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The Clock Is Ticking

Preparing to Seize M&A Opportunities While They Last

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The clock is ticking. After a predictably sharp contraction in mergers and acquisitions (M&A) in the wake of the crisis, there are signs that the tide could soon turn. For instance, equity values have started to stabilize, and debt markets are beginning to show signs of life, with greater liquidity and relatively reasonable rates.

Although it is difficult to predict when there will be a significant uplift in M&A, a recent BCG survey of 160 professional investors and equity analysts worldwide suggests that it could occur within the next 12 to 24 months.¹ There is little doubt that the current lull presents a unique and potentially short-lived window of opportunity for companies with the firepower to do a deal to capture the strategic high ground. However, there are two important caveats that potential acquirers need to heed before they pull the trigger: it is essential to be battle ready and to prepare to think differently.

Be battle ready. Buyers must be absolutely certain that they have the financial muscle to take on the risks of a deal without putting themselves in play. The reality is that most are not in this position—at least not at the moment. According to a BCG analysis of a subset of companies in the S&P 500, just one-fifth of companies have a sufficiently robust balance sheet and other financial credentials to engage in M&A (the *haves*), while another fifth are now so weak and vulnerable that their only course of action is to focus on surviving the downturn (the *have-nots*).

But more than half of the companies (60 percent) are neither battle ready nor on the ropes. They occupy a *gray area*, with the potential to become predators or prey—or perhaps simply to lose out on the gold rush. (See Exhibit 1.) To stay in control of their destinies, these businesses must assess their relative financial and market positions as a matter of urgency and take appropriate actions to ensure that they can make the right strategic moves, whether this involves M&A or not.

Prepare to think differently. Prospective acquirers must recognize that the rules of the game have changed. Yes, downturns are still an ideal time to do a deal, especially for purchasing divested assets, as BCG research has demonstrated. And, yes, many of the “golden rules” of M&A still hold, including the need for strategic alignment and flawless planning and execution of postmerger integration (PMI). But much greater caution and rigor are required today. Priority targets that once appeared to be the route to superior growth might now be poisoned chalices of debt or vulnerable to unprecedented declines in consumer confidence. Many of the long-term geographic and strategic hot spots have also gone into a deep freeze, and others are heading in this direction, with few indications of a thaw on the horizon. Understanding the standalone health of targets is more critical than ever.

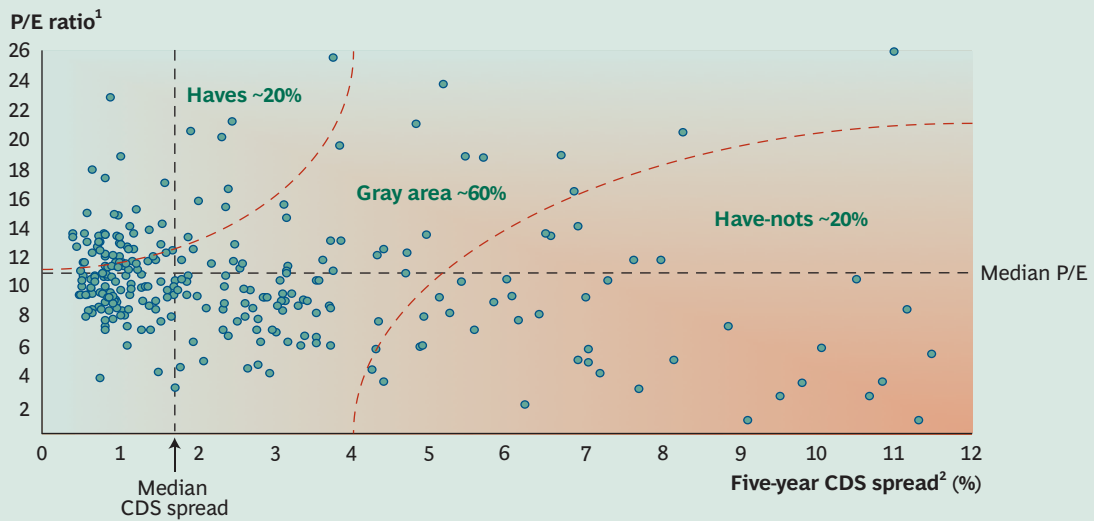
To stay on the right side of the game, prospective acquirers should systematically reassess their targets and markets, as well as their funding and deal-structuring options. PMI also requires a new twist—a much stronger focus on immediate cash generation. All of these strategic moves call for careful preparation. And this has to be done now in order to be two steps ahead of the competition before the most attractive opportunities evaporate.

Stress-Test Your Company: Are You a Predator or Prey?

Despite the sharp downturn and ongoing financial uncertainty, another recent BCG survey found that more than half of European companies (51 percent) were sticking to their M&A plans and, more

1. See *Collateral Damage: Function Focus—Valuation Advantage: How Investors Want Companies to Respond to the Downturn*, BCG White Paper, April 2009.

Exhibit 1. BCG Analysis Indicates That Roughly 20 Percent of the Surveyed S&P 500 Companies Can Be Considered Haves



A company with a higher CDS spread is considered more likely to default by the market.

Sources: Bloomberg; Thomson Reuters; BCG analysis.

Note: The sample consists of 281 companies in the S&P 500 with positive earnings forecast for 2010 and available data on CDS spread; data as of February 3, 2009.

¹Forward-looking price-to-earnings (P/E) ratio through 2010, based on consensus estimates.

²CDS is a credit derivative contract between two counterparties. The buyer makes periodic payments to the seller and in return receives a payoff if the underlying financial instrument defaults. CDS spread reflects the default risk of a company as viewed by the market. A five-year CDS spread reflects the annual price premium as a percentage of nominal value to insure a five-year bond against default. (1 percent = 100 basis points.)

significantly, that 21 percent intended to step up their deal activity—indicating that many sense a rare opportunity.² Some of these transactions will inevitably be consolidation deals, especially in industries that are on the ropes, such as the automotive and finance sectors. But survey respondents representing 43 percent of the companies believe there will be large-scale transactions that will transform the competitive landscapes of a broad cross section of industries, including currently robust sectors. Indeed, we have already seen several of these deals in sectors such as pharmaceuticals and utilities. But who will be the predators and who will be the prey in tomorrow's transformational transactions, especially as the M&A market accelerates?

To answer this question, companies can no longer rely on traditional indicators of M&A firepower or vulnerability, such as free cash flow and relative valuation multiples. What might appear to be strengths today can rapidly become major weaknesses if trading conditions suddenly deteriorate. Instead, companies need to stress-test each of their business units against a worst-case scenario in order to estimate the bottom limit of their company's free cash flow and balance sheet.

For example, what impact would a severe drop in sales have on earnings before interest and taxes (EBIT) and cash flow? Even a firm that still expects robust double-digit EBIT of, say, 10 percent (based on a modest, forecasted decline in volumes) would find its profitability and cash flow deep in the red if a worse-than-predicted recession forces sales down by, say, an additional 25 percent or if the downturn drags on longer than expected. And what if a major customer or supplier defaults?

Stress-testing not only enables companies to establish whether they are battle ready but also pinpoints the weaknesses within each business unit that need to be corrected in order to do a deal or defend the company against a hostile bid. Companies that fail the stress test should act quickly and decisively. Costs

2. See *M&A: Down but Not Out: A Survey of European Companies' Merger and Acquisition Plans for 2009*, BCG White Paper, December 2008.

should be cut and cost structures made as flexible as possible. Maximizing cash generation, using both operational and financial levers—including working-capital reductions—will also be critical.

In addition, executives should systematically manage their portfolio of businesses, channeling investments into the value creators and either fixing or divesting the value destroyers. As BCG showed in earlier research, downturn divestitures can create substantial value for sellers when aligned with the right buyers.³

BCG estimates that, with the correct steps, up to one-quarter of companies in the gray area could move into an offensive haves position before the M&A market surges ahead.

Review Your M&A Strategy Through a Downturn Lens

The economic crisis may be global, but its impact has been far from equal. Different geographic markets and individual companies within generally unscathed industries have all been affected differently, radically altering the relative attractiveness of targets on acquirers' predownturn hit lists. Although these shifts have made the prices of some potential targets mouthwateringly low, the first essential step is to align M&A strategy with long-term value-creation strategy: buying on price alone is the road to ruin in all economic environments.

More specifically, potential buyers should revisit their strategic priorities and view them through a downturn lens. Have any targets become particularly cheap? Are any facing imminent liquidity crises and in need of a "solution"? How severely has the recession hit the targets' core markets, including their suppliers? And how is this likely to play out, taking into account the possibility of government intervention, protectionist policies, and other factors?

BCG's predator-prey matrix, which maps operational stability against financial stability—taking into account liquidity, the relative vulnerability of companies' business units to a recession, and other considerations—indicates the steps that companies need to take to move into an effective defensive or offensive position. (See Exhibit 2.) Acquirers should also scan the world for potential business-unit divestitures that

3. See *The Return of the Strategist: Creating Value with M&A in Downturns*, BCG report, May 2008.

Exhibit 2. BCG's Predator-Prey Matrix Can Be Used to Clarify Your M&A Strategy

		Prey	Predators
Operational stability	High	<ul style="list-style-type: none"> ◇ Preserve intrinsic value of businesses ◇ Pay down debt <ul style="list-style-type: none"> • Sell nonstrategic business to pay off debt • Restructure debt schedule to reduce risk of default 	<ul style="list-style-type: none"> ◇ Enhance competitive advantages <ul style="list-style-type: none"> • Gain market share profitably • Invest wisely where returns are above cost of equity • Acquire "prey" when long-term value can be added • Acquire good pieces of business (that is, products that fit) and avoid toxic portions of liquidators
	Low	Liquidators	Cyclical leaders
		<ul style="list-style-type: none"> ◇ Sell off assets to reduce debt ◇ Improve profitability of remaining businesses ◇ Liquidate if unable to improve profitability above cost of capital 	<ul style="list-style-type: none"> ◇ Improve near-term EBIT as quickly as possible; reduce operational volatility in order to become less vulnerable in future downturns ◇ Avoid excessive debt that would turn the company into a liquidator
		Low	High
		Financial stability	

Source: BCG experience.

could enable them to consolidate their grip on markets. As BCG research has revealed, buyers can generate substantially higher long-term shareholder returns from purchases of select assets than from purchases of entire companies.⁴

Dive Beyond Your Targets' Financials

The oversights in the financial sector that triggered the current crisis have provided a salutary reminder of the importance of rigorous due diligence. In fact, the crisis has left so little room for errors of judgment that due diligence requires not only a microscopic analysis of a target's financials but also a forensic assessment of its sensitivity to the downturn.

Just as we recommend that acquirers stress-test their ability to generate the cash flow needed to fund a deal, we also believe that companies should stress-test their priority targets' ability to survive and thrive in a worst-case recession scenario. This requires going far beyond the targets' underlying financials. Using BCG's proprietary marketplace-research techniques, companies should assess how their customers will react to a deepening downturn and an upturn in order to obtain a better understanding of the shape of baseline cash flows and how they can be improved. What is the competitive positioning of the target's brand portfolio on a standalone basis? How vulnerable is the target to industry consolidation? And how would the target enhance or undermine the acquirer's financial position if it were integrated into the company's portfolio? Are there carve-out opportunities to minimize any potential risks?

Pricing the deal also has to be rethought. Earnings multiples—particularly precedent transaction multiples—are less relevant now than previously because earnings streams are so unstable. Instead, asset multiples and values based on discounted cash flows and similar measurements are likely to have a much bigger influence. The higher cost of capital will also have a bearing on funding options, as well as on the relative value of an acquisition versus a share buyback.

Explore Alternative Sources of Funding

Even the most strategically compelling deals can struggle to attract funding from the world's beleaguered capital markets and banks. However, there are alternatives. Sovereign wealth funds, for example, are sitting on war chests of more than \$3 trillion and are more than willing to dip into these funds, as we have seen over the past 12 months, while private-equity firms have about \$400 billion of "dry powder" in their arsenals, according to a recent BCG study.⁵ After taking into account private-equity firms' heavily reduced appetite for risk, we estimate that the top ten firms alone have nearly \$200 billion of unallocated unleveraged funds available for deals.

To tap into these alternative funding channels, acquirers should put together a cast-iron investment case, including stress-tested worst-case scenarios to ensure total transparency about the downside potential. A strong, long-term equity story, backed by institutionalized capabilities and brand strengths, is often especially important for sovereign wealth funds.

Concentrate on Cash Management During the Integration—and Beyond

Cash is king today. Ensuring that you have a well-planned and well-executed PMI strategy is obviously essential for releasing cost synergies as rapidly as possible. But acquirers need to look beyond time-consuming, earnings-oriented restructuring and concentrate on measures that *increase* cash generation from day one of the merger. In fact, in a cash-constrained world, unlocking additional cash will often be necessary to fund any restructuring.

One of the quickest, yet often overlooked, ways to release large amounts of cash is to optimize the three

4. See *The Return of the Strategist: Creating Value with M&A in Downturns*, BCG report, May 2008.

5. See *Get Ready for the Private-Equity Shakeout: Will This Be the Next Shock to the Global Economy?* BCG White Paper, December 2008.

key drivers of working capital: inventories, receivables, and payables. Our experience has shown that with a holistic approach that spans the entire value chain—from product design to manufacturing to sales—companies can reduce their working capital by as much as 30 to 40 percent and cut their costs by 5 to 10 percent.⁶ Recently, one of our clients that adopted this approach saved enough to acquire a business in Asia without taking on any additional debt.

Think Twice Before You Jump

There may be enticing targets on the market, but is a deal the most productive way to use your cash and support your strategic trajectory? If you are fundamentally undervalued, a major share buyback may be a better option—especially because you will know your company’s true worth, whereas your target’s real value may be far less transparent to you. Comparing the return on a deal with a share buyback will reveal the way forward.

Remember the Golden Rules of Downturn M&A

Times may have changed, but there are some empirical truths that always hold true for M&A during downturns.

- ◇ *Do deals during downturns.* Downturn transactions have a higher probability of generating shareholder value than deals executed in periods of above-average economic growth, and they produce, on average, 14.5 percent higher returns, on the basis of a BCG review of thousands of deals.
- ◇ *Target businesses with lower profitability than your own.* On average, companies acquiring targets with significantly lower profitability than their own during a downturn outperform the market by 14 percent two years after the acquisition, while companies that purchase targets with higher profitability produce returns that, on average, are comparable with the stock market average.
- ◇ *Keep deals relatively small.* The larger the transaction relative to the size of the acquirer, the greater the chance it will destroy shareholder value. For example, targets worth more than 50 percent of the acquirer destroy nearly twice as much value as targets worth less than 10 percent of the acquirer.
- ◇ *Prepare your PMI in advance—and plan strategically.* Companies often erroneously treat PMI as a mechanical process that occurs after a deal is done. But it is the strategic and tactical choices that are made before a deal is closed that ultimately determine its success. Special attention should be paid to the style and speed of the integration, as well as to softer cultural issues. It should be taken as a given that a systematic approach to PMI is vital to success.

Start Planning to Act Now

In high-pressure situations, there is always a risk that companies will seize the first opportunity that appears or recoil at the turmoil and become victims of indecision. Careful, yet rapid, analysis and planning are essential to making the right decision. There will be a three- to six-month window between the time the best-prepared companies are ready to act and the time the rest of the world catches up, which will provide those at the front of the M&A queue with a rare chance, assuming the deal is strategically suitable, to generate hundreds of billions of dollars of additional value. Whether you are ready and able to act now or not, now is the time to prepare so that you can be ahead of the pack when the time is right.

6. See “Cash for Growth: The Neglected Power of Working-Capital Management,” BCG Opportunities for Action, May 2008.

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