Growing through acquisitions: two disruptive models

By
Jean Berg
Vice President, Estin & Co

To create long-term value, it is necessary to grow. More and more, acquisitions form an integral part of growth strategies. Two models exist: the systematization of strategic acquisitions and the industrialization of organic (*bolt-on*) acquisitions. Those two modes require a strong, driven approach from management.

1. The systematization of strategic acquisitions

A strategic acquisition is an acquisition which significantly changes the size of a company. It enables the company to play in a different league and consequently, to either build leadership positions, or, as a challenger, to narrow the gap with the leader.

In businesses with a high value to the size, this strategy is essential. The issue is to define the right magnitude and speed as well as to assess the level of operational risk to ensure the success of the integration.

This is the strategy conducted for more than 15 years by Interbrew in the beer industry. In this sector, there is a strong value to national market share: profitability fundamentally depends on competitive positions.

Empirically, 1 point of market share point generates 1 point of ROCE. A company with a 20% market share has a ROCE of 20%, while a leader with a 40% market share has a ROCE of 40%.

In 2000, Interbrew decided to significantly concentrate the market by making major acquisitions and by accelerating the magnitude of the move. In 2004, it merged with AmBev and went from being an $8 billion to a $15 billion company. In 2008, it merged with Anheuser-Busch, became AB Inbev and doubled its revenue from $20 billion to $37 billion. In 2015, the company acquired the number two of the market, SABMiller and increases its revenue from $43 to nearly $70 billion. In 15 years, Interbrew's revenue rose from $5 billion to nearly $70 billion, i.e. an annual growth of over 20% per year. Its market share rose from 5% to 35% globally. It increase its EBITDA margin increased from 10% to 34% as a percentage of revenue by pulling four major levers:

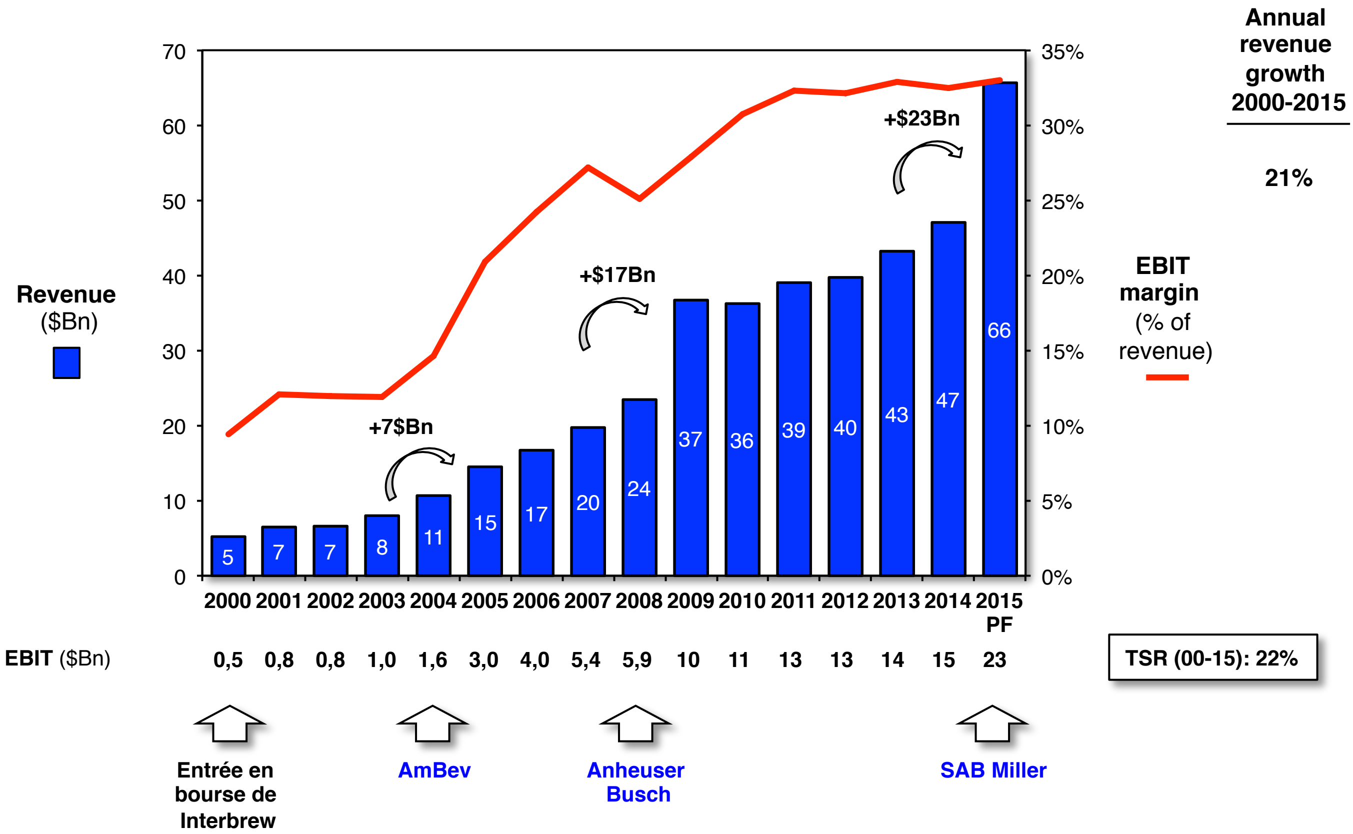
- Restructuring of the central costs.
- Sales, marketing and logistics synergies country by country.
- Transfer of best practices between countries, particularly throug clustering countries and developing common approaches.
- Industrial optimizations.

Four critical elements have enabled this exceptional performance:

- An unlimited ambition: concentrate a highly fragmented, low-growth market over 15 years.
- Financial risk taking by accepting high acquistion prices, significant leverage and shareholder dilution.

- Table 1 -

AB Inbev has grown by more than 20% per year over the last 15 years by increasing the size of its strategic acquisitions



Note : 2015 pro forma with SAB Miller
Sources : Estin & Co analyses and estimates

- A steady increase in the size of the strategic acquisitions from \$7 billion to \$23 billion in line with the increase in the size of the company.
- Know-how and the industrialization of integrations, focusing actions on the most critical synergy levers.

Many companies, including large ones, struggle to grow and to concentrate their market while the economics of their industry requires them to do so. Organic growth strategies are not the answer when the issue is speed and magnitude. Neither are small acquisitions. The risk is to be beaten by a bolder, more entrepreneurial management and visionary shareholders.

2. The industrialization of organic (*bolt-on*) acquisitions

This is generally the less developed and less structured gross model for companies. It involves a large number of small, local acquisitions which strengthen the business. If this strategy is "industrialized," it will contribute on a regular basis while pulling levers on the balance sheet rather than ones on the income statement.

Usually, it complements organic growth and it is effective for businesses with a high number of small national competitors:

- In mature countries, it is generally less expensive than organic growth to concentrate the market.
- In emerging countries, it helps build a platform for growth or accelerate growth to establish leadership.

This is the strategy lead by LKQ, an American company which supplies aftermarket auto parts as well as recycled, refurbished mechanical parts, including engines and gearboxes for car repairs. Since 2000, it has conducted a strategy consisting in consolidationg and industrializing salvage yards with more than 200 acquisitions over the period and around 30 per year in recent years. The company has grown its revenue by 25% annually from \$0.2 billion to more than 7.2 billion dollars in 15 years. Its EBIT margin has increased from 6% to over 12%.

The success of this strategy is based on:

- A specific "industrial" organization to detect, attract and conclude its large number of acquisitions.
- A strategy and an organization to "integrate" the acquisitions while developing a strong level of autonomy and synergies. That is made possible by combining the acquired company's entrepreneurial spirit, market knowledge and expertises with the acquiror's experience and frequently its technology and approach.
- An investment capacity for recurring, low unit price acquisitions which are significant when taken together if this strategy is successful. This strategy must not simply be organized, it must also be incorporated into a financial strategy.

Many companies conduct a strategy consisiting in acquiring small targets only to find out that the acquired firms grow little, earn no money and prove to be fiasco. Either the strategy is marginal and there is a risk that it might lead to nothing, or it is industrialized with a structured objective, approach and integration, in which case it may constitute a significant value creation axis.

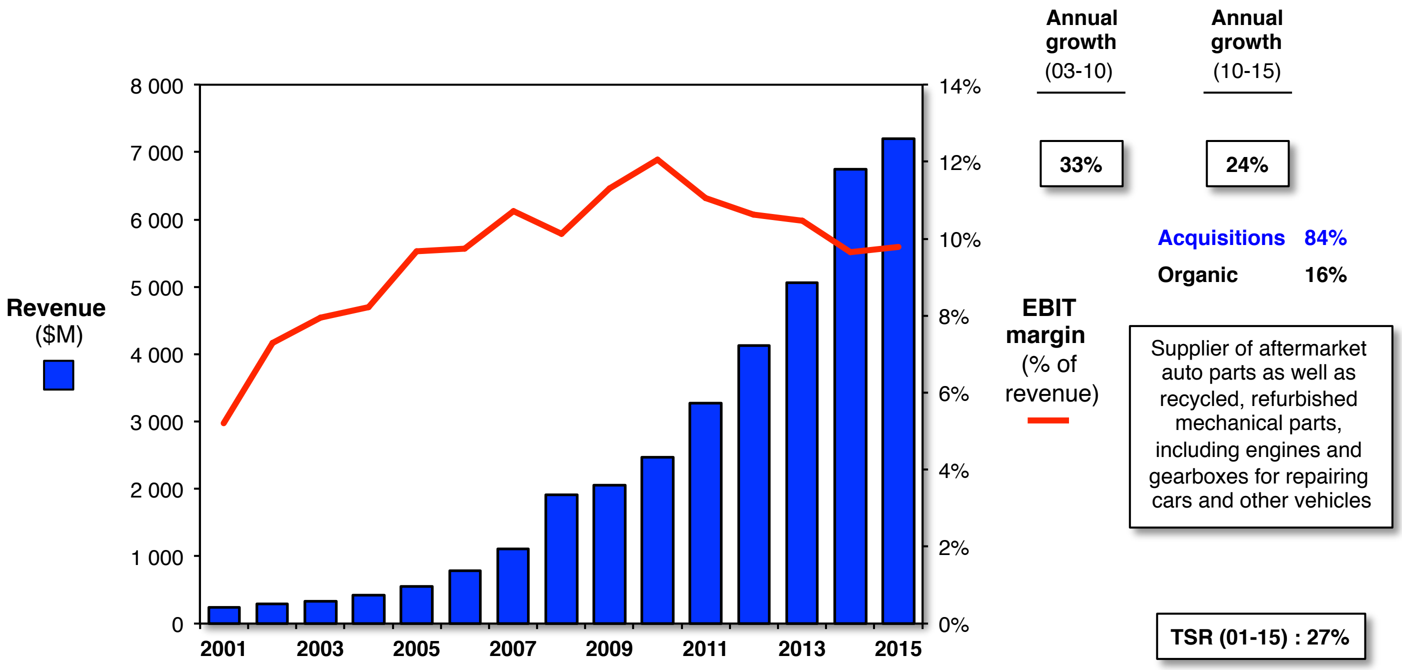
What to conclude?

Acquisition models are necessary in growth strategies. They are essential to accelerate concentration strategies or to stoke expansion strategies aiming at getting "out of the box." In both cases, two very different models can be implemented.

To consolidate markets quickly, the size of the acquisitions must be proportional to the size of the consolidating companies. It is a race against time. To become leaders, it is necessary to concentrate large challengers. The risk is to be beaten by more entrepreneurial challengers.

- Table 2 -

LKQ has grown by more than 20% per year over the last 15 years by consolidating the market of auto part distribution through the acquisition of more than 200 competitors



Sources : Estin & Co analyses and estimates

If the industry has no established leaders or challengers, strategies consisting in industrializating bolt-on acquistions are a necessary option. It is complex but creates significant value if successful. Regarding acquisition strategies, it is necessary to use approaches which are disruptive either in terms of magnitude or quantity.

May 2016

Jean Berg is Senior Vice President of Estin & Co, an internatinaal strategy consulting firm based in Paris, London, Zurich and Shanghai. Estin & Co assists CEOs and investors with their growth and resource allocation strategies.