Are companies **getting better** at M&A?

The latest boom in merger activity appears to be creating more value for the shareholders of the acquiring companies.

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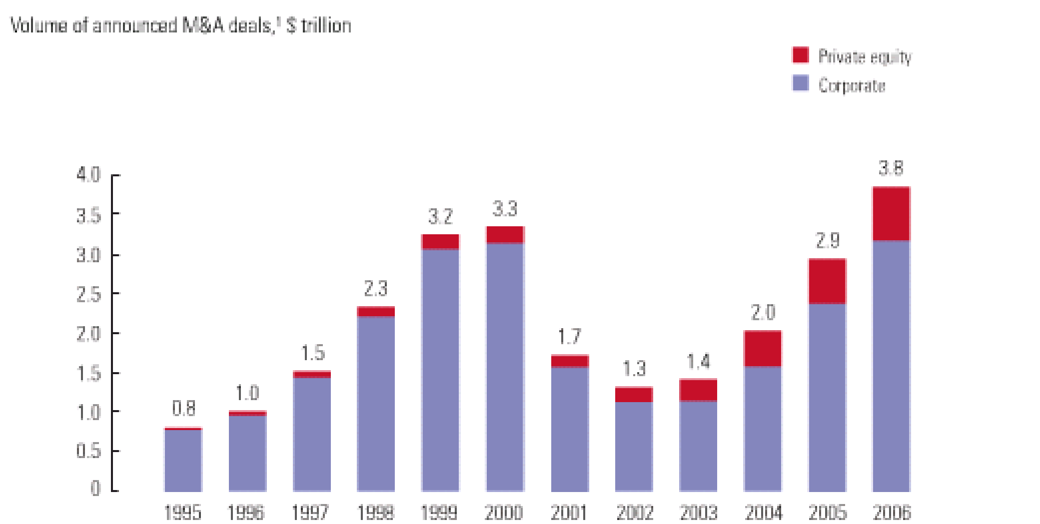
With announced merger activity approaching $4 trillion globally in the first 11 months[1] of 2006, the year had already surpassed the record levels set in 2000 (Exhibit 1). That earlier boom was known not only for the number of deals completed but also for a lack of discipline and the number of deals that destroyed value for the shareholders of the acquiring companies; in fact, earlier McKinsey research shows that as many as two-thirds of all transactions failed to create value for the acquirers.[2] Are shareholders doing any better this time around?

EXHIBIT 1

A new boom in mergers and acquisitions activity



[1]Includes announced deals (not withdrawn) >$25 million in value; 2006 data as of December 11.

Source: Dealogic; McKinsey analysis

They appear to be. But there is still room for improvement.

We reviewed nearly 1,000 global mergers and acquisitions from 1997 to 2006, comparing share prices two days before and two days after each deal was announced in order to assess the financial markets' initial reaction to the deals. Academic research has found a positive correlation between these so-called announcement effects and long-run value creation,[3] so in the aggregate, announcement effects are useful in assessing trends in the ability of M&A to create value.[4]

From our analysis of announcement effects, we compiled two indexes of M&A value creation. The first, deal value added (DVA), tracks the financial markets' assessment of how much total value a deal will create, irrespective of whether the buyer or seller captures it. DVA measures the aggregate value change at the time of announcement across both companies as a percentage of a transaction's value (adjusted for market movements). The second index, proportion of companies overpaying (POP), examines the success of acquirers in capturing value from deals, by measuring the proportion of all transactions in which the initial share price reaction for the acquirer was negative, indicating that the acquirer overpaid (adjusted for market movements). In other words, POP represents the proportion of acquirers that the market perceives to have transferred to the sellers more than 100 percent of the value created in their deal.

Our analysis of these measures indicates that deals in the boom beginning in 2003 are creating proportionally more value—and that acquiring companies are keeping more of it for their shareholders.[5]

The current boom is creating more value . . .

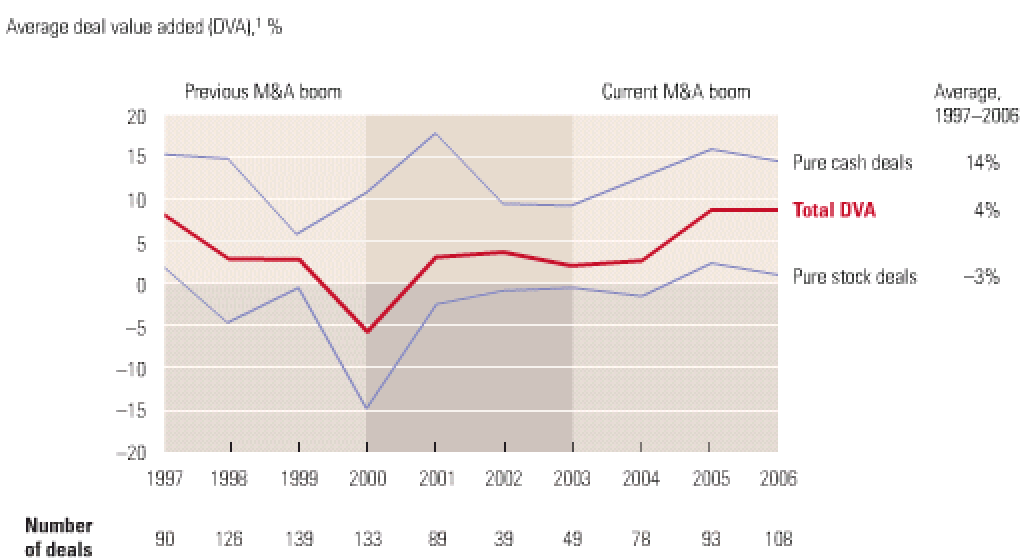
According to our research, the market's estimate of the value that deals created in the past ten years for the buyer and seller combined (as measured by the DVA index) averages around 3.4 percent of the transaction value. During the current boom, however, the average DVA has been 6.1 percent, with the annual numbers trending upward to +10.6 percent, from +2.1 percent. Today, in fact, the DVA index is at a ten-year record high. Those numbers stand in stark contrast to the previous boom's, when the DVA averaged only 1.6 percent for the whole period—and trended downward from +8.6 percent in 1997 to -5.9 percent[6] in 2000.

The financial structure of the deals announced during these two periods of intense M&A activity differs as well. This time around, cash deals represent a much greater percentage of the public-to-public transactions making up our database—nearly half, compared with the 1999 to 2000 range of 20 to 30 percent. Like some academic researchers,[7] we also found that cash deals in our sample received a more favorable market reaction than stock deals, possibly because of trading and signaling effects.[8] Cash deals generated an average DVA of +13.7 percent, compared with -3.3 percent for pure-stock deals.

This greater share of cash deals during the present boom partially explains the market's more favorable reactions. Yet even when we compared those reactions on a like-for-like basis, both cash and stock deals did better in the current boom. Both kinds of deals have also created more value as it has progressed; in contrast, during the previous boom, both types of deals created progressively less value (Exhibit 2).

EXHIBIT 2

Creating more value



[1] For M&A deals involving publicly traded companies; DVA defined as combined (acquirer and target) change in market capitalization, adjusted for market movements, from 2 days prior to 2 days after announcement, as % of transaction value; 2006 data as of December 11.

Source: Datastream; Dealogic; McKinsey analysis

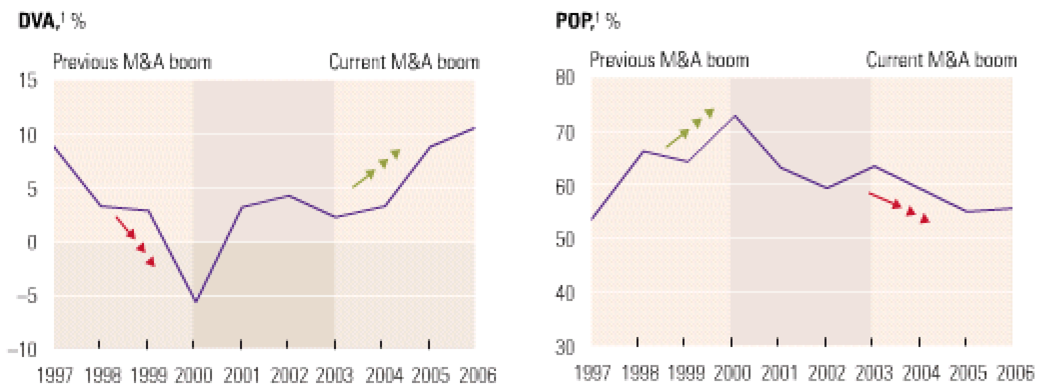
. . . and acquirers are keeping more of it

In the earlier M&A boom, the market judged that in more than two-thirds of the deals, all of the value created went to the target companies' shareholders. This time, however, shareholders of acquiring companies appear to be keeping more of that value, as measured by the lower proportion of acquirers that the market believes to be overpaying for deals (our POP index). In the current boom, the proportion overpaying has averaged 57 percent, decreasing annually from 63 percent in 2003 to 56 percent in 2006. In contrast, from 1997 to 2000 the overall average was 65 percent, with the level of overpayment increasing significantly, from 54 percent in 1997 to 73 percent in 2000. Today's POP index stands near a ten-year low, despite greater competition from private equity firms, which conduct more than 20 percent of all global merger activity. Both the DVA and POP indexes, which were moving in the wrong direction during the last M&A boom, are now moving in the right one (Exhibit 3).

EXHIBIT 3

Dramatically different trends

Trends in deal value added (DVA) and proportion overpaying (POP) during 2 most recent M&A booms[1]



[1] For M&A deals involving publicly traded companies; DVA defined as combined (acquirer and target) change in market capitalization, adjusted for market movements, from 2 days prior to 2 days after announcement, as % of transaction value; POP defined as proportion of transactions where share price reaction, adjusted for market movements, from 2 days prior to 2 days after deal, was negative for acquirer; 2006 data as of December 11.

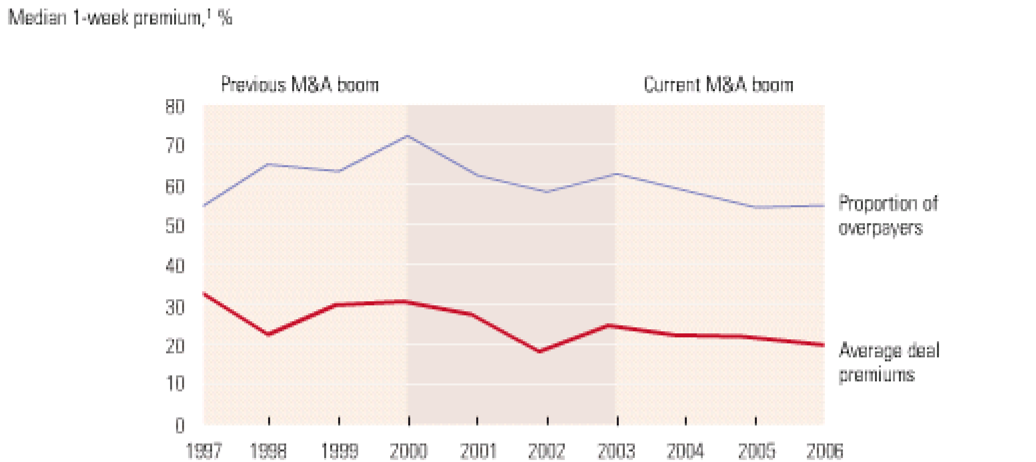
Source: Datastream; Dealogic; McKinsey analysis

While today's lower POP could reflect many factors, one explanation is lower deal premiums (Exhibit 4). In contrast to the 1990s, when the typical price premium hovered around 30 percent, acquirers now pay just slightly more than 20 percent to win their target acquisitions, suggesting that boards and management teams may be more cautious about overpaying. Not that prices are low—indeed, acquirers are paying very high multiples. But on average, price premiums are lower than they were before, and especially lower than they were at the last boom's peak, in 2000.

Another explanation for the lower proportion of deals that are deemed value destroying to the acquirer is the market's reaction to cash deals versus stock deals at the time of announcement. In pure-cash deals an average of around 49 percent of acquirers overpay, compared with 69 percent for pure-stock deals—a difference that has remained fairly constant over time (Exhibit 5). The overall POP index has improved considerably, thanks to the growing proportion of cash deals. Even when we consider cash deals and stock deals separately, however, the POP index is considerably lower today than it was in 2000.

EXHIBIT 4

Paying lower premiums

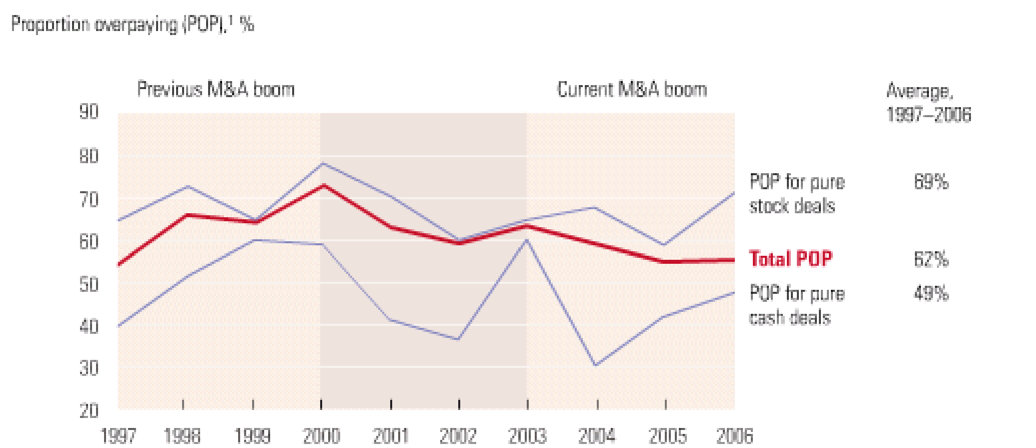


[1] For M&A deals involving publicly traded companies; 1-week premium = price offered per share vs target company's share price 1 week before announcement; 2006 data as of December 11.

Source: Datastream; Dealogic; McKinsey analysis

EXHIBIT 5

Cash deals are better received



[1] For M&A deals involving publicly traded companies; POP defined as proportion of transactions where share price reaction, adjusted for market movements, from 2 days prior to 2 days after deal, was negative for acquirer; 2006 data as of December 11.

Source: Datastream; Dealogic; McKinsey analysis

Mergers can and often do create value in the eyes of investors. The improvements reflected in our M&A indexes are encouraging: despite the recent intense volume of M&A, it appears that acquirers have been disciplined about creating value. Nonetheless, plenty of room remains for acquirers to improve their M&A performance by focusing on the scope to create value and to ensure that they don't overpay. Q

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Notes

1 As of December 11, 2006.

2 Tom Copeland, Tim Koller, and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies*, first edition, Hoboken NJ: John Wiley & Sons, 1990, pp. 318–21.

3 Paul Healy, Krishna Palepu, and Richard Ruback, "Do mergers improve corporate performance?" *Journal of Financial Economics*, 1992, Volume 31, pp. 135–75; and Todd Hazelkorn, Marc Zenner, and Anil Shivdasani, "Creating value with mergers and acquisitions," *Journal of Applied Corporate Finance*, 2004, Volume 16, Issue 2–3, p. 84.

4 Announcement effects are useful to assess the impact of M&A on its own, as they strip out many of the other factors that drive share price movements beyond just the M&A announcememt. But because the market's initial response to deals can be either wrong or affected by factors other than the value of the deal (such as bid speculation before the deal, signaling, and tax and market liquidity issues), announcement effects cannot be used to assess the value that any individual deal creates.

5 Given the methodology, our analysis excluded deals by private equity and other privately owned companies, since to measure the share price impact on both the acquirer and the target company both must be publicly listed. We established other criteria for inclusion as well: (1) The absolute size of the deal had to exceed $500 million, to ensure the liquidity of the target and materiality. (2) The target had to be at least 5 percent of the acquirer's size (measured by market capitalization), so that the resulting impact on share prices would adequately reflect the transaction and not other events or noise in the share price. (3) Transactions had to involve a full change of ownership (defined as the acquirer going from 0 to 100 percent ownership) to ensure that the premium paid reflected a full change of control and that the combined company would be fully capable of capturing the intended value from the combination.

6 The DVA is negative when the stock market's reaction to a deal announcement is so unfavorable (possibly because of the loss of creditability for the management team) that the decline in the acquirer's market capitalization more than offsets the increase in the acquired company's share price.

7 Gregor Andrade, Mark Mitchell, and Erik Stafford, "New evidence and perspectives on mergers," *Journal of Economic Perspectives*, 2001, Volume 15, Number 2, pp. 103–20.

8 One way to understand this difference is to think of a cash deal as a stock deal with a share buyback, with all its corresponding positive effects. See Richard Dobbs and Werner Rehm, "The value of share buybacks," *McKinsey on Finance*, Number 16, Summer 2005, pp. 16–20.
