Masters of the Deal: Part 1

Learning from the best performers

A study by the M&A Research Centre at Cass Business School and Intralinks | **November 2014**

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Executive summary

This research study seeks to investigate two separate but related areas. Part 1, whose findings are described in this report, tries to identify the drivers of shareholder value creation from the merger and acquisition (M&A) activity of an extremely large sample of global publicly listed companies over the past 20 years. Part 2, which will be released as a report in early 2015, examines the M&A strategies of an elite group of M&A-active corporate outperformers – companies that have demonstrated sustained, above average shareholder value creation (known as "excellent corporate portfolio managers", or ECPMs) – to try to determine if this group share common attributes and behaviours, and to identify what those are.

In conjunction with this research, interviews with 30 C-level and senior executives working within some of these high-performing companies were conducted by Remark. These professionals, working at companies that have some of the best records of shareholder value creation from M&A, offer their expertise and provide context to the findings.

Key findings of Part 1 of the study include the following:

Firms underperform the market during periods when they are inactive in terms of announcing M&A activity (acquisitions or divestments) and significantly underperform firms that are active

The study finds that the total shareholder return performance of firms during periods when they announce no M&A activity is 1.5% per annum lower than the overall market and 3.2% per annum lower than firms that announce one to two M&A deals. Firms outperform the market by 1.7% per annum during periods when they announce one to two M&A deals.

Considering acquisition activity alone, firms outperform the market the more frequently they announce acquisitions

The study finds that firms' total shareholder return performance increases with increasing frequency of acquisition activity. Firms outperform the market by 0.1% per annum during periods when they announce one to two acquisitions, by 2.0% per annum during periods when they announce three to five acquisitions and by 3.4% per annum during periods when they announce six or more acquisitions.

Considering divestment activity alone, firms only outperform the market during periods when they announce a limited number of divestments and significantly underperform the market when they announce a higher frequency of divestments

The study finds that the total shareholder return performance of firms during periods when they announce one to two divestments is 2.3% per annum above the market. However, firms' performance worsens significantly with increasing frequency of divestment activity. Firms underperform the market by 3.3% per annum during periods when they announce three to five divestments and by 3.6% per annum during periods when they announce six or more divestments.

Young firms only outperform the market during their first three years as public companies, when they announce a very high frequency of acquisition activity, signalling a high level of growth

The study finds that newly publicly listed firms as a whole underperform the market by 5.6% per annum during the first three years after listing. However, during periods when young firms announce a very high frequency of acquisitions (six or more) they outperform the market by 3.8% per annum.

The study finds a causality link between firms' past performance and future frequency of M&A activity and between frequency of M&A activity and future performance, which offers a possible explanation for the cyclical nature of M&A

Poorer performance in past periods drives firms to be either inactive or become active, which then drives future outperformance (active firms only) or future underperformance (if firms remain inactive); however, better past performance then drives firms to become over-active, which drives down future returns, leading to underperformance.

Overall, firms achieve superior total shareholder returns with an M&A portfolio management programme, which includes several acquisitions per year on average, while simultaneously conducting a limited number of divestments (one to two divestments in a three-year period) once they have been publicly listed for at least three years

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Introduction and methodology

This study is unique in two ways. First, its size and scale, in terms of the number of global companies that are analysed (25,082 firms), over a very long-term time series (1994–2013: 20 years), make the results robust and unlikely to be affected by sample bias – not least because the size of the sample makes it much more reflective of the total population of global companies than previous studies of this kind. Second, unlike many previous research studies that have attempted to investigate corporate value creation from M&A by assessing the impact of individual transactions over relatively short time periods, we believe that this is the first comprehensive study, which combines emerging thinking in M&A research of analysing the effect of M&A on companies' performance in the context of their overall programme of M&A activity over different time periods.

The sample of firms in this study comprises the entire global dataset of publicly listed companies with a market capitalisation of at least $10m, whose public equity was actively traded between 1994 and 2013. The firms and their associated data were obtained from Thomson Reuters Datastream®. The M&A activity (both acquisitions and divestments) of these firms during the study period was obtained from Thomson Reuters SDC Platinum®, with a restriction on the minimum transaction value of $1m and the maximum percentage ownership by the acquirer before announcement of 49%. The performance of the firms is defined as their total shareholder returns (share price performance plus dividends) measured over rolling three-year periods beginning in 1993 until 2013 (for example, 1993–1995, 1994–1996, 1995–1997, and so on). These figures are then adjusted by the total return for the primary equity market index of the firms' listing location, expressed as an annually compounded growth rate per three-year period – thus generating a consistent way to compare the performance of the firms on the basis of a market-adjusted annual percentage growth in total shareholder return.

The firms are further classified according to their frequency of M&A activity within each three-year period and by their maturity, based on the period of time since their first public listing. The frequency of M&A activity for each period is defined as either "inactive" (no deals announced in a three-year period), "active" (one to two deals announced, and subsequently completed, in a three-year period), "very active" (three to five deals announced, and subsequently completed, in a three-year period) or "extremely active" (six or more deals announced, and subsequently completed, in a three-year period). The maturity of a firm within each three-year period is defined as either "young" (listed for a maximum of three years), "medium" (listed for more than three but less than 10 years), or "mature" (listed for 10 or more years).

These classifications enable the relationship between the performance of firms along the twin dimensions of M&A frequency and firm maturity to be analysed. These dimensions provide the main basis for the insights, which are described in the rest of this report.

The study also uses time-series regression analysis to try to identify any causality links between the performance of firms and the frequency of M&A activity, and vice versa. That is, the study examines whether firms' past performance drives M&A frequency or whether the frequency of M&A activity drives future performance.

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How does the frequency of M&A activity affect shareholder returns?

Active firms, higher returns

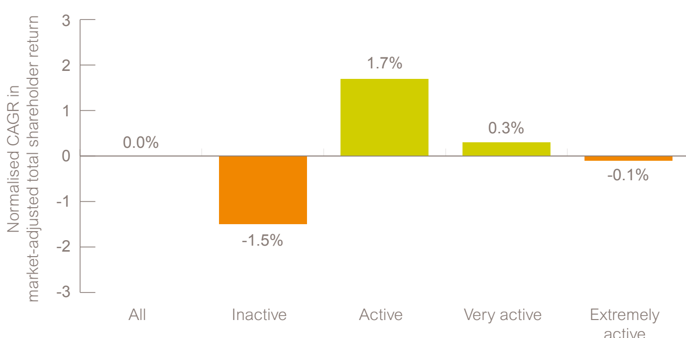
This study finds that companies underperform the overall market during periods when they are "inactive" in announcing any M&A transactions (in other words, during three-year periods when they announce no acquisitions or divestments), and also perform significantly worse than firms that announce some M&A activity. This result is repeated across all major geographical regions and therefore provides strong evidence that firms that undertake no M&A activity may not be maximising returns for investors.

As shown in Chart 1, on average, the returns performance of companies during inactive M&A periods is found to be 1.5% per annum lower than the overall market. In contrast, during periods when firms are "active" (announcing one to two deals per three-year period), returns performance is on average 1.7% per annum higher than the overall market and 3.2% per annum higher than that of firms during inactive periods.

> "Companies have to continuously change with the market and experiment and innovate. The fastest way to do this is to buy and sell companies."

The head of corporate development at a US waste management firm offers an explanation for this result: "Buying and selling is very important in a business environment where demand continuously changes and it is necessary for a company to adapt. Companies who are adept at buying and selling are more likely to stay ahead of the competition."

Chart 1. Relationship between M&A frequency (**acquisitions and divestments**) and returns (**all** companies)



This view is supported by the chief strategy officer at a Mexican pharmaceutical manufacturer: "We are always considering acquisitions and divestments. We are always looking for products to acquire to expand our reach and meet customer demand. At the same time, we have to constantly divest products that are not in demand to reduce costs."

> "Companies who are adept at buying and selling are more likely to stay ahead of the competition."

"Companies have to continuously change with the market and experiment and innovate. The fastest way to do this is to buy and sell companies," adds the chief financial officer at a UK synthetic chemical manufacturer.

While firms that announce no M&A transactions consistently perform worse than their more active counterparts, the study also finds evidence that during periods when firms are conducting a comparatively high frequency of M&A activity their returns performance worsens – perhaps evidence that doing too many of the wrong type of deal can become counterproductive. During periods when companies are "very active" (announcing three to five transactions over a three-year period) they outperform the market by only 0.3% per annum on average and during periods when companies are "extremely active" (announcing six or more transactions over a three-year period) they underperform the market by an average of 0.1% per annum (although still outperforming the inactive firms by 1.4%).

The definition of M&A "activity" in this first set of results includes both acquisitions and divestments. However, when these two types of transaction are viewed separately the results become much more illuminating, with the increasing frequency of divestments proving to be the principal reason for the drop in performance beyond the "active" frequency level.

The more frequently you buy, the higher you'll fly

When considering acquisition activity alone, there is in fact no evidence of performance deteriorating beyond a certain frequency of activity. Instead, there is evidence that increasing frequency of acquisition activity appear to be associated with increasing returns. As shown in Chart 2, the study finds that during periods when firms are "very active" (three to five acquisitions announced over a three-year period) or "extremely

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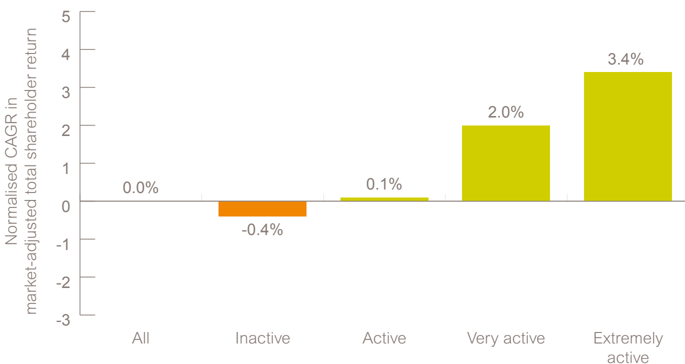
Chart 2. Relationship between **acquisition** frequency and returns (**all** companies)



active" (six or more acquisitions announced over a three-year period), they outperform the market by an average of 2% and 3.4% per annum respectively.

By contrast, during periods when firms are merely "active" (one to two acquisitions announced over a three-year period) they perform on average in line with the market, but underperform the market by an average of 0.4% per annum during periods when they announce no acquisitions.

"For us, acquisitions are not just for growth but are also part of a broader innovation and capability building strategy."

The director of finance at a UK building services company outlines the importance of regular acquisitions for his firm: "For us, acquisitions are not just for growth but are also part of a broader innovation and capability building strategy. We are looking to buy niche companies that fill the gaps in intellectual property, product portfolios and product line-ups."

Careful with that axe, Eugene

While there is a strong relationship between acquisition frequency and returns, when we look at divestment activity alone, the picture is more nuanced.

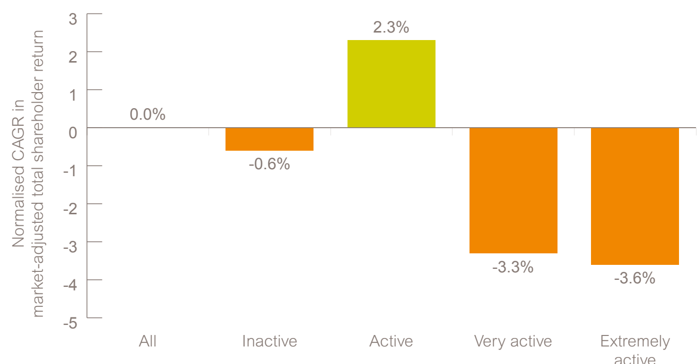
As shown in Chart 3, "active" firms (those announcing one to two divestments over a three-year period) outperform the overall market by an average of 2.3% per annum. However, firms that are "very active" (announcing three to five divestments over a three-year period) or "extremely active" (announcing six or more divestments over a three-year period) no longer see any benefits and instead underperform the overall market by a substantial 3.3% and 3.6% per annum respectively.

These results suggest that firms that undertake a limited number of carefully considered divestments are more likely to enhance their growth by, for example, selling non-core assets to create better focused businesses or to give themselves financial flexibility (potentially to perform value-creating acquisitions). However, during periods when firms announce a greater frequency of divestments they may be signalling to the market that they are doing so for reasons of strategic, operational or financial difficulty and therefore, at least in the short term, are at risk of underperformance.

Some reasons for the striking difference between firms' performance when looking at acquisition versus divestment frequency are spelled out by the head of corporate development at a US waste management company: "Doing a divestment is a much more complex and tiring process than doing an acquisition. We have to involve multiple parties related to the part of the business being divested, including shareholders and lenders."

This view is echoed by the senior vice president of strategy and M&A at a Finnish metal products manufacturer: "Divesting is not really that similar to acquiring, which is a much more straightforward process."

Chart 3. Relationship between **divestment** frequency and returns (**all** companies)



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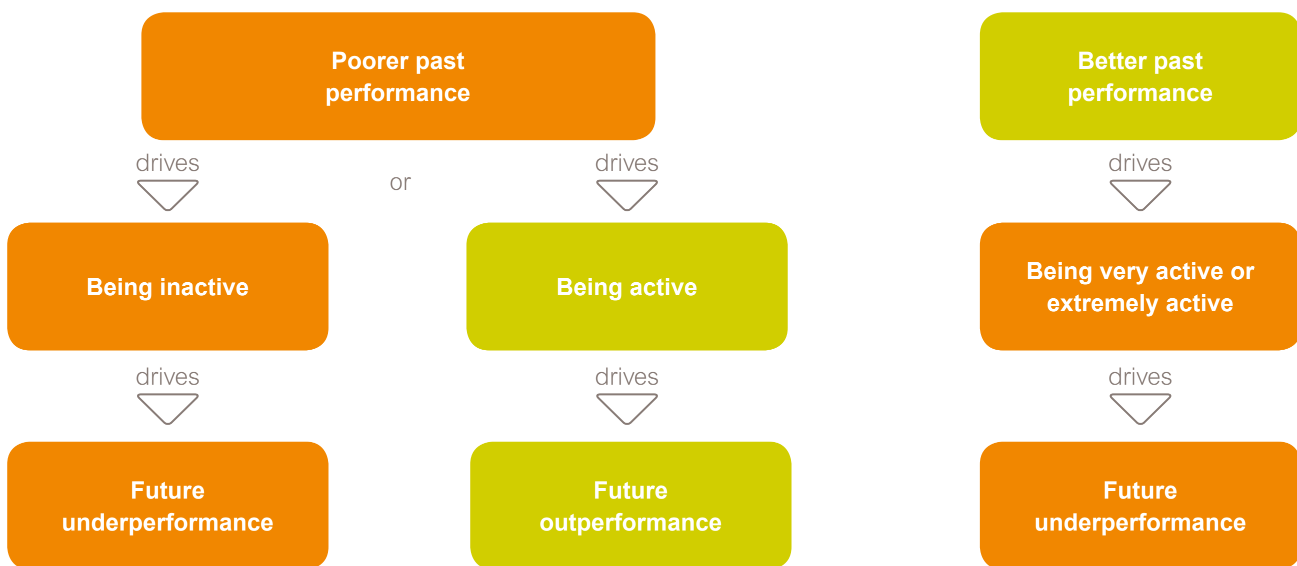
Causality – does a firm's past performance drive future frequency of M&A activity or does M&A frequency drive future performance?

Chart 4. Causality links between performance and M&A frequency (**acquisitions and divestments**)



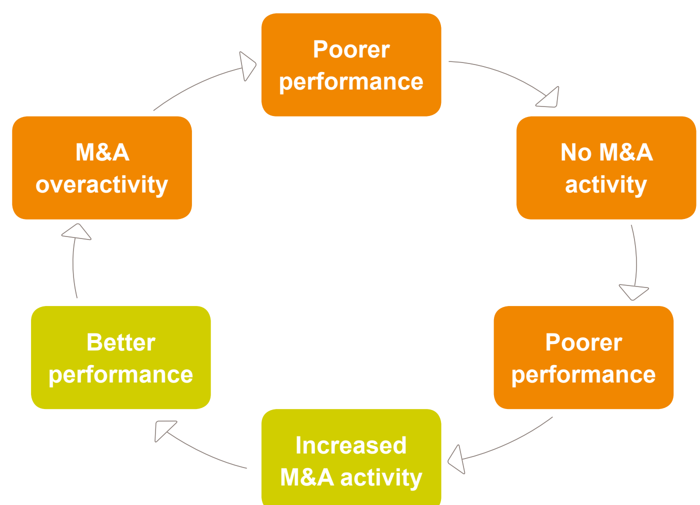
To understand the causality links between firms' performance and M&A frequency, and vice versa, the study is able to analyse the dataset using time-series regression techniques to look at:

- whether differences in firms' past returns performance are driving the frequency of M&A activity; and
- to what extent M&A frequency is driving future returns performance.

The study finds that *poorer* performance in past periods drives firms to be either inactive or active, which then drives future outperformance (active firms) or future underperformance (inactive firms); however, *better* performance in past periods then drives firms to become over-active, which drives down future returns, leading to underperformance. These causality relationships between firms' performance and the frequency of M&A activity are shown in Chart 4 above.

The causality links between a firm's performance and M&A frequency found by the study would appear to offer a possible explanation for the apparent cyclicality of M&A, which can be summarised in Chart 5 below.

Chart 5. Cyclicality of firm performance and M&A frequency



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What effect does maturity as a publicly listed company have on these results?

Further insights into the relationships between the frequency of M&A activity and firm performance can be obtained by analysing the results along an additional dimension – that of the maturity of the firm since its public listing. When considering age as a public company as an additional factor, the study strongly suggests that the optimum M&A strategy for "young" firms (defined as those which have been publicly listed for a maximum of three years) is different from companies that are medium-aged (publicly listed for more than three but less than 10 years) and those that are mature (publicly listed for at least 10 years).

Buy while you're young

As with the full sample, young firms also show a positive relationship between increasing frequency of acquisition activity and returns, as Chart 6 shows. However, young companies only manage to outperform the market (by an average of 3.8% per annum) during periods when they are announcing at least two acquisitions per year on average, whereas young companies overall are found to significantly underperform the market, by an average of -5.6% per annum.

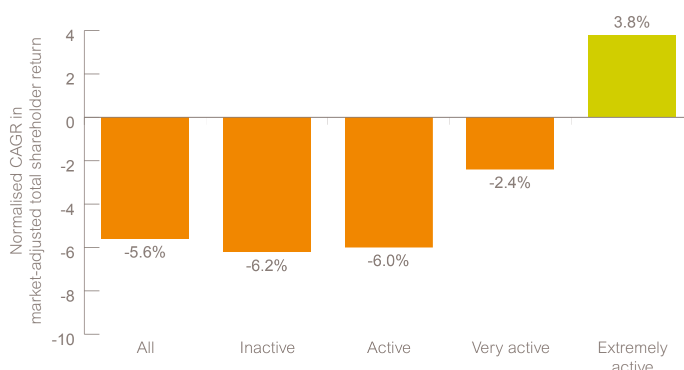
These results would appear to suggest strongly that newly publicly listed companies are expected to achieve rapid growth, including through M&A activity, and that making a significant number of acquisitions in the three years after listing is viewed positively by investors and is rewarded. The chief financial officer at a US electromedical and control instruments manufacturer comments on this result: "With any newly listed company, there are a lot of expectations from investors. To maintain its value, a newly listed company has to take concrete measures for growth in a short time period. Acquisitions are therefore a way of pleasing investors and also growing the business."

> "When done effectively, acquisitions after listing can generate real choices for a company to grow."

The chief strategy officer at a US computer programming firm agrees: "Acquisitions are often a necessary path for a young company that has newly listed and has a lot of cash in hand. Acquisitions will allow the firm to introduce new expertise and advance its capabilities, while accelerating growth in the business."

"When done effectively, acquisitions after listing can generate real choices for a company to grow," adds the director of corporate development at a UK rubber and plastic products manufacturer.

Chart 6. Relationship between **acquisition** frequency and returns (**young** companies)



As Chart 7 shows, when considering their frequency of divestment activity alone, the average performance results for young firms show a strong negative bias across almost all divestment frequency categories, with the only exception being a small 1% per annum outperformance by young firms during periods when they are extremely active (announcing at least two divestments per year on average). However, this level of extremely active divestment frequency is undertaken by only 51 of the firms in the sample of 9,292 young firms, or 0.5% of the sample. These results reflect the fact that divestment activity by young firms is relatively rare, as newly listed firms will generally be in a strong growth phase. In fact, the study finds that only 27% of firms announce at least one divestment while they are young, compared to 49% of firms when they become medium-aged and 68% of firms when they are mature.

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Chart 7. Relationship between **divestment** frequency and returns (**young** companies)

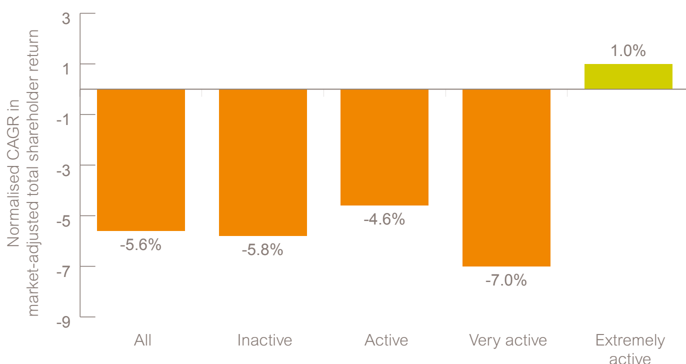
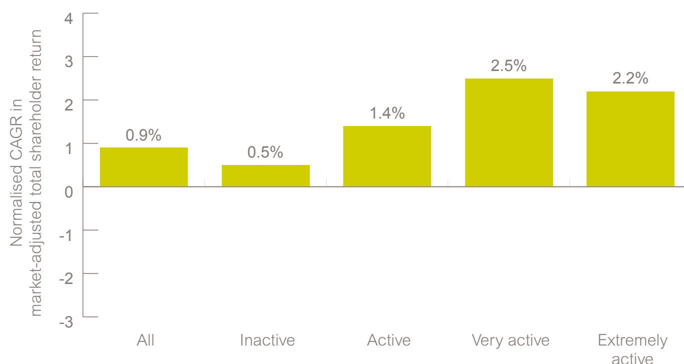


Chart 8. Relationship between **acquisition** frequency and returns (**mature** companies)



As Chart 7 shows, the study finds that companies that undertake divestments during their first three years as publicly listed firms, on average, significantly underperform the market. One possible reason for this underperformance could be that young public companies undertaking divestments are not signalling "growth" opportunities strongly enough to investors.

Age concerns

As shown in Chart 8, the performance of mature companies (those publicly listed for 10 or more years) also shows a broadly positive relationship with increasing acquisition frequency. The highest average market-adjusted return of 2.5% per annum is found during periods when mature firms are very active (announcing one to two acquisitions per annum on average), but dips slightly, to 2.2% per annum, during periods when mature firms become extremely active (announcing two or more acquisitions per annum on average).

These results suggest that mature companies should continue to seek acquisition opportunities for growth, but that the very highest frequency of acquisition activity may only be advisable during their younger years. A mature firm may need to think more carefully about the consequences of adding and integrating new acquisitions to an existing portfolio of businesses and products in order to achieve expected returns and synergies.

The executive vice president of global corporate development at a US professional services firm comments on this finding: "A firm needs to have the capacity to manage an acquisition well to deliver the expected performance. When there is a high number of deals, the time allowed for each becomes constrained, making it sometimes difficult to get the value expected."

"A firm needs to have the capacity to manage an acquisition well to deliver the expected performance."

"A large number of deals means that M&A may be consuming critical organisational resources which could result in a lack of proper integration," adds the director of corporate development at a UK rubber and plastic products manufacturer.

As shown in Chart 9, when looking at their divestment activity alone, the pattern for mature companies is similar to that of the overall sample, with companies outperforming the market by 3% per annum on average during periods when they are "actively" divesting (announcing one or two divestments during a three-year period) and underperforming the market during periods when announcing three or more divestments during a three-year period.

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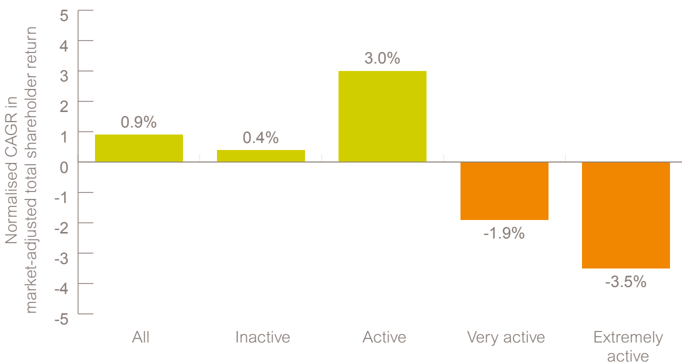
Chart 9. Relationship between **divestment** frequency and returns (**mature** companies)

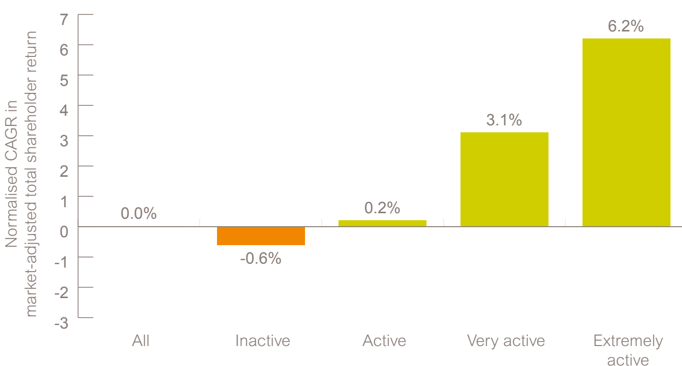


Middle-aged spread

For medium-aged companies (those publicly listed for more than three but less than 10 years) the performance pattern for acquisitions is similar to that of young companies, while the pattern for divestments is similar to that of mature companies.

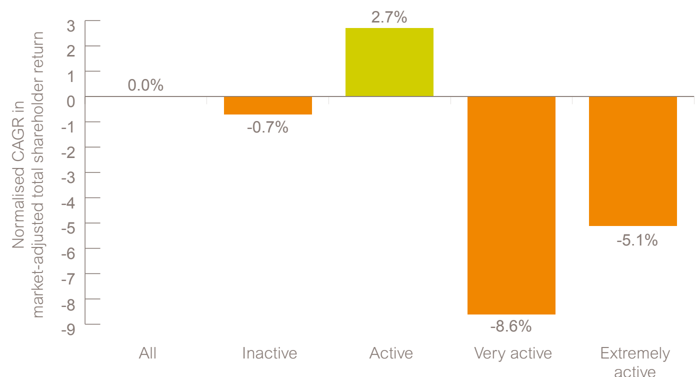
As shown in Chart 10, there is again evidence that average market-adjusted returns increase during periods of increasing acquisition frequency. For medium-aged firms, peak returns of 6.2% per annum are observed during periods when they are extremely active (two or more acquisitions announced per annum on average). Medium-aged firms that announce one to two acquisitions per annum on average also outperform the market by an average of 3.1% per annum. In contrast, merely active medium-aged firms perform almost in line with the market and medium-aged firms that are inactive underperform the market.

Chart 10. Relationship between **acquisition** frequency and returns (**medium-aged** companies)



As shown by Chart 11, when considering their divestment activity alone, the returns performance for medium-aged companies is significantly worse than the market during periods of high frequency of divestments (very active and extremely active), even worse than either the young or mature firms – medium-aged firms announcing a high frequency of divestments may be signalling strategic, operational or financial difficulties, which could be a cause of their underperformance. Similar to the mature firms, medium-aged firms only outperform the market, by 2.7% per annum, during periods when they are announcing one or two divestments during a three-year period.

Chart 11. Relationship between **divestment** frequency and returns (**medium-aged** companies)



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About Cass

Cass Business School, which is part of City University London, delivers innovative, relevant and forward-looking education, training, consultancy and research. Located in the heart of one of the world's leading financial centres, Cass is the business school for the City of London.

Our MBA, specialist Masters and undergraduate degrees have a global reputation for excellence, and the School supports nearly 100 PhD students.

Cass offers the widest portfolio of specialist Masters programmes in Europe. It also has the largest faculties of Finance and Actuarial Science and Insurance in the region. It is ranked in the top 10 UK business schools for business, management and finance research and 90% of the research output is internationally significant. Cass is a place where students, academics, industry experts, business leaders and policymakers can enrich each other's thinking.

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About Intralinks

In 1997, Intralinks (NYSE: IL) pioneered the use of software-as-a-service solutions for business collaboration and transformed the way companies work; initially for the debt capital markets and M&A communities. Today, Intralinks empowers global companies to share content and collaborate with business partners without losing control over information. Through the Intralinks platform, companies and third parties can securely share and collaborate on even the most sensitive documents – while maintaining compliance with policies that mitigate corporate and regulatory risk.

Intralinks Dealspace™
The market-leading deal management and virtual data room (VDR) solution supports all parties involved throughout the M&A lifecycle: from deal preparation through to marketing, due diligence, closing and post-merger integration. Intralinks Dealspace enables financial advisors, legal advisors and corporate development officers to securely collaborate and share confidential information while maintaining complete control over content.

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