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Rethinking the M&A process: Learning private equity's secret to outperforming corporate strategic acquirers

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When private equity (PE) fails, it often fails with a big bang. As a result, the PE industry has received ample criticism for the “pain they inflict” on the businesses they buy. It has become a familiar narrative that when a PE firm takes control of a company, draconian cost cuts follow while at the same time the company is saddled with unsupportable debt, ultimately leading to disastrous results, including mass layoffs and eventual bankruptcy for the business. While high profile examples can be identified to support this perception including Toys-R-Us, Payless Shoes and RadioShack [1], the actual data tells a different story. Though many view PE firms as value-destroyers, various peer-reviewed studies have found that PE-backed firms have a surprisingly favorable record. [2]

A revealing look at the record of PE-backed companies

- PE-backed companies do not suffer from higher mortality rates, unless backed by inexperienced private equity funds.
- PE-backed firms are not any more likely to default than other firms with similar debt characteristics.
- Creditors of PE-backed firms recover 63 percent of secured debt against 30 percent for listed companies.
- Buyouts sponsored by high reputation PE firms are less likely to experience financial distress or bankruptcy after a buyout.
- PE-backed deals are somewhat more likely to go bankrupt than listed companies, but this includes buyouts of distressed firms, which are significantly more likely to fail.
- The net effect across 31 highly leveraged transactions (HLTs) was an increase from pre-transaction to post-transaction value, suggesting that “overall the HLTs [in the study sample] succeeded in creating value.”
- Overpayment by PE firms for deals, rather than high leverage is the major cause of subsequent business distress.

Corporate strategic acquirers too often destroy shareholder value

After the lull caused by Covid-19, merger and acquisition (M&A) activity has come roaring back for both “strategic buyers” -- companies that endeavor to use M&A to

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3 supplement or grow their operations -- as well as for “financial buyers” -- private equity
4 firms (see Exhibit 1). [3] However, ample evidence exists demonstrating that corporate
5 strategic buyers experience significant difficulty in creating value from their transactions.
6 For example, a broad analysis of 2,500 deals found that more than 60 percent
7 destroyed shareholder value. [4] Recent high-profile examples of value-destroying
8 strategic buyer transactions include:
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- 10 • Bayer’s ill-fated \$63bn U.S. acquisition of Monsanto. Within two years after
11 completing the deal in 2018, Bayer’s market value dropped to half of where it was
12 when the deal was completed. [5]
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- 14 • Occidental Petroleum’s \$55bn acquisition of Anadarko. A year after acquiring
15 Anadarko in 2019, Occidental Petroleum’s market capitalization fell from about \$42bn
16 on the day the Anadarko deal completed to roughly \$12bn, and the firm cut its
17 dividend by almost 90 percent, their first dividend cut since 1991. [6]
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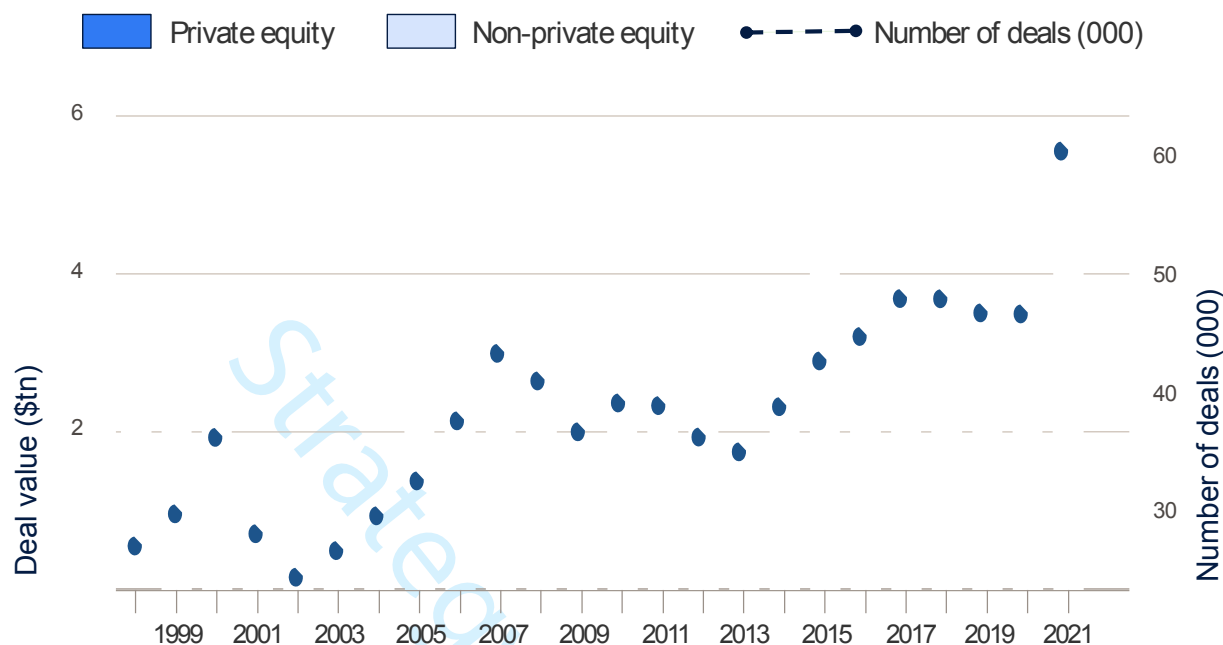
20 The poor results for strategic buyers have been attributed to a variety of management
21 missteps across the process in M&A strategy -- target identification, due diligence,
22 negotiation, integration and measurement. [7] As another wave of M&A is driving
23 valuations of acquired assets ever higher, achieving projected value from transactions is
24 likely to be increasingly challenging. [8]
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28 **Private equity firms create value for their investors**

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30 Although M&A transactions often destroy shareholder value for corporate strategic
31 buyers, PE firms, whose business model is predicated upon repeating M&A, have a
32 better record of creating value for their investors. The average annual return to investors
33 across 1,297 U.S. private equity funds was 14.23 percent after management fees over a
34 25-year period through Q2 2021 compared with 9.69 percent for the Russell 3000. [9]
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36 Moreover, the increasingly popular PE “buy and build” approach -- comparable to a
37 strategic buyer adding multiple business to an existing entity -- appears to be even more
38 effective at generating returns than stand-alone deals, resulting in a reported average
39 internal rate of return of 31.6 percent from entry to exit compared with 23.1 percent for
40 standalone PE-owned businesses. [10] Based upon the data there is an apparent
41 paradox: PE creates value for their investors by repeatedly pursuing what conventional
42 thinking sees as a shareholder value-destroying activity for corporate strategic buyers.
43 How can this paradox be explained?
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Exhibit 1. Annual M&A activity**Private equity's programmatic approach to value creation**

PE employs two basic strategies within their business model to create value for investors. The first is to increase the value of the “stand-alone” assets they acquire by increasing the cash flows of those businesses through standard operating cost reductions and revenue enhancement activities such as renegotiating supplier contracts, tightening inventory controls, zero-based budgeting, selling non-core assets, expanding into new markets and re-pricing the company's goods and services. [11]

The second approach -- analogous to a strategic buyer approach -- is for a PE firm to grow an acquired asset through a “buy and build” or “add on” strategy of several subsequent acquisitions to expand operations, generate value and increase returns. Use of the buy and build approach has grown in popularity across the PE industry, from one-fifth of all transactions in 2003 to approximately one-third of all PE transactions in 2019. [12] A buy-and-build strategy is accomplished through the acquisition of a “platform company” -- one with already established internal capabilities that can be built upon. Add-on businesses are then sequentially acquired, and their operations integrated into the platform company to create a larger and more valuable entity.

Buy and build PE transactions often target fragmented sectors as opportunities to consolidate an industry. A classic example comes from the United Kingdom's funeral industry. Dignity funeral services was a buy and build platform established by Montagu Private Equity (MPE.) After being acquired by MPE, Dignity initially grew almost entirely by conducting add on acquisitions of family-owned funeral businesses. Once at scale, Dignity began achieving cost reduction and revenue improvement synergies by

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3 changing the logistics of the business, raising prices and cross-selling other services
4 such as monuments. The success of the Dignity add on strategy was such that it
5 attracted imitators within the United Kingdom's funeral industry, which transformed from
6 fragmented to concentrated almost entirely due to the activities of PE funds. Dignity is
7 now a quoted company on the London Stock Exchange. [13]
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11 The PE playbook

12 Based on over three-decades of advisory work with various private equity firms in
13 Europe and the US, an unmistakable characteristic is commonly noticeable across the
14 industry: PE firms' approach their deal-making as a repeatable process driven activity,
15 especially when employing a buy-and-build strategy. The PE transaction process entails
16 seasoned dealmakers, trusted external advisors -- attorneys, bankers, consultants,
17 accountants, technology specialists -- experienced operators and expert functional
18 leaders -- IT, HR, legal and marketing -- using a repeatable "playbook" to drive value
19 creation. The critical aspects that comprise the PE playbook are organized around the
20 three main deal phases -- Pre-deal, Deal and Post-deal:
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23 **Pre-deal – Thematic investing:** The first component of the PE playbook entails
24 systematically scouring markets for potential investment opportunities. PE firms do this
25 both by regularly interacting with bankers who represent sellers of businesses and by
26 analyzing markets thematically looking for attractive sectors to target using a rigorous
27 and systematic acquisition filter. [14]
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30 **The Deal – Identifying issues and developing plans:** Once actively engaged in
31 discussions with target firms, PE firms commence established due diligence
32 procedures, employing well-developed checklists to identify potential issues and
33 opportunities in key areas including accounting, tax, legal and regulatory, operations,
34 technology, human resources, pensions, environmental, markets and organizational
35 culture. [15] Information gathered during due diligence is also used during the deal
36 phase by the PE firm's deal team, often working with the seller's management, to create
37 a "100-day plan" to be executed immediately after the business is acquired.
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40 **Post-Deal – 100 Days and Beyond:** The post-deal 100-day plan typically entails
41 strategy, operational, technology, human resources and other changes to the acquired
42 company's business designed to achieve cost efficiencies and increase revenue.
43 Additionally, PE firms frequently change the acquired company's governance structure
44 by drawing from a "bench" of experienced, industry-knowledgeable senior executives
45 and appointing them to a top-level position in the acquired company post-transaction.
46 This is another key element of the PE playbook, which is designed to reinforce strategic
47 and operational changes beyond the first 100-days of ownership.
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52 The PE playbook at Visma

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54 Owned by the private equity firm HgCapital, Visma, headquartered in Oslo, Norway, offers a
55 range of software solutions for businesses, organizations and the public sector. Visma's "buy
56 and build" M&A strategy is focused on acquiring future sector leaders and profitable fast-
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growing Software-as-a-Service companies to bring in and expand the Visma product portfolio. At the same time, Visma gains cost efficiencies from integrating the back-office functions – including HR, accounting and, legal -- of the firms they acquire, as well as realizing revenue synergies through joint marketing and cross-selling of newly acquired products.

To accelerate both cost and revenue synergy realization, HgCapital has worked with the Visma management to build Visma's "deal-making muscle," turning Visma's acquisition approach into a repeatable process-driven activity entailing seasoned dealmakers using a repeatable "playbook." Their M&A playbook has enabled Visma to continually assess the market for potential investment opportunities. Then, once engaged with a target firm, Visma employs well-established due diligence procedures and checklists to 1) refine their valuation modeling, 2) detect potential post-deal issues and opportunities and 3) develop detailed "first 100-day" post-deal close execution plans. As a result, once Visma completes an acquisition they are immediately prepared to implement strategic, operational, technology, human resources and other changes to the acquired company's business model designed to rapidly achieve cost efficiencies and increase revenue. Since 2015, Visma has applied their "playbook" to conduct over 120 acquisitions.

Nic Humphries, Senior Partner and Executive Chairman of HgCapital notes, "At Visma, we have worked with the experienced management team to develop an M&A engine with a proven and repeatable process to identify and acquire software companies and improve their performance post-acquisition."

Strategic buyers should take lessons from the PE playbook

Although the history M&A value destruction presents a challenging picture for corporate strategic buyers, the news isn't all bad. An analysis of 228 bank mergers found that combining two key factors enhance deal performance. The first factor, "tacit knowledge," consists of M&A experience and exists largely in the minds of executives, managers and employees. The second factor, "codified knowledge," consists of written procedures that a company articulates and codifies through standards and methods that guide actions and decision-making throughout the M&A process. [16] PE firms apply both tacit and codified M&A knowledge during deals – implemented by seasoned dealmakers who utilize repeatable playbooks. Furthermore, a recent study of the largest 2,000 global companies by market capitalization assessed the excess total returns to shareholders by transaction type over a ten-year period, finding that "programmatically M&A" (+2.1 percent) outperformed large-deal M&A (-1.3 percent), intermittent M&A (-1.3 percent), and organic growth (-2.0 percent). [17] Programmatic M&A is precisely the approach PE firms take.

While a clear M&A process has been shown to improve deal success, unlike PE firms, research has found that 60 percent of surveyed strategic buyer executives indicated their companies do not have a comprehensive end-to-end M&A approach using a playbook. [18] So it stands to reason that strategic buyers can improve transaction results by emulating the PE approach by developing their own internal M&A talent and identifying external M&A service providers who all diligently apply a transaction playbook that spans the three key deal phases: Pre-deal, Deal and Post-deal (see

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3 Exhibit 2). Exhibit 3 summarizes seven steps strategic buyers can take to build their
4 own transaction playbook across the three deal phases [19] identified in Exhibit 2 by:
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- 6 • Conducting an M&A performance assessment.
- 7 • Performing an internal M&A talent inventory.
- 8 • Completing an external M&A service provider inventory.
- 9 • Performing an M&A tools and templates inventory.
- 10 • Conducting cross-functional M&A training.
- 11 • Producing an M&A knowledge repository.
- 12 • Performing M&A competence maintenance.
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16 **Take-aways**

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18 Although M&A has been found to be a shareholder value-destroying activity for strategic
19 buyers, research shows that PE firms are able to create value for their investors across
20 multiple transactions. PE firms' success can be attributed to employing seasoned
21 dealmakers who consistently apply a transaction "playbook" across their deals.
22 Strategic buyers can improve shareholder returns by learning from the PE approach,
23 developing their own internal M&A talent and identifying external M&A service providers
24 who diligently apply a playbook across each transaction.
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27 **[Quotes]**

28 **"Though many view PE firms as value-destroyers, various peer-reviewed studies**
29 **have found that PE-backed firms have a surprisingly favorable record."**

30 **"Ample evidence exists demonstrating that corporate strategic buyers experience**
31 **significant difficulty in creating value from their transactions."**

32 **"Although M&A transactions often destroy shareholder value for corporate**
33 **strategic buyers, PE firms, whose business model is predicated upon repeating**
34 **M&A, have a better record of creating value for their investors."**

35 **"An apparent paradox: PE creates value for their investors by repeatedly pursuing**
36 **what conventional thinking sees as a shareholder value-destroying activity."**

37 **"The critical aspects that comprise the PE playbook are organized around the**
38 **three main deal phases – Pre-deal, Deal and Post-deal."**

39 **"Research has found that 60 percent of surveyed strategic buyer executives**
40 **indicated their companies do not have a comprehensive end-to-end M&A**
41 **approach using a playbook."**
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3 **Exhibit 2.** Three key M&A playbook phases
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	Key Objectives	Core Activities
Pre-deal	Clear M&A strategy	<ul style="list-style-type: none"> Define the business strategy. Define an M&A strategy to support the business strategy.
	Targets that fit the M&A strategy	<ul style="list-style-type: none"> Identify potential targets. Assess strategic and organizational “fit” of potential targets.
	No surprises after deal close	<ul style="list-style-type: none"> Conduct financial, operational, legal, technological, and organizational due diligence. Draft operational and cultural integration plans. Draft communications plan. Draft key talent retention plan. Draft key customer retention plan.
Deal	Realistic bidding range	<ul style="list-style-type: none"> Determine cost and revenue assumptions. Develop valuation models using multiple techniques.
	Agreed deal terms	<ul style="list-style-type: none"> Meet with target’s negotiating team. Discuss and agree deal terms. Submit bid (in an auction transaction).
	Transaction close	<ul style="list-style-type: none"> Draft transaction documentation. Sign documentation. Gain regulatory approval. Transfer transaction funding.
Post-deal	Synergy capture	<ul style="list-style-type: none"> Execute integration plans. Adjust implementation as needed. Implement key customer retention and “re-recruitment” plan.
	Maximum workforce productivity	<ul style="list-style-type: none"> Implement communications plan. Implement key talent retention and “re-recruitment” plan. Implement cultural integration plan.
	Additional revenue growth	<ul style="list-style-type: none"> Transfer knowledge between firms. Develop and implement new or enhanced products, services, and/or processes.
	Measured and reported deal success	<ul style="list-style-type: none"> Track and report operational integration activities and milestones. Track and report cultural integration activities and milestones. Track and report key talent retention activities and milestones. Track and report synergy capture (cost reduction and revenue enhancement).

Exhibit 3. Seven steps for strategic buyers to build a repeatable transaction playbook

Steps	Key Activities
1. Conduct an M&A performance assessment	<ul style="list-style-type: none"> • Identify recent M&A transactions. • Identify what went well and what could have been done better across the entire M&A process (i.e., pre-deal, deal, post-deal). • Catalog key learnings to apply to future M&As during each M&A stage.
2. Perform an internal M&A talent inventory	<ul style="list-style-type: none"> • Identify key M&A talent across functions (finance, HR, IT, operations, legal, etc.). • Identify roles each person has performed during past M&A efforts and will be able to perform during future efforts throughout each deal stage. • Catalog key M&A talent identified.
3. Complete an external M&A service provider inventory	<ul style="list-style-type: none"> • Identify key service providers used in prior M&As (e.g., legal, financial, tax, etc.). • Identify potential other service providers and determine how each could support talent on future M&As. • Conduct analysis of current and potential M&A service providers to determine “best fit” with the company. • Select future M&A service providers.
4. Perform an M&A tools and templates inventory	<ul style="list-style-type: none"> • Conduct M&A tools and templates inventory across functions and M&A stages (e.g., due diligence checklists, valuation templates, communications planning matrix, cultural analysis and integration matrix, integration project management tools, etc.). • Identify M&A tools overlaps and gaps. • Rationalize tools overlaps and gaps. • Catalog future M&A tools and templates.
5. Conduct cross-functional M&A training	<ul style="list-style-type: none"> • Identify M&A training needs/objectives, based on the recent M&A performance and key M&A talent capabilities assessments above. • Develop training content for each transaction stage, designed to achieve each training objective identified. • Identify training participants representing various functions based on the M&A talent inventory above. • Schedule and conduct cross-functional M&A training.
6. Produce an M&A knowledge repository	<ul style="list-style-type: none"> • Establish an M&A knowledge repository, housed on the firm’s intranet, for each deal stage. • Populate the repository with M&A tools and templates across each of the M&A stages.
7. Perform M&A competence maintenance	<ul style="list-style-type: none"> • Conduct regular reviews of M&A tools, templates and talent. • Update tools, templates and talent in the M&A repository as needed.

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