DEALMAKERS DO WELL IN DOWNTURNS

Downturns are not a time for dealmakers to retreat to the sidelines. In fact, our research shows that markets reward dealmakers who take the risk of pursuing acquisitions in a weak economy. (See the sidebar "About Our Data Set and Analyses.") Two years after an acquisition, buyers' relative total shareholder return (RTSR) is significantly higher (and positive) for deals done in a weak economy than for deals done in a strong economy. (See Exhibit 7.)

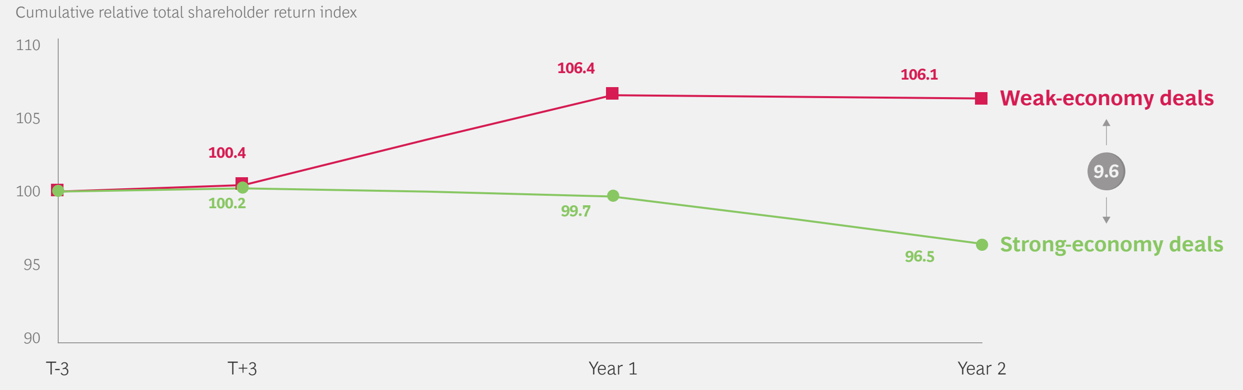
For our analysis, we used an RTSR index to assess the performance of strong- and weak-economy deals. The index compares performance around the time of the deal announcement (in terms of CAR) and one year and two years after the announcement (in terms of RTSR). Around the deal announcement, the difference in the CAR is rather small (0.2 percentage points). But the difference widens to nearly 7 percentage points one year after the deal, as the RTSR index decreases slightly for strong-economy deals to 99.7 while jumping to 106.4 for weak-economy deals. The increase for weak-

ABOUT OUR DATA SET AND ANALYSES

The data set used for the analyses in BCG's M&A research comprises approximately 759,000 deals, covering the period 1980 through 2018. We collected and collated data from a variety of financial databases, including Refinitiv (formerly Thomson Reuters Financial & Risk), Datastream, Worldscope, and S&P Capital IQ, as well as our own proprietary data and analytics. For the analyses in this report, we focused on roughly 51,600 deals that met our study criteria and involved transfers of majority shares, including spinoffs, with a transaction value of at least $250 million. The data set covers all acquisitions—of both private and public targets—by public buyers.

To determine whether the economy was strong or weak in each year covered by our analysis, we looked at the growth rate of global GDP in real terms. We defined the top third of all growth rates in our observation period as an indicator of a strong economy and the bottom third as an indicator of a weak economy. We excluded years in the middle third of growth rates from the analysis.

Exhibit 7 | Weak-Economy Deals Outperform Strong-Economy Deals



Sources: Refinitiv; Datastream; BCG analysis.
Note: Strong-economy (weak-economy) years are those in which the respective global real GDP growth rate is in the top (bottom) third of all growth rates in our observation period. The total of 9,987 M&A transactions comprises pending, partly completed, completed, unconditional, and withdrawn majority deals announced between 1980 and 2018 with a deal value greater than $250 million. Only deals with a public buyer were considered. The share price three days before the announcement date (T–3) equals 100. Share performance from T-3 to three days after the announcement (T+3) equals the announcement effect.

economy deals translates into an RTSR one year after the announcement of 6.4%. The gap between strong- and weak-economy performance grows to more than 9 percentage points two years after the deal.

In this analysis, we used realized GDP growth as the benchmark for comparing performance. We reached similar results in benchmarking performance against the forward-looking Economic Policy Uncertainty Index. The similarity in findings implies a stable relationship between post-deal RTSR performance and the state of the economy at deal announcement. The remaining analyses in this chapter use realized GDP growth as the benchmark.

Why Do Buyers Outperform in a Weak Economy?

Which specific types of deals are responsible for buyers' outperformance in a weak economy? To find the answer, we considered the short-term capital market reaction (in terms of CAR) as well as buyers' mid-term value creation (in terms of one- and two-year RTSR).

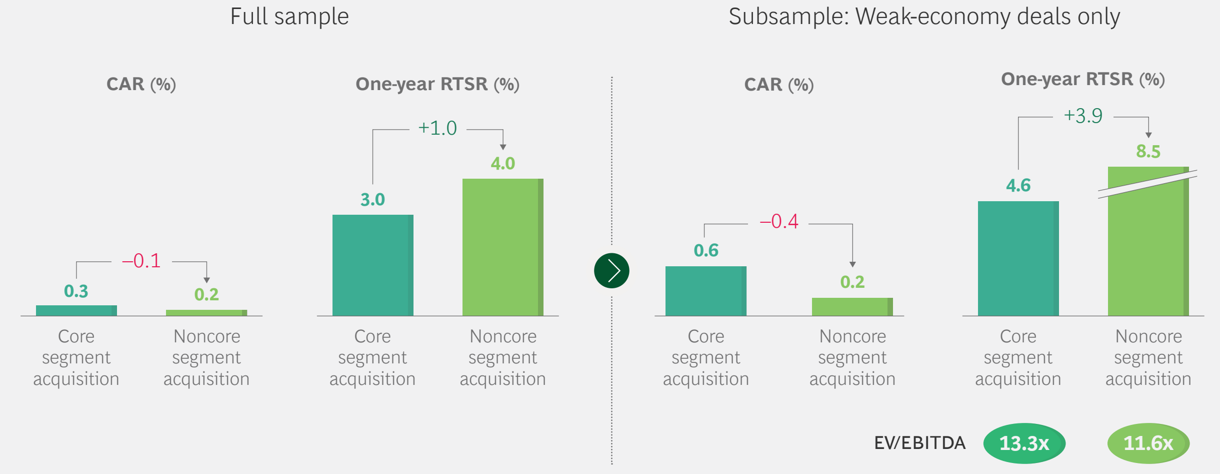
We compared the business models of the buyer and the target to determine if the acquisition involved a target within the buyer's industry (that is, a "core" deal) or outside the buyer's industry (that is, a "noncore" deal).

We then analyzed the difference in performance of core versus noncore deals. In our overall sample, capital markets perceive core segment acquisitions more positively on announcement (CAR is 0.1 percentage point higher). (See Exhibit 8.) However, this effect is driven mostly by the subsample of weak-economy deals; core segment acquisitions have a CAR of 0.6%, compared with 0.2% for noncore deals. Among other factors, higher levels of risk aversion during a weak economy may be leading capital markets to favor acquisitions of businesses within the buyer's industry.

Looking at the medium term, we observed a reversal of market preferences: noncore deals create more value for buyers (one-year RTSR of 4.0% for noncore versus 3.0% for core). Again, the subset of weak-economy deals drives this result. In a downturn, noncore deals outperform by a large margin: one-year RTSR is 3.9 percentage points higher than for core deals. During good economic times, by contrast, noncore deals destroy value for the buyer (RTSR of –1.0%), while core deals preserve value (RTSR of 0.0%). Investors apparently prefer that companies focus on their core businesses in good economic times, while they appreciate diversification in weak economic times.

Our findings point to two imperatives for dealmakers:

EXHIBIT 8 | Investors Favor Deals Outside the Buyer's Industry, Especially in Downturns



Sources: Refinitiv; Datastream; BCG analysis.
Note: The total of 15,153 M&A transactions comprises pending, partly completed, completed, unconditional, and withdrawn majority deals announced between 1980 and 2018 with a deal value greater than $250 million. Only deals with a public buyer were considered. A core segment acquisition is one in which the primary two-digit Standard Industrial Classification codes of the target and the acquirer are identical.

- First, during downturns, have the courage to stay the course. A company that has a well-considered transformation strategy should not alter its plans when it faces the prospect of a negative short-term reaction by capital markets. Although core segment deals are greeted more favorably by markets around the announcement date, medium-term value creation is higher for companies that make bold moves to acquire attractive targets beyond their core industry. The higher returns might be partly attributable to the lower average deal multiple paid for noncore assets.

- Second, in a strong economy, resist the temptation to go on a buying spree or to follow the crowd in acquiring the most sought-after assets. Our research makes clear that strong-economy deals deliver, at best, only modest returns. In fact, after a year, on average, noncore acquisitions destroy value. Corporate decision makers who simply follow the herd, without a clear strategic rationale for their acquisitions, will eventually destroy shareholder value. Academic research supports the view that an undisciplined, herd mentality is broadly responsible for the underperformance of strong-economy deals on average.

Economic conditions, as well as the target's industry, also affect value creation for the sellers of assets. (See the sidebar "Is It Wise to Divest in a Weak Economy?")

How Do Economic Conditions Affect Execution?

In addition to strategy and target selection, a well-executed M&A process, with the appropriate due diligence, is essential for creating value. How does the economic environment influence the effectiveness of the process? The time between deal announcement and closing is a proxy for the efficiency of the buyer, the complexity of reaching the closing conditions, and the length of the overall M&A process. We looked at how three variables—the economic environment, the industry of the target, and the type of target—affect the length of this time period.

Not surprisingly, as a group, weak-economy deals take longer to close than strong-economy deals—regardless of whether the target is public or private or in a core or noncore segment of the buyer. (See Exhibit 9.) Several factors may account for this finding. The decision-making process may take longer in a weak economy, because boards take longer to analyze and approve the deal and shareholder meetings take longer to prepare for. The due diligence process may be more thorough and thus take longer to complete. Acquirers also need more

IS IT WISE TO DIVEST IN A WEAK ECONOMY?

Capital markets greet the announcement of divestitures, as a group, very positively. CAR around the announcement date is approximately 3%. Somewhat surprisingly, divestitures in weak economies have a slightly lower CAR than those in strong economies (2.9% versus 3.2%). Investors appear to place greater value on selling assets in good times (when prices are generally higher) than on unloading assets in downturns (perhaps at fire-sale prices).

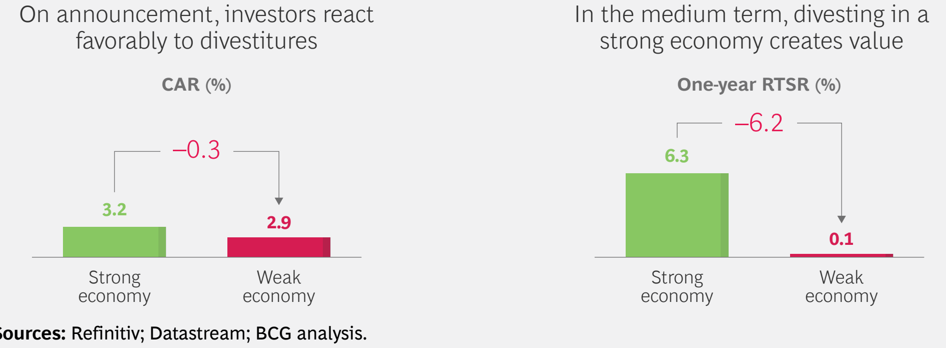
In the medium term, the preference for sales in a strong economy is clearer. The one-year RTSR for sellers in strong-economy divestitures is 6 percentage points higher than that of weak-economy divestitures. (See the exhibit.) Interestingly, strong-economy divestures of core businesses are primarily responsible for this spread (one-year RTSR of 10.8%). Perhaps sellers are seeking to take advantage of high deal multiples (such as those observed in recent years) by divesting well-performing assets at high prices. Sellers can put the money to work again, such as by reinvesting it in M&A or organic growth, distributing it, or saving it.

Digging deeper, we find that noncore divestitures create value primarily during downturns (one-year RTSR of 3.0%). This suggests that companies are selling noncore assets in a downturn to generate funds to finance a turnaround and/or other strategic moves. This finding stands somewhat in contrast to our finding (discussed earlier) that buyers capture higher returns when acquiring noncore assets in a downturn. There are several takeaways from these conflicting messages:

- A company that needs liquidity in a downturn should sell its noncore assets, not its "crown jewels."
- A company that is able to make acquisitions in a downturn should consider diversification or tapping into new business fields—in order to benefit from the lower acquisition prices and position itself for the recovery.
- The economic cycle is among the factors that determine the optimal level of diversification for each company.

These aggregated findings do not mean that it is necessarily a bad move to divest noncore assets during an upturn. In fact, sales of noncore assets, sometimes made to appease activist investors, have become more common in recent years. Regardless of the state of the economy, creating value through divestitures requires the right portfolio logic and a crystal-clear understanding of where to invest the proceeds to generate higher returns than those generated by the divested asset.

Divesting Assets in Upturns Seems to Pay Off in the Medium Term



Sources: Refinitiv; Datastream; BCG analysis.
Note: The total of 386 M&A transactions comprises pending, partly completed, completed, unconditional, and withdrawn majority deals announced between 1980 and 2018 with a deal value greater than $250 million. Only deals with a public seller were considered.

EXHIBIT 9 | The Buy-Side M&A Process, Including Closing, Takes Longer in a Downturn

Sources: Refinitiv; Datastream; BCG analysis.
Note: Timelines are illustrative only. The total of 15,153 M&A transactions comprises pending, partly completed, completed, unconditional, and withdrawn majority deals announced between 1980 and 2018 with a deal value greater than $250 million.

time to arrange for debt financing. Additionally, a less competitive M&A market may reduce incentives to complete the process rapidly.

Experienced Buyers Excel in Downturns

Does dealmaking experience make a difference with respect to value creation in a weak economy? To find the answer, we distinguished between two types of buyers: "occasional" buyers completed one to three transactions in our data sample; "experienced" buyers completed at least four transactions in the sample.

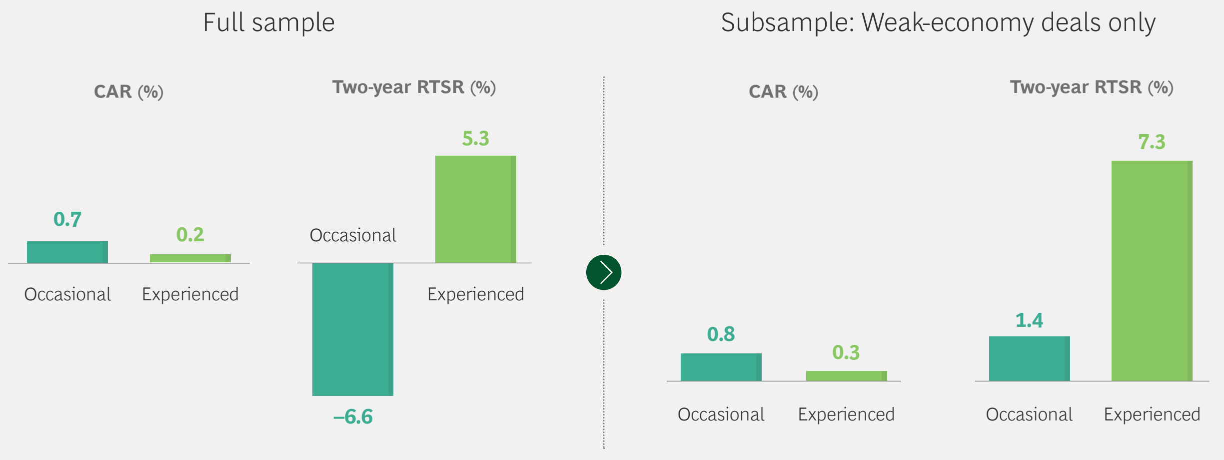
Confirming the results of research discussed in our 2016 M&A Report, we found that occasional buyers earn a higher CAR on announcement than experienced buyers (0.7% versus 0.2%). This is likely attributable to a positive surprise effect. Medium-term value creation is, however, negative for the occasional buyers (two-year RTSR of –6.6%). By contrast, experienced buyers apply the knowledge gained from their previous deals to generate significant value (two-year RTSR of 5.3%). (See Exhibit 10.)

This difference becomes even more apparent when you look at the subsamples of strong- and weak-economy deals. Experienced buyers can create value from M&A in any economic environment (two-year RTSR of 1.1% in a strong economy and 7.3% in a weak economy). Remarkably, they achieve this value creation even as the overall sample of strong- and weak-economy deals experiences, on average, a negative two-year RTSR.

Occasional buyers, in contrast, fail to create value from acquisitions in upturns—and are obviously responsible for the value destruction observed in the overall sample. In fact, they destroy value by a significant margin (two-year RTSR of –13.8%). In weak economic times, they are able to deliver some value creation from M&A (two-year RTSR of 1.4%), but clearly lag behind the experienced buyers' returns.

Overall, experienced buyers create more value than occasional buyers—and this is particularly true in a weak economy. These analyses also imply that, in general, occasional buyers should not shy away from doing M&A deals, especially in downturns. Indeed, they should regard a weak economy as an oppor-

EXHIBIT 10 | Experienced Buyers Create Value from M&A in Any Economic Environment



Sources: Refinitiv; Datastream; BCG analysis.
Note: The total of 51,644 M&A transactions comprises pending, partly completed, completed, unconditional, and withdrawn majority deals announced between 1980 and 2018 with a deal value greater than $25 million. Only deals with a public buyer were considered. “Occasional” buyers completed one to three transactions in the data sample. “Experienced” buyers completed at least four transactions in the sample.

tunity to gain experience, because depressed asset prices (as reflected in the lower deal multiples observed during the Great Recession) increase the margin for error in dealmaking. Of course, every acquisition should still be rooted in a clear-cut strategic rationale and sound financial considerations.

Our research and experience indicate that a number of characteristics set experienced buyers apart from occasional dealmakers. The next section explains how all companies can excel at M&A dealmaking during a downturn.