The six types of successful acquisitions

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For an acquisition to be successful, there must be a strategic rationale. In general, value is created by an acquisition if one of the following strategic objectives is pursued.

Improving the performance of the target company: This is what private equity firms do. It is easier to improve the performance of a company with low margins and low ROIC.

Removing excess capacity from the industry: As industries mature, they typically develop excess capacity. It is easier for companies to shut down plants across the larger combined entity than to shut down their least productive plants and become a smaller company. When there is substantial value to be created by removing excess capacity, bulk of the value goes to the acquirer's shareholders. Moreover, other companies in the industry can take advantage of the benefits of excess capacity without having made any contribution.

Creating market access for products: Often, relatively small companies with innovative products have difficulty in marketing their product. A bigger company can acquire such small entities and provide the required market access.

Acquiring new skills or technologies: Technology companies often acquire other companies to get access to a new technology more quickly. An acquisition can also serve as a pre-emptive strategy to keep the new technology away from competitors.

Exploiting scalability: Economies of scale are often the justification for mergers. But one needs to be careful here. Large companies are already operating at scale. Economies of scale can create value when the unit of incremental capacity is large or when a larger company buys a company operating below scale. Generic economies of scale such as back office savings are usually not significant enough to justify an acquisition. Economies of scale must be unique to justify an acquisition.

Picking winners early and helping them develop their business: This calls for a disciplined approach. The company must be willing to make the investment early and before competitors. Multiple bets must be made, some of which are bound to fail. Skills and patience are needed to nurture the acquired business.

Other strategies: A few other strategies may also create value but success is rare in these cases.

A **Roll up** strategy can be used to consolidate highly fragmented industries where the current competitors are too small and are operating below scale.

A **Consolidation** strategy may improve competitive behaviour and reduce price competition. But this usually happens only when the number of players reduces to 3 or 4. Otherwise, the smaller players will continue to try to gain market share through lower prices.

Transformational mergers can also create value. But the circumstances must be right and the execution great. The merger of Ciba Giegy and Sandoz is a rare example. The merged entity, Novartis captured $ 1.4 billion in cost synergies and also redefined the company's mission, strategy, portfolio and key processes. Novartis organized its R&D on a therapeutic rather than geographic basis. The specialty chemicals business was spun off. Novartis also moved away from a seniority based to a performance based compensation system.

Another way to create value is to **buy cheap**. Such opportunities are usually rare. In the long run, market prices revert to intrinsic value. But there can be temporary periods of under-pricing. In cyclical industries, such opportunities are more and assets can be purchased at the bottom of the cycle.

Whatever be the approach, it will be difficult to create value if the company has overpaid for an acquisition. When the price paid is high, large improvements are needed to justify an acquisition. Such improvements may be difficult to achieve.