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Should assessing financial similarity be part of your corporate portfolio strategy?

Businesses with different financial profiles can tax managers and put performance at risk. When divesting isn't an option, here's how to manage the conflicts.

Tim Koller, Dan Lovallo, and Zane Williams

Strategic connections among, for example, a company's suppliers, customers, skills, and technology have long been the sine qua non of corporate portfolio decisions. Businesses that are strategically similar—or *related*, in the parlance of portfolio theory—belong in the same company. Those that aren't, the theory posits, would be better owned by someone else.

What we are calling *financial similarity* may be just as relevant. In a recent survey of more than 1,200 executives,[1] we found that those managing portfolios of financially similar businesses are 20 percent more likely than those managing financially dissimilar portfolios to describe themselves as more profitable and faster growing than their peers (exhibit). Financial similarity is not an issue addressed in discussions of portfolio theory, and (other than among executives at complex conglomerates) we frequently find that it's a subconscious issue for many executive teams. As a result, they underestimate the difficulty of managing businesses with fundamentally different economic characteristics—including revenues, margins, capital intensity, and revenue growth.

How does financial dissimilarity affect performance? In part, it's a cognitive challenge for managers to make comparisons across businesses with dissimilar business models, growth rates, and maturity.[2] Using different metrics to evaluate and capture the complexity of the portfolio complicates comparisons, while turning to coarser metrics or crude rules of thumb leads to worse decisions.

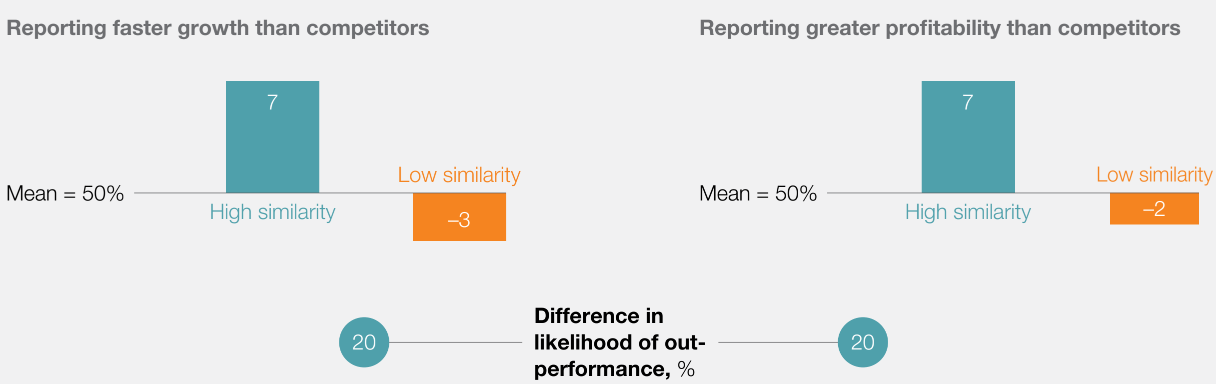
Managers of financially dissimilar businesses also often face greater internal political challenges. Performance goals and resource allocation necessarily vary across units that differ in business model, scale, or maturity, and that variability can generate conflict. This is especially true when some units are given a budget to invest and grow while others are asked to cut costs, or when one unit's goals seem easier to hit than do another's. As a result, large, established units often end up with more of a company's resources than their performance warrants—at the expense of small, faster-growing businesses. Large, powerful business units are often not cash cows but rather just fat cows.

When strategic linkages among businesses are limited or nonexistent, often the most value-creating solution is just to divest or spin off those with significantly different financial characteristics from the core business. But in many cases, the strategic advantages of keeping financially dissimilar businesses in the same portfolio may outweigh the inevitable challenges. For example, consider a company that serves the same customers with two businesses: one that supports a legacy, analog technology and another that supports a transition to an emerging digital one. Or consider companies with units that offer complementary goods to common customers, such as the

Exhibit

Financially similar companies are more likely to outperform peers.

Difference, relative to the mean, between the share of high- and low-similarity companies,[1]
percentage-point difference in survey responses



[1] Financial similarity defined as companies with business units that have similar size, margins, returns on capital, and revenue growth.
Source: McKinsey Investment Performance Survey

manufacturing, servicing, and financing of equipment or combinations of products and an advisory/data business.

In these cases, a company must make an extra effort to ensure that all units are managed to maximize value. This might entail combining financially dissimilar businesses into a separate unit with distinct and specialized management—much as Google did when it renamed itself Alphabet. Managers there left the core business in a central Google division and designated smaller, newer businesses as separate units—which it reports collectively to investors as "Other Bets"—under Alphabet's CEO.[3]

A company might also implement a flat accounting structure, eliminating most intermediate reporting units. With unit results reported at a highly detailed level, for as many as 50 or more units, managers could more easily identify smaller, faster-growing businesses, protect their resources, and foster their development. Both approaches protect the budgets and other resources of small units embedded in larger ones from cuts to their product development or advertising spending to meet the larger unit's budget. A company might also consider more structural protection for smaller-unit budgets, commonly known as ring-fencing.

Similarly, a company's planning processes must differentiate performance targets for different units, rather than applying broad corporate programs to all units. For example, some units may need to be exempt from a broad general and administrative cost-reduction program. For very new fast-growing units, more emphasis might be shifted to revenue targets rather than profit targets, or even to meeting specific nonfinancial objectives, such as launching a product by a certain date. Targets for more mature units might put more weight on margins and return on capital.

■ ■ ■

Financial similarity is an issue that's seldom a part of corporate portfolio discussions. Our research suggests that companies will benefit if more leaders become more aware of the challenge and look for opportunities to address it. ■

[1] The online survey was in the field from April 12 to April 22, 2016, and received responses from 1,271 executives. Analysis controlled for strategic linkages as well as industry, region, company size, and functional specialties.

[2] See, for example, Robert L. Goldstone, "Similarity, interactive activation, and mapping," *Journal of Experimental Psychology: Learning, Memory, and Cognition*, 1994, Volume 20, Number 1, pp. 3–28; Arthur B. Markman and Dedre Gentner, "Structural alignment during similarity comparisons," *Cognitive Psychology*, 1993, Volume 25, Number 4, pp. 431–67.

[3] Alphabet Inc. Form 10-K, US Securities and Exchange Commission, December 31, 2016, sec.gov.

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McKinsey Classic

The six types of successful acquisitions

Companies advance myriad strategies for creating value with acquisitions—but only a handful are likely to do so.

Marc Goedhart, Tim Koller, and David Wessels

There is no magic formula to make acquisitions successful. Like any other business process, they are not inherently good or bad, just as marketing and R&D aren't. Each deal must have its own strategic logic. In our experience, acquirers in the most successful deals have specific, well-articulated value creation ideas going in. For less successful deals, the strategic rationales—such as pursuing international scale, filling portfolio gaps, or building a third leg of the portfolio—tend to be vague.

Empirical analysis of specific acquisition strategies offers limited insight, largely because of the wide variety of types and sizes of acquisitions and the lack of an objective way to classify them by strategy. What's more, the stated strategy may not even be the real one: companies typically talk up all kinds of strategic benefits from acquisitions that are really entirely about cost cutting. In the absence of empirical research, our suggestions for strategies that create value reflect our acquisitions work with companies.

In our experience, the strategic rationale for an acquisition that creates value typically conforms to at least one of the following six archetypes: improving the performance of the target company, removing excess capacity from an industry, creating market access for products, acquiring skills or technologies more quickly or at lower cost than they could be built in-house, exploiting a business's industry-specific scalability, and picking winners early and helping them develop their businesses.

Six archetypes

An acquisition's strategic rationale should be a specific articulation of one of these archetypes, not a vague concept like growth or strategic positioning, which may be important but must be translated into something more tangible. Furthermore, even if an acquisition is based on one of the archetypes below, it won't create value if a company overpays.

Improve the target company's performance

Improving the performance of the target company is one of the most common value-creating acquisition strategies. Put simply, you buy a company and radically reduce costs to improve margins and cash flows. In some cases, the acquirer may also take steps to accelerate revenue growth.

Pursuing this strategy is what the best private-equity firms do. Among successful private-equity acquisitions in which a target company was bought, improved, and sold, with no additional acquisitions along the way, operating-profit margins increased by an average of about 2.5 percentage points more than those at peer companies during the same period.[1] This means that many of the transactions increased operating-profit margins even more.

Keep in mind that it is easier to improve the performance of a company with low margins and low returns on invested capital (ROIC) than that of a high-margin, high-ROIC company. Consider a target company with a 6 percent operating-profit margin. Reducing costs by three percentage points, to 91 percent of revenues, from 94 percent, increases the margin to 9 percent and could lead to a 50 percent increase in the company's value. In contrast, if the operating-profit margin of a company is 30 percent, increasing its value by 50 percent requires increasing the margin to 45 percent. Costs would need to decline from 70 percent of revenues to 55 percent, a 21 percent reduction in the cost base. That might not be reasonable to expect.

Consolidate to remove excess capacity from industry

As industries mature, they typically develop excess capacity. In chemicals, for example, companies are constantly looking for ways to get more production out of their plants, even as new competitors, such as Saudi Arabia in petrochemicals, continue to enter the industry.

The combination of higher production from existing capacity and new capacity from recent entrants often generates more supply than demand. It is in no individual competitor's interest to shut a plant, however. Companies often find it easier to shut plants across the larger combined entity resulting from an acquisition than to shut their least productive plants without one and end up with a smaller company.

Reducing excess in an industry can also extend to less tangible forms of capacity. Consolidation in the pharmaceutical industry, for example, has significantly reduced the capacity of the sales force as the product portfolios of merged companies change and they rethink how to interact with doctors. Pharmaceutical companies have also significantly reduced their R&D capacity as they found more productive ways to conduct research and pruned their portfolios of development projects.

While there is substantial value to be created from removing excess capacity, as in most M&A activity the bulk of the value often accrues to the seller's shareholders, not the buyer's. In addition, all the other competitors in the industry may benefit from the capacity reduction without having to take any action of their own (the free-rider problem).

Accelerate market access for the target's (or buyer's) products

Often, relatively small companies with innovative products have difficulty reaching the entire potential market for their products. Small pharmaceutical companies, for example, typically lack the large sales forces required to cultivate relationships with the many doctors they need to promote their products. Bigger pharmaceutical companies sometimes purchase these smaller companies and use their own large-scale sales forces to accelerate the sales of the smaller companies' products.

IBM, for instance, has pursued this strategy in its software business. Between 2010 and 2013, IBM acquired 43 companies for an average of $350 million each. By pushing the products of these companies through IBM's global sales force, IBM estimated that it was able to substantially accelerate the acquired companies' revenues, sometimes by more than 40 percent in the first two years after each acquisition.[2]

In some cases, the target can also help accelerate the acquirer's revenue growth. In Procter & Gamble's acquisition of Gillette, the combined company benefited because P&G had stronger sales in some emerging markets, Gillette in others. Working together, they introduced their products into new markets much more quickly.

Get skills or technologies faster or at lower cost than they can be built

Many technology-based companies buy other companies that have the technologies they need to enhance their own products. They do this because they can acquire the technology more quickly than developing it themselves, avoid royalty payments on patented technologies, and keep the technology away from competitors.

For example, Apple bought Siri (the automated personal assistant) in 2010 to enhance its iPhones. More recently, in 2014, Apple purchased Novauris Technologies, a speech-recognition-technology company, to further enhance Siri's capabilities. In 2014, Apple also purchased Beats Electronics, which had recently launched a music-streaming service. One reason for the acquisition was to quickly offer its customers a music-streaming service, as the market was moving away from Apple's iTunes business model of purchasing and downloading music.

Cisco Systems, the network product and services company (with $49 billion in revenue in 2013), used acquisitions of key technologies to assemble a broad line of network-solution products during the frenzied Internet growth period. From 1993 to 2001, Cisco acquired 71 companies, at an average price of approximately $350 million. Cisco's sales increased from $650 million in 1993 to $22 billion in 2001, with nearly 40 percent of its 2001 revenue coming directly from these acquisitions. By 2009, Cisco had more than $36 billion in revenues and a market cap of approximately $150 billion.

Exploit a business's industry-specific scalability

Economies of scale are often cited as a key source of value creation in M&A. While they can be, you have to be very careful in justifying an acquisition by economies of scale, especially for large acquisitions. That's because large companies are often already operating at scale. If two large companies are already operating that way, combining them will not likely lead to lower unit costs. Take United Parcel Service and FedEx, as a hypothetical example. They already have some of the largest airline fleets in the world and operate them very efficiently. If they were to combine, it's unlikely that there would be substantial savings in their flight operations.

Economies of scale can be important sources of value in acquisitions when the unit of

Economies of scale are often cited as a key source of value creation in M&A. While they can be, you have to be very careful in justifying an acquisition by economies of scale, especially for large acquisitions.

incremental capacity is large or when a larger company buys a subscale company. For example, the cost to develop a new car platform is enormous, so auto companies try to minimize the number of platforms they need. The combination of Volkswagen, Audi, and Porsche allows all three companies to share some platforms. For example, the VW Toureg, Audi Q7, and Porsche Cayenne are all based on the same underlying platform.

Some economies of scale are found in purchasing, especially when there are a small number of buyers in a market with differentiated products. An example is the market for television programming in the United States. Only a handful of cable companies, satellite-television companies, and telephone companies purchase all the television programming. As a result, the largest purchasers have substantial bargaining power and can achieve the lowest prices.

While economies of scale can be a significant source of acquisition value creation, rarely are generic economies of scale, like back-office savings, significant enough to justify an acquisition. Economies of scale must be unique to be large enough to justify an acquisition.

Pick winners early and help them develop their businesses

The final winning strategy involves making acquisitions early in the life cycle of a new industry or product line, long before most others recognize that it will grow significantly. Johnson & Johnson pursued this strategy in its early acquisitions of medical-device businesses. J&J purchased orthopedic-device manufacturer DePuy in 1998, when DePuy had $900 million of revenues. By 2010, DePuy's revenues had grown to $5.6 billion, an annual growth rate of about 17 percent. (In 2011, J&J purchased Synthes, another orthopedic-device manufacturer, so more recent revenue numbers are not comparable.) This acquisition strategy requires a disciplined approach by management in three dimensions. First, you must be willing to make investments early, long before your competitors and the market see the industry's or company's potential. Second, you need to make multiple bets and to expect that some will fail. Third, you need the skills and patience to nurture the acquired businesses.

Harder strategies

Beyond the five main acquisition strategies we've explored, a handful of others can create value, though in our experience they do so relatively rarely.

Roll-up strategy

Roll-up strategies consolidate highly fragmented markets where the current competitors are too small to achieve scale economies. Beginning in the 1960s, Service Corporation International, for instance, grew from a single funeral home in Houston to more than 1,400 funeral homes and cemeteries in 2008. Similarly, Clear Channel Communications rolled up the US market for radio stations, eventually owning more than 900.

This strategy works when businesses as a group can realize substantial cost savings or achieve higher revenues than individual businesses can. Service Corporation's funeral homes in a given city can share vehicles, purchasing, and back-office operations, for example. They can also coordinate advertising across a city to reduce costs and raise revenues.

Size is not what creates a successful roll-up; what matters is the right kind of size. For Service Corporation, multiple locations in individual cities have been more important than many branches spread over many cities, because the cost savings (such as sharing vehicles) can be realized only if the branches are near one another. Roll-up strategies are hard to disguise, so they invite copycats. As others tried to imitate Service Corporation's strategy, prices for some funeral homes were eventually bid up to levels that made additional acquisitions uneconomic.

Consolidate to improve competitive behavior

Many executives in highly competitive industries hope consolidation will lead competitors to focus less on price competition, thereby improving the ROIC of the industry. The evidence shows, however, that unless it consolidates to just three or four companies and can keep out new entrants, pricing behavior doesn't change: smaller businesses or new entrants often have an incentive to gain share through lower prices. So in an industry with, say, ten companies, lots of deals must be done before the basis of competition changes.

Enter into a transformational merger

A commonly mentioned reason for an acquisition or merger is the desire to transform one or both companies. Transformational mergers are rare, however, because the circumstances have to be just right, and the management team needs to execute the strategy well.

Transformational mergers can best be described by example. One of the world's leading pharmaceutical companies, Switzerland's Novartis, was formed in 1996 by the $30 billion merger of Ciba-Geigy and Sandoz. But this merger was much more than a simple combination of businesses: under the leadership of the new CEO, Daniel Vasella, Ciba-Geigy and Sandoz were transformed into an entirely new company. Using the merger as a catalyst for change, Vasella and his management team not only captured $1.4 billion in cost synergies but also redefined the company's mission, strategy, portfolio, and organization, as well as all key processes, from research to sales. In every area, there was no automatic choice for either the Ciba or the Sandoz way of doing things; instead, the organization made a systematic effort to find the best way.

Novartis shifted its strategic focus to innovation in its life-sciences business (pharmaceuticals, nutrition, and products for agriculture) and spun off the $7 billion Ciba Specialty Chemicals business in 1997. Organizational changes included structuring R&D worldwide by therapeutic rather than geographic area, enabling Novartis to build a world-leading oncology franchise.

Across all departments and management layers, Novartis created a strong performance-oriented culture, supported by shifting from a seniority- to a performance-based compensation system for managers.

Buy cheap

The final way to create value from an acquisition is to buy cheap—in other words, at a price below a company's intrinsic value. In our experience, however, such opportunities are rare and relatively small. Nonetheless, although market values revert to intrinsic values over longer periods, there can be brief moments when the two fall out of alignment. Markets, for example, sometimes overreact to negative news, such as a criminal investigation of an executive or the failure of a single product in a portfolio with many strong ones.

Such moments are less rare in cyclical industries, where assets are often undervalued at the bottom of a cycle. Comparing actual market valuations with intrinsic values based on a "perfect foresight" model, we found that companies in cyclical industries could more than double their shareholder returns (relative to actual returns) if they acquired assets at the bottom of a cycle and sold at the top.[3]

While markets do offer occasional opportunities for companies to buy targets at levels below their intrinsic value, we haven't seen many cases. To gain control of a target, acquirers must pay its shareholders a premium over the current market value. Although premiums can vary widely, the average ones for corporate control have been fairly stable: almost 30 percent of the preannouncement price of the target's equity. For targets pursued by multiple acquirers, the premium rises dramatically, creating the so-called winner's curse. If several companies evaluate a given target and all identify roughly the same potential synergies, the pursuer that overestimates them most will offer the highest price. Since it is based on an overestimation of the value to be created, the winner pays too much—and is ultimately a loser.[4] A related problem is hubris, or the tendency of the acquirer's management to overstate its ability to capture performance improvements from the acquisition.[5]

Since market values can sometimes deviate from intrinsic ones, management must also beware the possibility that markets may be overvaluing a potential acquisition. Consider the stock market bubble during the late 1990s. Companies that merged with or acquired technology, media, or telecommunications businesses saw their share prices plummet when the market reverted to earlier levels. The possibility that a company might pay too much when the market is inflated deserves serious consideration, because M&A activity seems to rise following periods of strong market performance. If (and when) prices are artificially high, large improvements are necessary to justify an acquisition, even when the target can be purchased at no premium to market value.

■ ■ ■

By focusing on the types of acquisition strategies that have created value for acquirers in the past, managers can make it more likely that their acquisitions will create value for their shareholders. ■

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[1] Viral V. Acharya, Moritz Hahn, and Conor Kehoe, "Corporate governance and value creation: Evidence from private equity," Social Science Research Network working paper, February 19, 2010.
[2] IBM investor briefing 2014, ibm.com.
[3] Marco de Heer and Timothy Koller, "Valuing cyclical companies," mckinseyquarterly.com, May 2000.
[4] K. Rock, "Why new issues are underpriced," *Journal of Financial Economics*, 1986, Volume 15, pp. 187–212.
[5] R. Roll, "The hubris hypothesis of corporate takeovers," *Journal of Business*, 1986, Volume 59, Number 2, pp. 197–216.

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Making M&A deal synergies count

When investors understand where deal value comes from, they tend to reward companies up front.

Ankur Agrawal, Rajeev Varma, and Andy West

Information is the lifeblood of investor efforts to confirm—or challenge—their confidence in a company's ability to create value. This is especially true when companies make deals large enough to redirect, reshape, or even completely redefine a company's strategy. It's only natural for investors to want to know what to expect—to give them confidence that the deal price isn't just value being transferred to a target company's shareholders. And when companies aren't forthcoming, investors may well interpret it as a sign that managers don't know how they'll make a deal work.

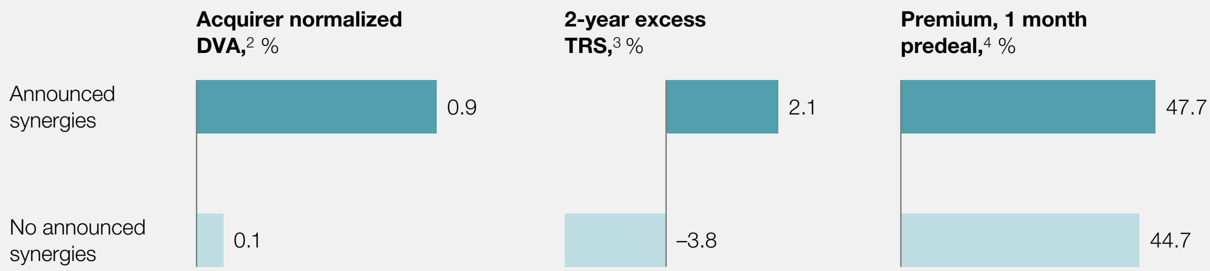
That's why holding back may reflect a missed opportunity for many acquirers. In our analysis of 1,640 deals over the past seven years, we found that on average, companies making acquisitions have been paying a premium of 40 percent or more than their targets' market value. And while they typically justify those premiums with a nod to potential synergies from the deal, few actually specified those synergies in their deal announcements. Since 2010, only about 20 percent of acquirers publicly disclosed the synergies they intended to capture.

Companies may have their reasons for keeping mum. Sometimes managers feel compelled to move too quickly to compile the data. Sometimes they fear overpromising, especially when the underpinning data, talent, or pipeline are incomplete. Sometimes the data they have doesn't support a simple synergy story. And sometimes they execute deals for strategic reasons besides synergies, such as to acquire R&D capabilities, intellectual property, or emerging technology.

Exhibit 1

Acquirers who announce synergies enjoy stronger returns than those who don't—in spite of higher premiums.

Large public transactions, 2010–17, year to date[1]



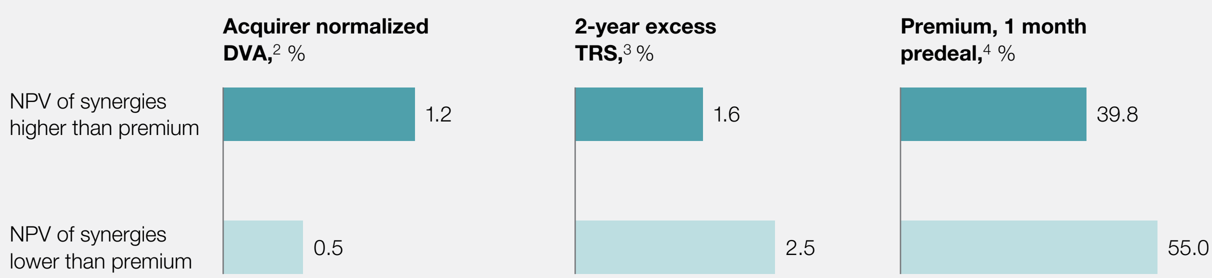
[1] Includes largest acquisitions across multiple nonfinancial sectors; only includes deals where the target is a publicly traded company.
[2] DVA = deal value added. Average acquirer total returns to shareholders (TRS) in excess of industry-sector TRS, around time of the deal (2 days preannouncement vs 2 days postannouncement).
[3] Average acquirer long-term TRS in excess of industry-sector TRS, 1 month predeal vs 2 years postdeal.
[4] Average premium announced based on target share price 30 days before deal announcement.

Source: Dealogic; MSCI; S&P Capital IQ; McKinsey's SynergyLab

Exhibit 2

Among acquirers that announce synergies, the initial market reaction is stronger when the net present value (NPV) of synergies is higher than the premium paid.

Large public transactions where synergies were announced, 2010–17, year to date[1]



[1] Includes largest acquisitions across multiple nonfinancial sectors; only includes deals where the target is a publicly traded company.
[2] DVA = deal value added. Average acquirer total returns to shareholders (TRS) in excess of industry-sector TRS, around time of the deal (2 days preannouncement vs 2 days postannouncement).
[3] Average acquirer long-term TRS in excess of industry-sector TRS, 1 month predeal vs 2 years postdeal.
[4] Average premium announced based on target share price 30 days before deal announcement.

Source: Dealogic; MSCI; S&P Capital IQ; McKinsey's SynergyLab

But as our analysis has found, where companies have a synergy story to tell, they should be as forthcoming as they can be:

- Investors reward acquirers with a higher share price when they disclose the sources of value in their deal announcement (Exhibit 1). This assumes that the deals where acquirers announced synergies were good ones with clear expected synergies. Acquirers that made such announcements earned a higher deal value added[1] in the days around the deal's announcement, even though, on average, they paid slightly higher premiums than the companies that didn't specify synergies. And then, as the deals matured, they enjoyed around a six-percentage-point boost in two-year excess TRS compared with those that didn't mention synergies.

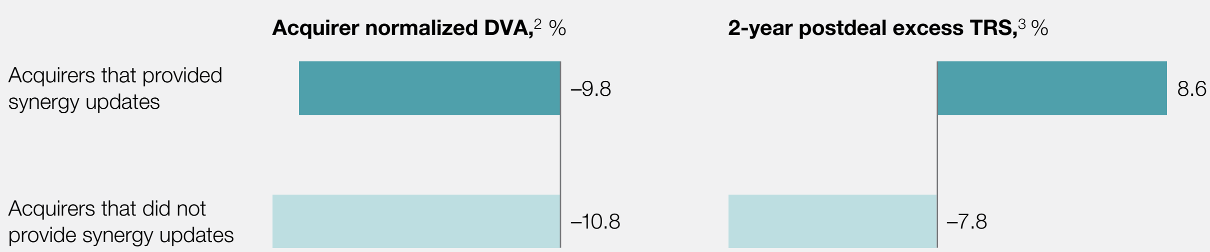
- Not surprisingly, our analysis confirms that when the expected long-term value of the cost synergies is greater than the premium paid by the acquirer, investors are even more enthusiastic about the deal (Exhibit 2). That return-on-investment perspective isn't always visible or convincing unless companies explicitly describe expected synergies when they announce a deal—as suggested by the higher longer-term TRS of companies with expected value that doesn't cover the premium.

- Finally, we found that acquirers that updated the market on synergy benefits during deal integration were more likely to maintain the positive share-price effect of synergy announcements. Our analysis found that even those whose deals initially received a muted market reaction often see significantly higher excess TRS two years after the transaction when they provided synergy updates (Exhibit 3). Two-year excess returns are important, since that time frame reflects successes in cultural integration and maintaining a deal's business momentum—which lead to synergies. Initial

Exhibit 3

Deals with initially lackluster market reactions outperformed in the long term after investors were updated on synergies.

Large public transactions, 2010–17 year-to-date,[1] acquirers with negative DVA[2]



[1] Includes largest acquisitions across multiple nonfinancial sectors; only includes deals where the target is a publicly traded company.
[2] DVA = deal value added. Average acquirer total returns to shareholders (TRS) in excess of industry-sector TRS, around time of the deal (2 preannouncement vs 2 days postannouncement).
[3] Average acquirer long-term TRS in excess of industry-sector TRS, 1 month predeal vs 2 years postdeal.

Source: Dealogic; MSCI; S&P Capital IQ; McKinsey's SynergyLab announcement effects are not correlated with value creation.[2]

Of course, investors don't reward companies just for making announcements. They reward companies for the present value of future earnings from a deal. When companies announce synergies, they give investors a deeper understanding of the deal rationale. When they update investors on progress during integration, they build trust and confidence in their skills as stewards of investor resources.

In our experience, more information is better. Acquirers should disaggregate the cost, capital, and revenue synergies, and provide a clear rationale and vision for each. They should communicate a timeline for when they expect the synergies to be fully recognized and what one-time investments and costs are required to capture the synergies. And their communiqués to investors should clearly identify any risks that could prevent the companies from capturing the synergies, along with mitigation plans. ■

[1] For M&A involving publicly traded companies, this is defined as combined (acquirer and target) change in market capitalization, adjusted for market movements, from two days prior to two days after announcement, as a percent of transaction value.

[2] Werner Rehm, Robert Uhlaner, and Andy West, "Taking a longer-term look at M&A value creation," January 2012, McKinsey.com.

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Focusing your M&A team on revenue growth

Revenue synergies can make a good deal even better.

John Chartier, Alex Liu, and Rui Silva

Capturing revenue synergies in M&A deals often takes a back seat to securing cost synergies. Cost cutting is more intuitive—eliminating duplicate IT, human resources, or executive functions, for example. The benefits tend to come quickly. And cost cuts alone are often more than enough to justify a merger.

Revenue synergies might be more elusive and aren't always available in every deal. But managers who neglect them can inadvertently forgo significant value. Our analysis of global 1000 companies by sector finds that, on average, companies that fail to pursue both cost and revenue synergies from large mergers see the sales growth of the combined companies fall by an average of seven percentage points.[1] That's consistent with our 2015 survey of integration executives[2] in which more than a third of respondents reported failing to achieve their revenue goals after a merger.

Not surprisingly, those who reported the most value from revenue synergies were also significantly more likely to have followed a number of organizational best practices (exhibit). None of these is likely to make the difference on its own—and preserving existing revenues is paramount. But the data suggest a significant difference in outperformance when several well-established best practices are applied. Validating the deal model to set realistic targets comes out on top, followed by engaging the right senior leaders, retaining the best of sales operations, establishing an effective deal team, and addressing cultural differences.

Validate the deal model to set realistic targets

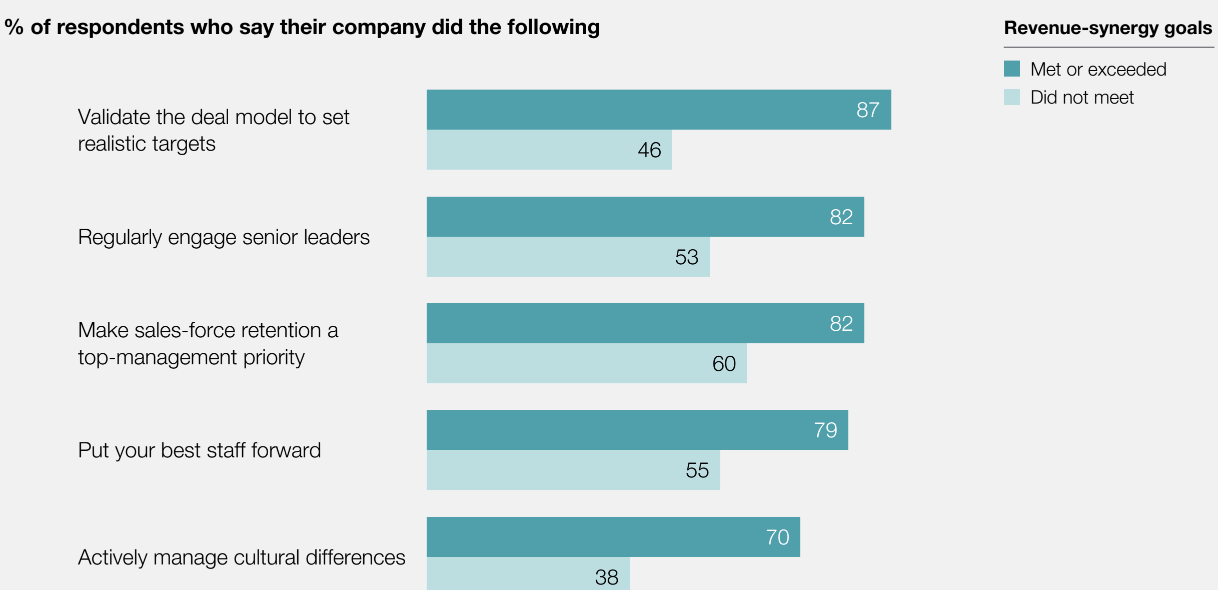
In many cases, pre-deal estimates of revenue synergies turn out to be based on little more than gut-level, back-of-the-envelope calculations. Left unchecked, those estimates can set up potentially unrealistic aspirations that misdirect integration efforts, threaten existing revenues, and reduce a deal's value even further. Among survey respondents who identified their mergers as successful, nearly nine in ten were also those who reported validating their deal model to set realistic targets—compared with less than half of their less successful peers.

One of the biggest mistakes companies make is moving too fast to capture revenue synergies without confirming that pre-deal assumptions won't threaten the base business. We've seen too many companies learn the hard way, for example, that changing sales and customer coverage too quickly can lead to a sharp decline in revenue. And among our survey respondents, those who reported preserving and protecting existing revenue were significantly more likely to report meeting or exceeding their synergy targets.

Stress testing the deal model requires bringing enough people into the process to kick the tires on key assumptions, but not so many that the volume threatens the necessary confidentiality of pre-deal preparations. Integration teams need to ensure that careful, bottom-up logic supports any estimate of potential revenue synergies, and that performance targets are achievable within a

Exhibit

Companies that follow established best practices are more likely to meet their synergy goals.



Source: McKinsey M&A capabilities survey of nearly 1,600 C-level and senior executives, May 2015 reasonable time frame. This requires both deep probing within the sales organizations to develop a clear basis of facts and detailed marketing research to answer important questions, including the following: Do the sales teams from both companies sell to the same decision maker within a given customer? Is the nature of the sales, whether more transactional or strategic, the same in both organizations? What knowledge and selling skills are required to effectively cross-sell products? Is the customer-adoption process—and therefore the sales cycle—similar in each?

The integration team should supplement and test this analysis by setting up a clean team to dig deep into both organizations' data. This allows the merged business to develop a complete picture of deal value and how to capture it. It also helps to detect and resolve conflicts and overlap between the two sales organizations, so that they do not become obstacles to reaching sales targets. For example, a clean-team approach was particularly helpful in a recent merger of two distribution companies that had more than 2,000 overlapping accounts, putting some 15 percent of combined revenue at risk. The two companies set up a commercial clean team that matched customers, resolved the sales-rep assignments on those accounts, and used advanced analytics to design new territories—all before day one.

Regularly engage senior leaders

Senior-level leaders may understand in principle how important their involvement is, especially in bigger deals. But too often they simply delegate integration planning to the commercial-integration managers. The less clear managers are about who has what role at the leadership level, the more likely they are to be reluctant to make decisions or engage deeply.

As might be expected, senior-level commitment is important for a successful commercial integration. But our survey underscored just how important it is: more than 80 percent of mergers and acquisitions that achieved or exceeded their revenue-synergy goals have strong senior-leadership involvement from the CEO to sales.

In these situations, we have found establishing a clear governance structure made up of the future commercial leaders to be most helpful. This committee should meet regularly to review and make decisions on robust, fact-based recommendations developed by integration teams. For one media merger, the committee comprised the business-unit presidents, leaders of each sales force, and the commercial-integration leader. Together, the committee members established a detailed governance model to drive clear, regular, and effective decision making.

> Communications to the sales force, especially, needs to be led by the executive suite—often deploying the CEO to communicate personally and directly to top sales staff.

Make sales-force retention a top-management priority

The most common source of disruption to a company's revenue after a merger comes when it fails to identify who has responsibility to reconcile overlapping customer accounts and sales territories. Sales teams operate best under conditions of certainty and clarity, particularly with regard to role, leadership, account assignments, quota and target attainment, and compensation. Uncertainty threatens existing revenues as well as revenue growth.

Transparency helps—whether it's providing concrete answers to questions or just describing the process you're undertaking to reach an answer. We've long advised companies on the importance of communicating—even overcommunicating—as companies merge. Our most recent survey supports that guidance, finding that nearly eight in ten companies that successfully build commercial strength through a merger also commit and invest in a clear communication strategy. Top performers reach out purposefully to employees as well as customers. They keep an open channel with both in order to reassure them that the company is engaged and focused on avoiding disruption to services and offerings. Among survey respondents, that's true of less than half of less-successful companies.

Communications to the sales force, especially, needs to be led by the executive suite—often deploying the CEO to communicate personally and directly to top sales staff. In fact, among survey respondents, 82 percent of merging companies that achieved their revenue goals had also made it a priority to implement a plan to retain top commercial talent. That's compared with just 60 percent of less successful companies that did so.

Put your best staff forward

Companies often staff their integration teams with managers who happen to be available or are part of special-projects groups, including part-time team members who lack the necessary skills. An inadequate team results in a failure to prepare the commercial organization for a seamless integration on day one of the merged company's existence. And although even highly experienced teams can stumble, they're the best prepared to tailor the integration to the specific needs of a deal.

In our survey, more than 70 percent of those who reported meeting or exceeding their revenue-synergy goals establish a commercial integration-management office (IMO). This group, which is ideally established soon after announcement and well before close, is responsible and accountable for the overall commercial integration effort.

To be successful, the IMO needs an integration leader allocated full-time for the duration of the effort, with complete accountability and the appropriate seniority to guide the integration strategy. The rest of the team should consist of highly skilled A players who can devote the necessary time and are deeply networked within their respective organizations.

Actively manage cultural differences

Addressing cultural differences has long been an aspect of integration that has vexed merging companies. Going by the responses of our survey participants, it's also among the most powerful differentiators of success. Nearly three-quarters of companies that met their revenue-synergy targets also actively managed cultural differences—compared with just over a third of companies that fell short of revenue targets that reported doing so.

Nevertheless, executives in M&A situations often overlook or fail to pay enough attention to cultural issues. The most important principle here is to address those differences in practices, processes, and capabilities that truly have an impact on the value at stake and at risk. Even differences in language can portend significant cultural conflict. For example, when two healthcare organizations were merging, it became clear in the integration process that there was a difference in what the term "target" meant. In one organization, it was a stretch goal deployed to encourage new thinking; in the other, it meant an absolute "must hit" expectation that, if missed, could impact compensation. Early on, this simple semantic misalignment, which reflected very different cultures, caused a period of unproductive confusion about basic expectations, requiring the team to clearly define the vocabulary as well as a new set of metrics within the performance system.

■ ■ ■

Any merger has the potential to deliver significant value. But successfully improving revenue growth requires focus on and commitment to the activities that can actually make it happen. ■

[1] Revenue growth in excess of industry growth; industry revenue growth based on cumulative revenues of global 1000 companies by sector.

[2] "How M&A practitioners enable their success," October 2015, McKinsey.com. The online survey was in the field from May 19 to May 29, 2015, and garnered 1,841 responses from C-level and senior executives representing the full range of regions, industries, company sizes, and functional specialties. Of them, 85 percent say they are knowledgeable about their companies' M&A activity and answered the full survey.

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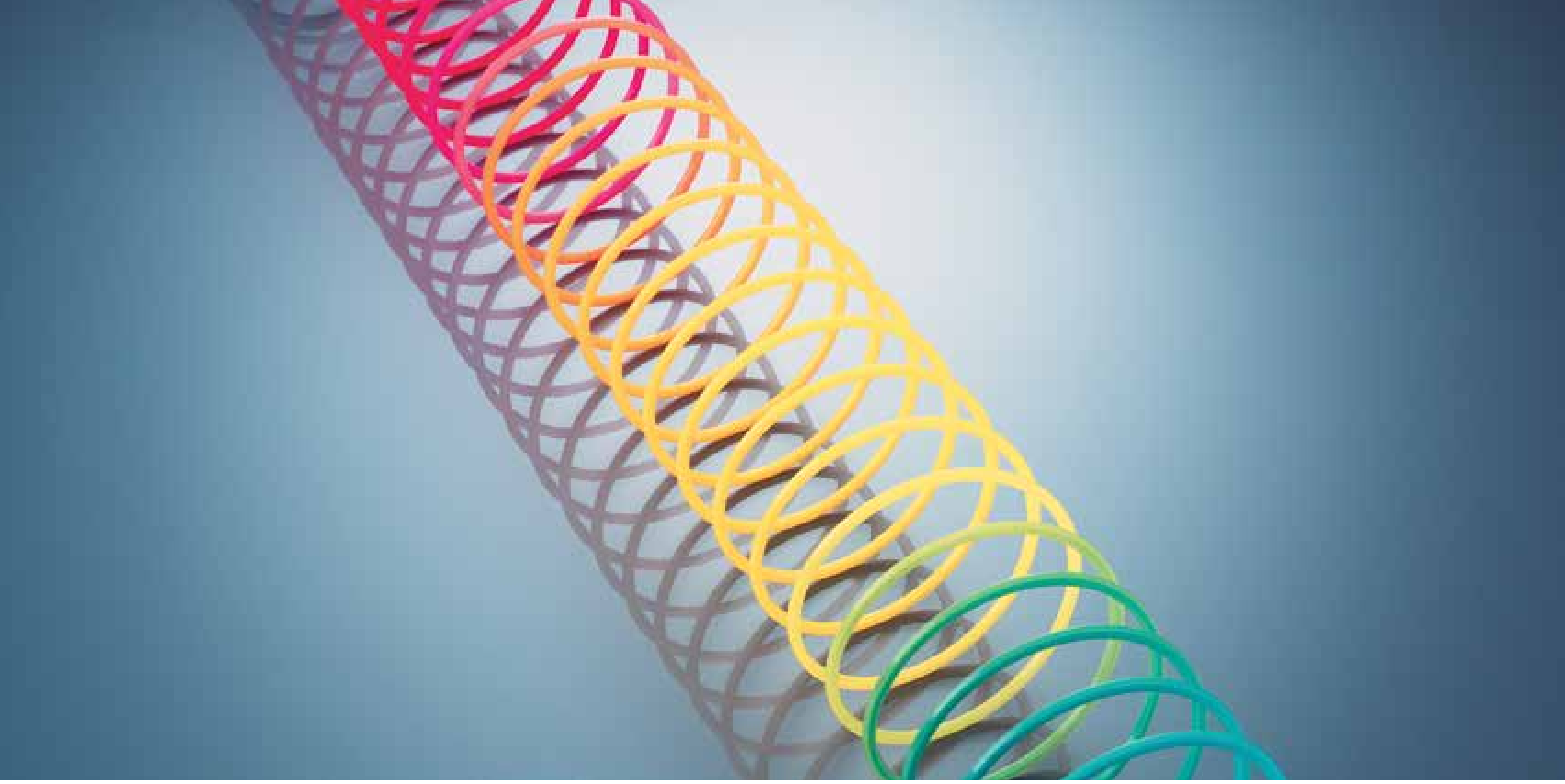

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In search of a better stretch target

Aggressive goals can dramatically improve a company's performance. But unachievable goals can do more harm than good. Here's how to stretch without breaking.

Ryan Davies, Hugues Lavandier, and Ken Schwartz

The urge to improve is innate in most companies, where better service, stronger performance, and faster operations are inextricably tied to earnings, bonuses, and shareholder returns. The impetus is so strong, in fact, that the practice of setting stretch targets for a company's performance has become emblematic for the grit and aggressiveness expected of a modern executive. Managers take pride in seeking to achieve the unthinkable.

Sometimes they succeed, surprising even themselves with how much stretch targets can improve performance. But there are limits to how far they can push. The wrong metrics can sap motivation and undermine performance.[1] Targets set along one metric without regard for the effect on performance elsewhere can destroy value. And broad-based aggregate measures of profit margin, operating profit, and earnings per share are only loosely linked to valuation. One CFO recently admitted to us that his multibillion-dollar global company would hit its quarterly goals for earnings before interest, taxes, depreciation, and amortization (EBITDA), but only at the cost of reducing its operating cash flow. Signs of unhealthy stretch targets can be quite clear—and any of them can lead to poor behaviors, distracting senior managers and having no impact on value.

Healthy stretch targets start with using the right kinds of metrics: achievable, focused, transparent, and grounded in objective data tied to value creation. But even the right kinds of metrics can destroy value when managers neglect best practices. In our experience, a healthier stretch requires companies to calibrate targets against cross-functional trade-offs. It demands that executives build trust with employees, rewarding success rather than always moving the goal up, but also that they confirm that employees succeed fairly. And it requires that there be no stigma attached to bringing out bad news, so that employees are encouraged to be transparent about their progress.

Calibrate cross-functional trade-offs between targets

The larger and more complex a company is, the more likely one unit or function's stretch targets will affect the performance of others. For example, reducing inventory levels to meet a working-capital target can make it hard to fill orders if a company's production system, its demand, and its suppliers are not stable enough—and that can lead to lost sales. Conversely, if a sales team pushes for 7 percent growth in a market that is growing at 4 percent, for example, it's likely to chase as many deals as possible. Since the team can't sell what the company doesn't have, they'll have to initiate production even for deals that are more likely to fall through. That, in turn, affects performance up and down the supply chain—with negative consequences for the company's cash-conversion rate, depending on how much unsold inventory piles up.

CFOs—or other C-suite managers—can set targets from a cross-functional perspective across the entire business, but they often lack a functional or business-unit perspective on the details. The business-unit leaders they rely on for those details often promote different metrics depending on their own siloed vantage points. In the end, managers often resort to targets anchored in past performance, catchy slogans, or just lazy application. We often see them simply adding a flat percentage-point increase to last year's results, averaging performance levels across an entire group, or setting sales targets based on growth assumptions oblivious to the pace of the market (exhibit). Managers at one Asian company arbitrarily targeted 25 percent growth per year for 25 years—apparently unencumbered by the mathematical implications. And managers at a global manufacturer decided that tripling inventory turns would be an inspirational target, even though the company was already better than most of its peers and the target was physically impossible.

Managers that set the best stretch targets do so with a clear understanding of the trade-offs between interconnected objectives—between earnings goals and cash needs, for example, or between growth objectives and R&D costs. The experience at one manufacturing company is illustrative. Managers of the various units each sought to optimize their own particular target. Manufacturing wanted to maintain a constant level of production to keep utilization up. Sales wanted shorter lead times and more product variants. Sourcing wanted lower unit costs. And finance wanted to improve cash performance. This led to uncertainty among functions and made it difficult for any of them to plan. For example, sourcing could cut costs if there were more certainty on volumes from sales, and sales could sell more and hit its target margins if it was clear that sourcing could lower costs.

To make the various functions work better together, the company undertook an exercise to align the key assumptions that they should all use for planning purposes. That way, everyone would be using consistent assumptions on costs, price, and the performance baseline. These included, for example, that sales should assume a certain cost per unit if managers committed to selling a certain number of units. Through several iterations, the

Exhibit **Unhealthy stretch targets lead to unhealthy behaviors.**

Types of unhealthy stretch targets

Formulaic	Set by adding a flat percentage on top of whatever was proposed by the business unit
Excessive	Unclear, even at a relatively high level, how these targets will be met
Opaque	Rolled up from different functions, without clarity on shared assumptions
Overly broad	Broad-based aggregate measures of profit margin, operating profit, and earnings per share

Signs of unhealthy behavior

Manipulation	Signs of gaming to meet the targets, such as sales spiking unexpectedly at the end of the quarter or inventory increasing dramatically right after it's measured
Surprises	Actual performance levels are regularly well off targets and forecasts
Hedging	Signs that any layer of the organization is underestimating or not revealing some opportunity, as a reserve for when it's inevitably asked for more
Misplaced priorities	Meeting goals even at the cost of lowering performance on measures that affect valuation

company was able to set a matrix of targets to which each function could commit, knowing that other functions had committed to delivering the prerequisites for success. Based on this, each function was able to create a comprehensive plan to achieve the targets.

Build trust with employees—but verify they succeed fairly

Stretch targets succeed only when employees believe they can meet their goals if they try hard enough and that they will be rewarded if they do. There has to be a chance of failure in order to motivate employees to work harder. But if they expect failure and see targets as unrealistic, they will conclude that they won't receive a bonus anyway and just stop trying. When their good work earns them little more than endless rounds of ever-harder-to-meet stretch targets, they're more likely to hold opportunities in reserve—allowing themselves to fall short for one goal in order to improve their chances of meeting the next one. That leads to lower performance, poor morale, and declining trust in management. Expecting this kind of sandbagging, managers set ever more aggressive targets, and a vicious cycle of eroding trust develops.

Moreover, when the path to improvement looks like it will take too long, managers also need to be on the lookout for shortcuts. Function or unit managers can use a variety of cheats that improve some metrics in the short term. But such cheats can also create a kind of expectations treadmill that demands ever greater improvements over time and ultimately undermines the company's overall performance. For instance, when sales repeatedly offers customers big discounts to take delivery at the end of the quarter—so-called pull-ins—customers learn to time their purchases in expectation of those benefits. When sourcing pushes out orders to the day after quarter's end, plant inventory levels skyrocket immediately after the end of the quarter. When business managers change inventory-reserve policies, they may improve earnings temporarily, but not cash flow.

Some companies address this gaming with a combination of executive jawboning and visible consequences. The CEO and CFO repeatedly emphasize the importance of doing things the right way and celebrate successes. But they also deal harshly, even publicly, with any instances of egregious gaming. Others have employed more structural guardrails, strengthening their underlying systems to make sure that targets aren't gamed. For example, when managers at one company discovered that the sales staff was systematically creating fake orders in the system to ensure that supply would be available for last-minute orders, they introduced a more robust process to scrutinize orders. To prevent last-minute sales pull-ins, managers set a firm deadline for when orders could be placed and required new documentation from customers before approving an order and initiating production. And they reviewed their sales- and operations-planning processes to identify and remove unlikely commitments.

Setting targets collaboratively can also help. Executives at one global materials company, for example, spent six weeks analyzing and benchmarking performance targets that they could realistically achieve. They then spent another six weeks identifying specific initiatives and developing detailed implementation plans—including a weekly dialogue to fine-tune their stretch targets and confirm the targets worked together. In the end, the full senior-executive team committed to the plan, and the numbers were memorialized in a progressive series of targets that were reviewed weekly to prevent backtracking. The outcome exceeded senior management's expectations—with the additional benefit of strongly felt ownership throughout the organization of the actions taken to deliver the target.

Make it safe to share bad news

It's human nature to discount, ignore, or deny bad news. And when everyone is striving for a stretch target, it's hard to admit that you're the one falling behind. As a result, we often see managers taken by surprise when everyone finally admits where they are in the last few days of the quarter. Performance forecasts at one company, for example, were consistent with the expectations of meeting the stretch targets for many months. So managers were taken aback at the end of the quarter when actual performance numbers were much worse. In the aftermath, they were chagrined to learn that business and functional group leaders had known the stretch targets were unreachable for several months but were reluctant to break the news.

Such surprises can leave companies in an unexpectedly bad position. For instance, if manufacturing waits until a week before deliveries are expected to lower its production commitments, the sales force would be in an extremely poor position with customers. Such behavior could lead to lower sales, or it may lead sales managers to overforecast demand or artificially accelerate delivery deadlines.

We have seen companies address this in several ways. If managers set interim milestones for major deliverables and a regular operating mechanism to review them, they can create an early warning signal that something might be at risk. For instance, one milestone for commercial deals might be obtaining essential permits and qualifications by a certain date. If managers learn that the permits are running behind schedule, they would see that as an early sign that the deals might not land as expected.

Managers can also reward people for coming forward with potential issues and working proactively to solve them—even if this involves reporting bad news. At one global chemical company, for example, junior-level managers alerted senior executives that negotiations with customers and suppliers hadn't led to expected supply-chain improvements and that some value continued to be lost with regard to service. Fortunately, they elevated the bad news early enough in the cycle to address it, even presenting an action plan to fill the gap with the stretch targets, and were recognized for their resilience. Facing similar shortfalls in meeting demand-management targets, another unit was ultimately praised for collaborating across functions to create a solution that was in the interest of the business overall and not just their own work stream.

■ ■ ■

Managers can improve a company's performance by setting the right stretch targets that motivate employees. But pushing too hard can have the opposite effect. ■

[1] See, for example, John W. Atkinson, *An Introduction to Motivation*, first edition, Princeton, NJ: Van Nostrand, 1964; John W. Atkinson, "Motivational determinants of risk-taking behavior," *Psychological Review*, Volume 64, Part 1, Number 6, pp. 359–72.

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