zurich and Shanghai. The firm assists management boards of large European, North American and Asian firms with their growth strategies, as well as private equity funds in the analysis and valuation of their investments.

- Table 3 -

Examples of symbolic companies regularly conducting large acquisitions
Period 2005-2015

Consolidation of mature markets

Buyer	Targets	Industry	TSR p.a 2005-15
Kraft Foods	Heinz, Cadbury, …	Consumer markets	13%
AT&T	DirectTV, Bellsouth, CellularOne, …	Cable	10%
WellsFargo	Wachiova, First Security, First Commerce, …	Bank	9%
Pfizer	Wyeth, AstraZeneca, Hospira, …	Pharmacy	9%
Procter & Gamble	Gillette, NuMaid, Zirh, Natura Pet, …	Consumer market	6%
		Average	**9%**

Geographic Diversification

Buyer	Targets	Industry	TSR p.a 2005-15
ABInbev	SABMiller, Oriental Brewery, Ambev …	Beer	20%
Prudential PLC	Thanachart, Shield Assurnance, Express Life, …	Insurance	14%
Groupe SEB	Supor, OBH Nordica, Asia Fan, …	Small appliances	14%
Imperial Tobacco	Altadis, portefeuille de marques américaines de Reynolds / Loriillard, …	Tobacco	13%
Sodexo	Motivcom, Puras do Brasil, …	Catering services	11%
		Average	**14%**

Diversification related trades

Buyer	Targets	Industry	TSR p.a 2005-15
Actavis	Allergan, Forest Laboratories, Durata Therapeutics, …	Pharmacy	24%
Ecolab	Champion Technologies, Nalco, Microtek Medical, …	Services	15%
Nestlé	Gerber, Novartis Medical Nutrition, Kraft frozen pizza, …	Consumer market	14%
Roche	Genentech, Santaris, InterMune, …	Pharmacy	10%
Microsoft	Nokia Handset, Yammer, Skype, …	High Tech	9%
		Average	**14%**

Portfolio Management

Buyer	Targets	Industry	TSR p.a 2005-15
Valeant	Bausch & Lomb, Medicis Pharmaceutical, …	Conglomerate	26%
Roper	Sunquest Information Systems, CBORD, …	Conglomerate	18%
Jarden Corp	Waddington, Yankee Candle, Holmes, …	Conglomerate	15%
Danaher	Nobel Biocare, Tektronix, Navman Wireless …	Conglomerate	13%
Berkshire Hathaway	Burlington Northern Sante Fe Corp, Precision Castparts, …	Holding	9%
		Average	**16%**