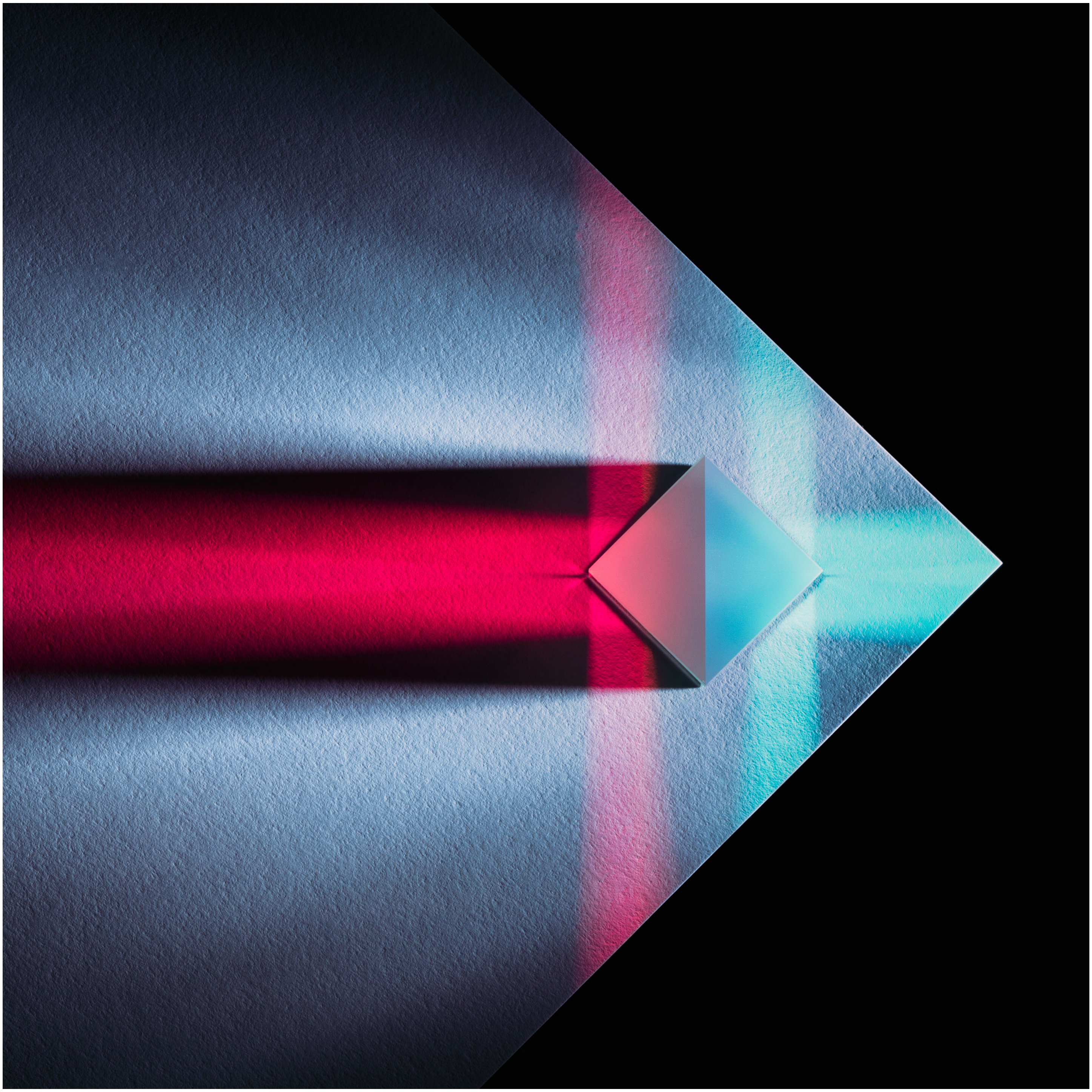

Global M&A Report 2023

When M&A is the answer: In an uncertain market, bold moves will define the future

BAIN & COMPANY

Acknowledgments

This report was prepared by the leadership team of Bain & Company's Global M&A and Divestitures practice, with special direction from Les Baird, partner; David Harding, advisory partner; Andrew Grosshans, partner; Kai Grass, partner; Suzanne Kumar, practice vice president; Madhurima Bhattacharya, associate partner; Joerg Ohmstedt, practice director; and an editorial team led by David Diamond.

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Letter from the M&A Team

Dear friends,

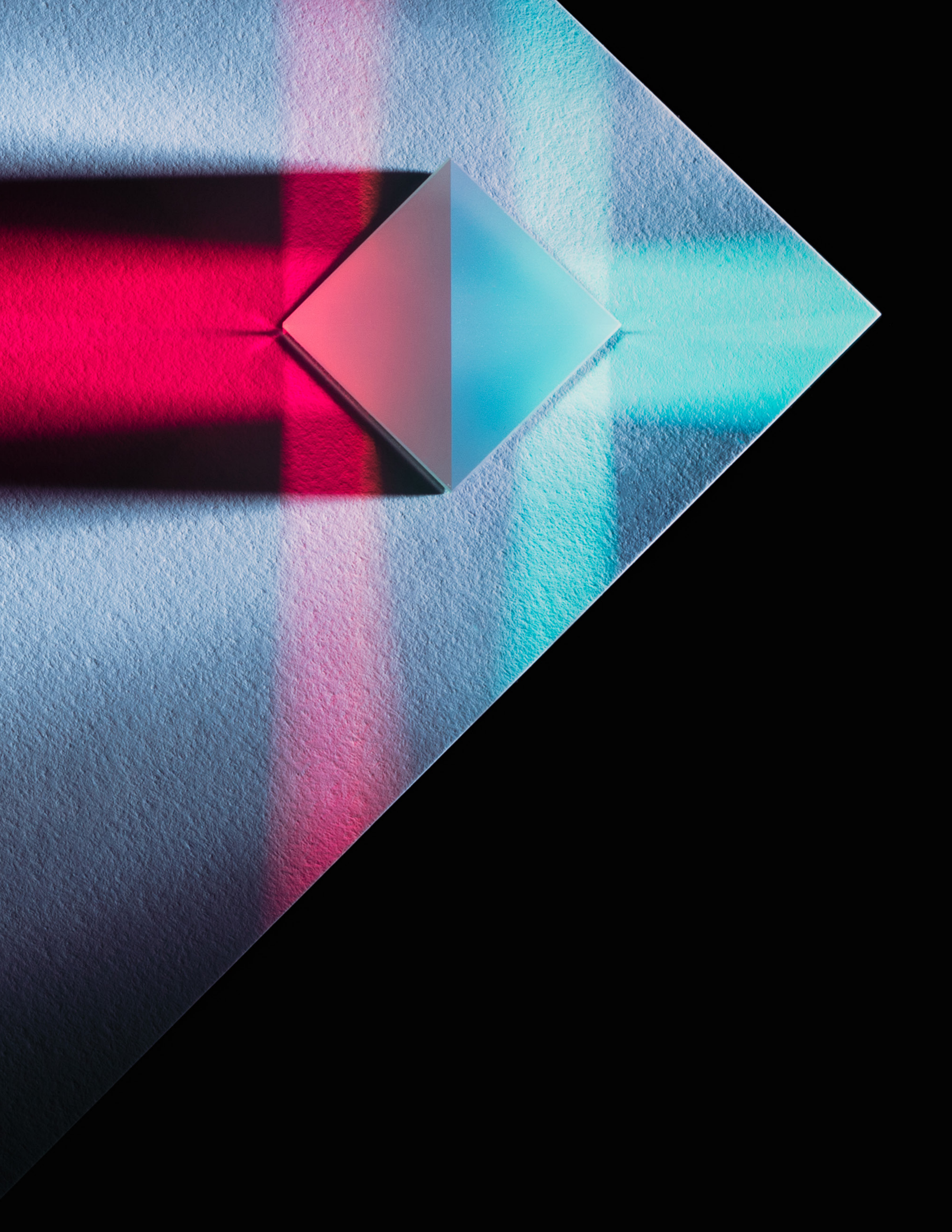
Last year was a challenging one for all dealmakers as inflation, interest rates, geopolitical tensions, and increased regulatory oversight placed unprecedented demand on the skills of deal executives. Throughout it all, though, M&A persevered—not always in the same numbers or with the same processes as in the past, but deals got done.

Overall deal value fell during the year, with multiples dropping from record highs in 2021 and fewer large deals. But the pace of small deals was surprisingly resilient. And dealmaker sentiment as we enter 2023 is optimistic.

History tells us that **companies making bold moves during times of turbulence tend to win** over the long term. The mission of this, our fifth annual report: Improve M&A by sharing the insights of the world's best dealmakers.

Les Baird

Leader of Bain's Global M&A practice



State of the Market

State of the Market

Looking Back at M&A in 2022

Even as macroeconomic uncertainty reset the M&A market, dealmakers persisted.

By David Harding, Kai Grass, Andrew Grosshans, Suzanne Kumar, and Madhurima Bhattacharya

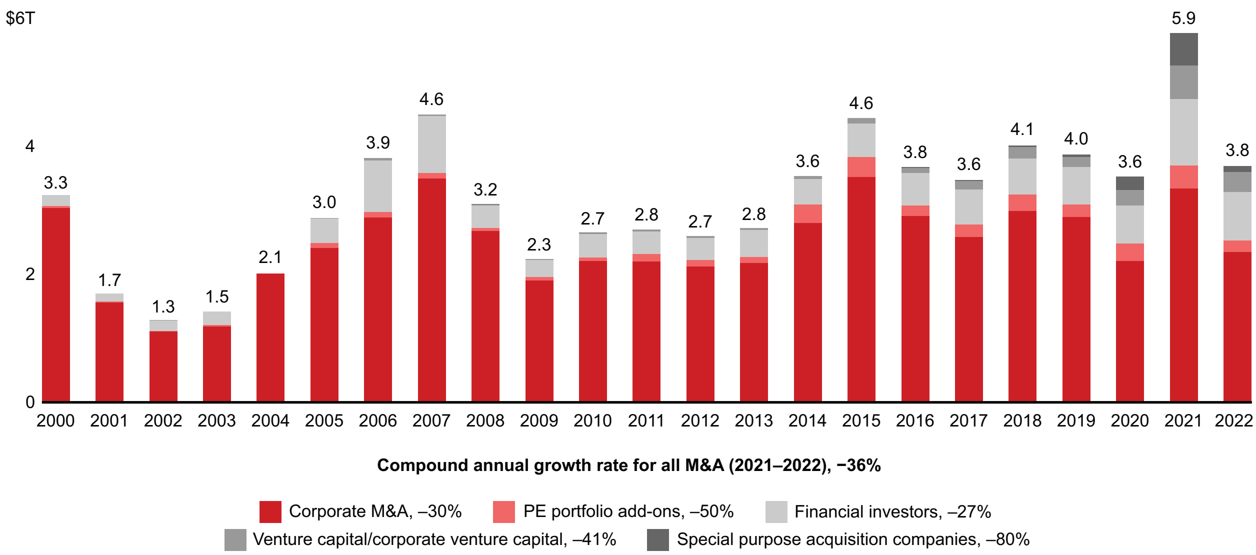
At a Glance

- After a strong first half of 2022, the market slowed in the second half, although fundamental deal activity persisted.
- Declines in multiples and a midyear pause in megadeals were the key contributors to a 36% decline in deal value in 2022 from a record high in 2021.
- Geopolitics, regulation, and other external factors also continued to impact deal activity patterns.

The year 2022 was a tale of two halves. After a blockbuster year for M&A in 2021, the first five months of 2022 reflected continued strong dealmaking activity. The big turning point occurred on June 16, 2022, when an interest rate hike by the US Federal Reserve Bank, combined with heightened macroeconomic uncertainty, put a chill on the deal market. Megadeals greater than $10 billion went on pause while smaller deals slowed. Deal multiples tempered. The midyear correction resulted in a 36% decline in annual M&A deal value, to $3.8 trillion (*see Figures 1 and 2*). Yet volumes dropped by only 12%, suggesting resilience and commitment among dealmakers.

Figure 1: Global M&A deal value fell by 36% in 2022

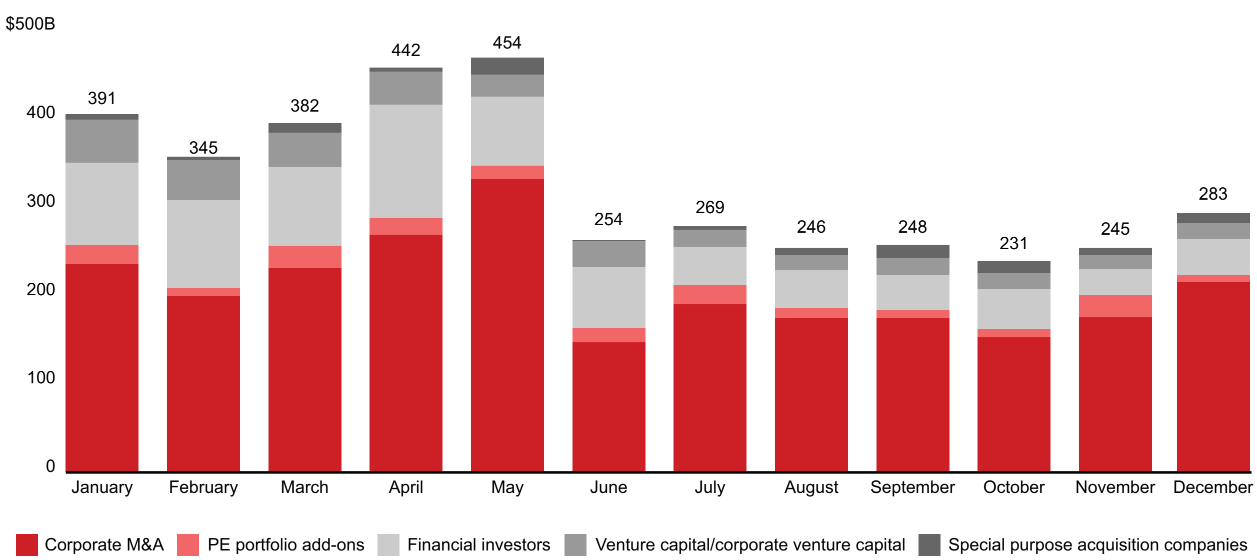
M&A deal market value (in trillions of US dollars)



Note: Categorizations based on deal technique, industry, and acquirer business description
Source: Dealogic

Figure 2: The year 2022 was a tale of two halves

2022 M&A deal market value (in billions of US dollars)



Notes: Strategic deals include corporate M&A and PE portfolio add-ons; categorizations based on deal technique, industry, and acquirer business description
Source: Dealogic

As the market reset, we observed some unanticipated shifts in dealmaking and, at the same time, a persistence of longer-term trends. On the one hand, the sudden drop in megadeals and deal multiples reflected the impact of structural uncertainty on M&A. Yet M&A remained central to corporate strategies for growth and profitability as evidenced by the relatively consistent levels of deal volume and balanced mix of scale and scope deals.

Structural uncertainty

Inflation, interest rates, capital availability, industrial policy, national security, geopolitical tension, supply chain uncertainty—in 2022, dealmakers faced new levels of volatility everywhere they looked as well as risks from variables that previously weren't a focus in many deal models.

June's interest rate hike marked a new phase in the era of capital superabundance. In the face of rising inflation, the Fed's move to raise rates happened more quickly than many expected. The implications were felt internationally as other central banks followed suit. The role of the US dollar in global trade amplified the impact. Dealmakers across the globe suddenly confronted an unfamiliar unknown—namely, the cost and availability of capital—amid a weakening economic environment. After decades of low and predictable interest rates, however, acquirers told us they were shaken less by the rising cost of capital and more by the uncertainty they now faced.

The interest rate warning shot impacted financial investors and strategic buyers differently. Private equity investors, reliant on debt for financing deals, were more immediately exposed to capital constraints and costs, which particularly impacted large deals. Lenders increased scrutiny on new offers as banks absorbed loan commitments that they could no longer syndicate. By comparison, corporates tend to be shielded from the near-term effects of interbank interest rate changes. Moreover, as we explored in our *Global M&A Report Midyear 2022*, corporates have more options to finance M&A than leverage alone—namely, stock and cash. Regardless, the new level of uncertainty about the economic outlook revealed by the interest rate hike led to a secular reset in M&A value and volume for all players in the second half of 2022.

Acquirers faced a variety of other external factors besides interest rate ambiguity. Inflation and the emerging recessionary environment challenged assumptions about base business trajectories for strategic acquirers and targets alike. Supply chain disruptions continued to impact the accuracy of projections, and industrial policy reemerged as a swing factor for sector economics. Western government responses to climate and geopolitical crises presaged shifts in corporate profit pools. In Europe, amid growing concern about the Russia-Ukraine war, the likely need to subsidize winter energy costs for consumers forced a pullback on funding for other social needs such as healthcare. In the US, the Inflation Reduction Act placed bets on renewables at the cost of fossil fuels, and national security concerns prompted a decoupling of the semiconductor industry from China.

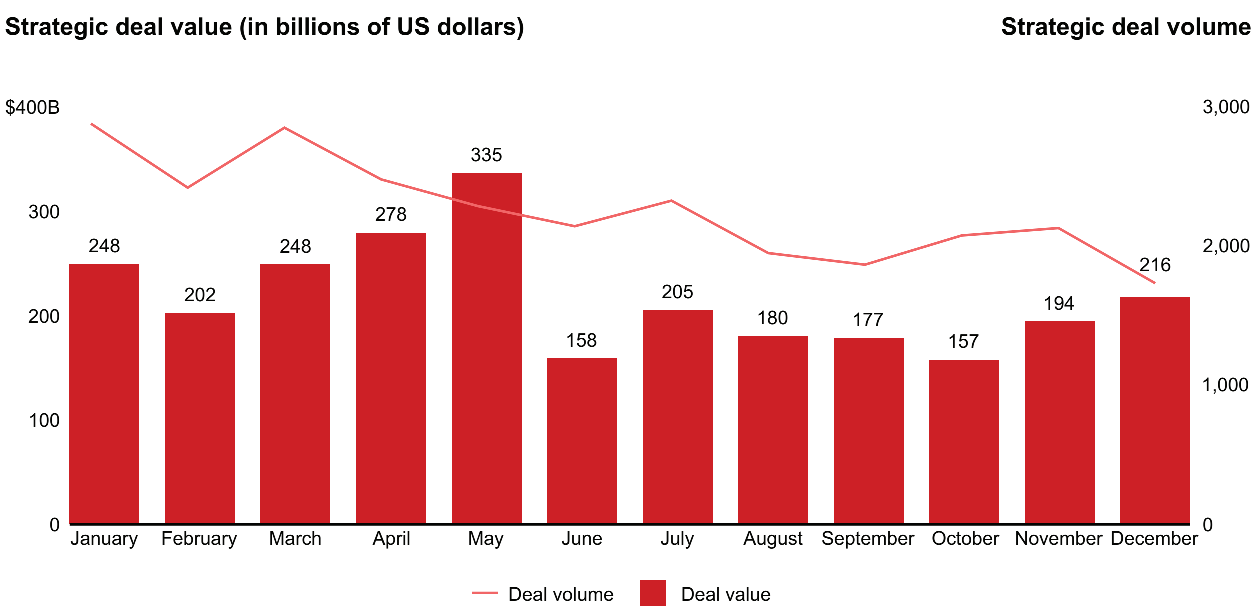
Strategic dealmaking during an uncertain year

Despite a healthy start to 2022, the strategic deal market closed at $2.6 trillion, a 32% decline from the all-time high in 2021. Strategic deal volumes dropped 9% and continued to hold steady during the last few months of 2022, particularly in smaller to midsize deals (*see Figure 3*). Divestments held steady at 33% of deals.

Deal multiples declined as higher discount rates caused companies to put a premium on near-term cash flows over long-term growth. Multiples fell from record highs in 2021 to a 10-year low median multiple of 11.9 times enterprise value to EBITDA (*see Figure 4*). The drop-off was most notable in the high-growth industries of tech and healthcare and life sciences—each fell by more than five turns (*see Figure 5*). It's worth noting that this decline mirrored changes in public market valuations. For example, the S&P 500 was off by 20% during the same time period. M&A practitioners tell us that they respond to deal multiple volatility with lower valuations and changes to deal structure, but few are waiting on the sidelines for multiples to stabilize—as evidenced by sustained deal volume.

A midyear pause in megadeals (valued at more than $10 billion) also had a significant impact on total deal value for the year. The year began with more than a few headline deals such as Microsoft's

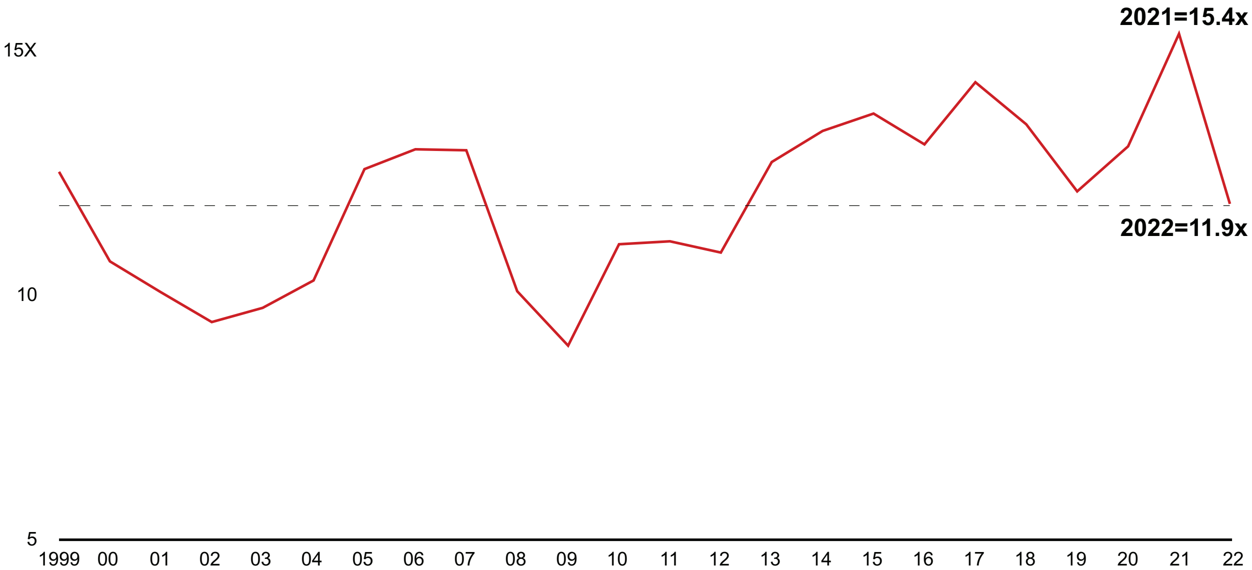
Figure 3: 2022 overall strategic deal value and volume by month



Notes: Total for year=strategic value total; strategic deals include corporate M&A and PE portfolio add-ons; categorizations based on deal technique, industry, and acquirer business description
Source: Dealogic

Figure 4: Strategic M&A multiples fell to nearly 12 times from 2021's historic high of 15.4 times

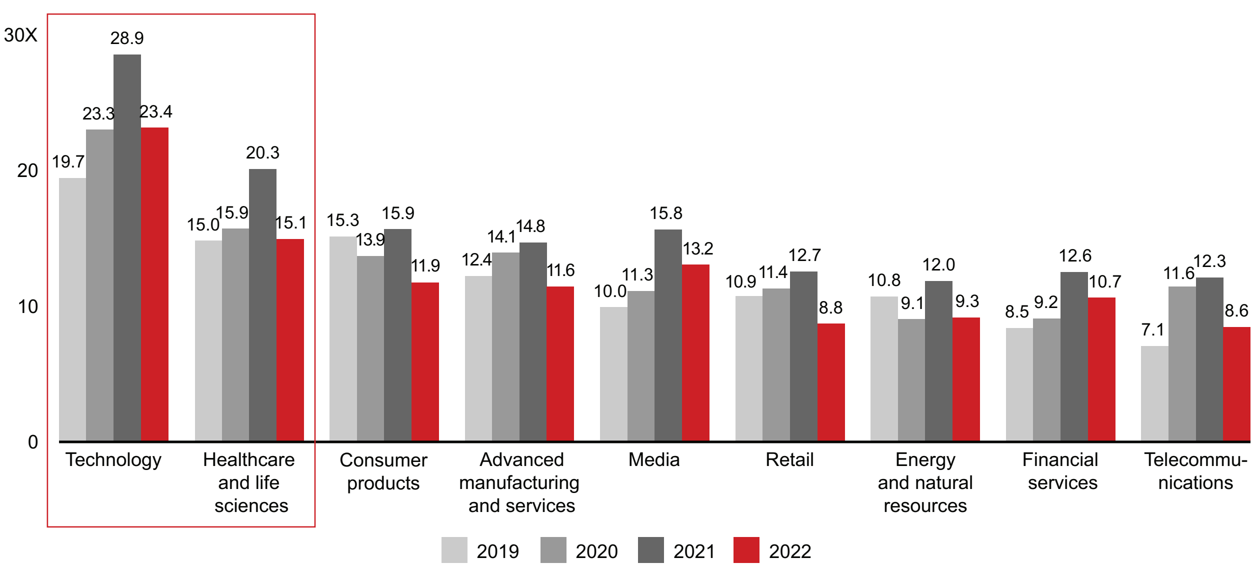
Median enterprise value to EBITDA multiples



Notes: Median deal multiples for announced strategic deals in which valuation data was available; strategic deals include corporate M&A and PE portfolio add-ons
Source: Dealogic

Figure 5: Technology and healthcare and life sciences multiples fell by more than five turns

Median enterprise value to EBITDA multiples per industry (strategic deals)



Notes: Median deal multiples for announced strategic deals in which valuation data was available; strategic deals include corporate M&A and PE portfolio add-ons
Source: Dealogic

$69 billion bid for the gaming company Activision Blizzard, Broadcom's $61 billion offer for VMware, and the Prologis-Duke Realty logistics real estate deal for $23 billion. After a blockbuster May, the strategic megadeal market dried up temporarily in June. The rest of the year saw a steady (if more moderated) pace of megadeals. The healthcare and life sciences sector led the way for large deals, with Johnson & Johnson's nearly $17 billion offer for Abiomed, a medtech company; the $27.8 billion Amgen-Horizon Therapeutics biotech deal; and, most recently, the Novozymes-Chr. Hansen merger for around $12 billion (see the chapter "M&A in Healthcare and Life Sciences: Why the Industry's Wait-and-See Days Will End").

Overall, large strategic M&A deals were nearly evenly split between scale and scope theses (*see Figure 6*). We believe, over the long run, the relative balance of scale and scope observed during the first three quarters of 2022 is consistent with the winning strategies of corporate outperformers—namely, a balancing of growth in revenue and profits. An examination of the largest deals reveals diverging sector dynamics and strategies. In 2022, advanced manufacturing and services, energy and natural resources, and financial services companies were most likely to strengthen their core business via scale deals (*see Figure 7*). For advanced manufacturing and services and financial services, this continues a focus on efficiency and operations via scale deals. Energy and natural resources companies, however, showed a new shift toward scope M&A as energy transitions prompted large renewables deals (see the chapter "M&A in Energy and Natural Resources: Beating the Odds in Energy Transition Deals"). Technology and healthcare and life sciences' appetite for scope and capability deals remained constant as companies in both industries pursued top-line growth.

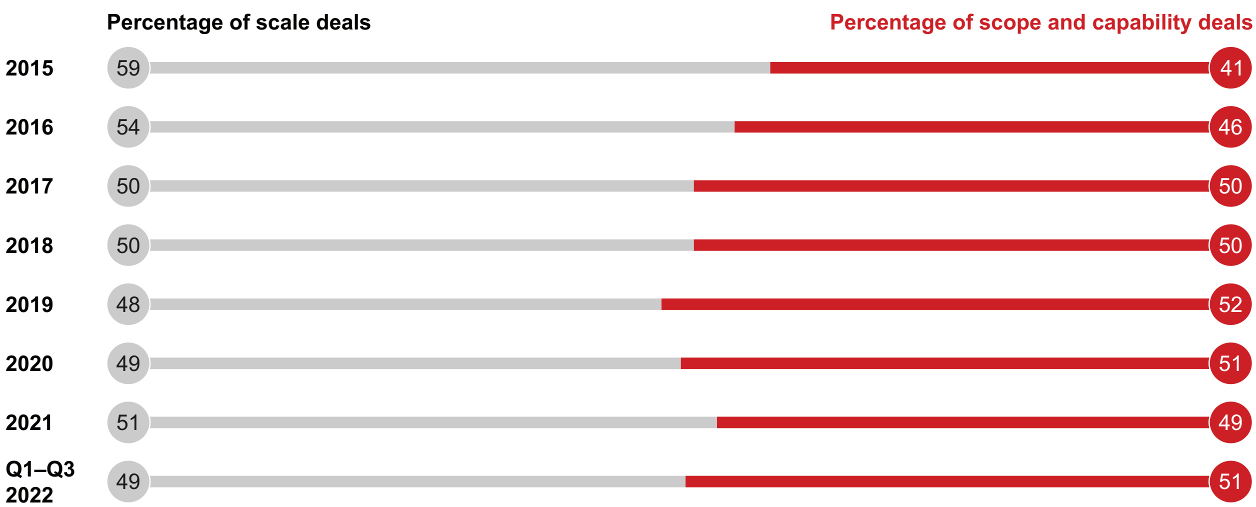
The healthcare and life sciences sector led the way for large deals.

Taking a geographic lens, we continued to see a preference for in-region targets as supply chain shocks, China-US decoupling, and geopolitical risks focused acquirer attention on targets closer to home. Europe shifted to intraregional deals, representing more than three-quarters of deal value in 2022 compared with about two-thirds in recent years. Meanwhile, China and India remained largely domestic markets (more than 90% of value). In India, the most notable takeaway for the year was not flow directionality but rather the overall explosive growth in M&A. By the end of October, total deal value was nearly 140% higher than in all of 2021. The rest of Asia and the Americas held steady in their balance of target by geography.

In 2022, the regulatory environment reflected the longer-term trend of increased scrutiny on antitrust and national security grounds. For example, regulators in the UK, Europe, and the US raised both antitrust and national security concerns about Nvidia's scrapped purchase of UK semiconductor maker Arm. And in the US, the Biden administration has adopted a more expansive

Figure 6: Deals continue to be split evenly between scope and scale

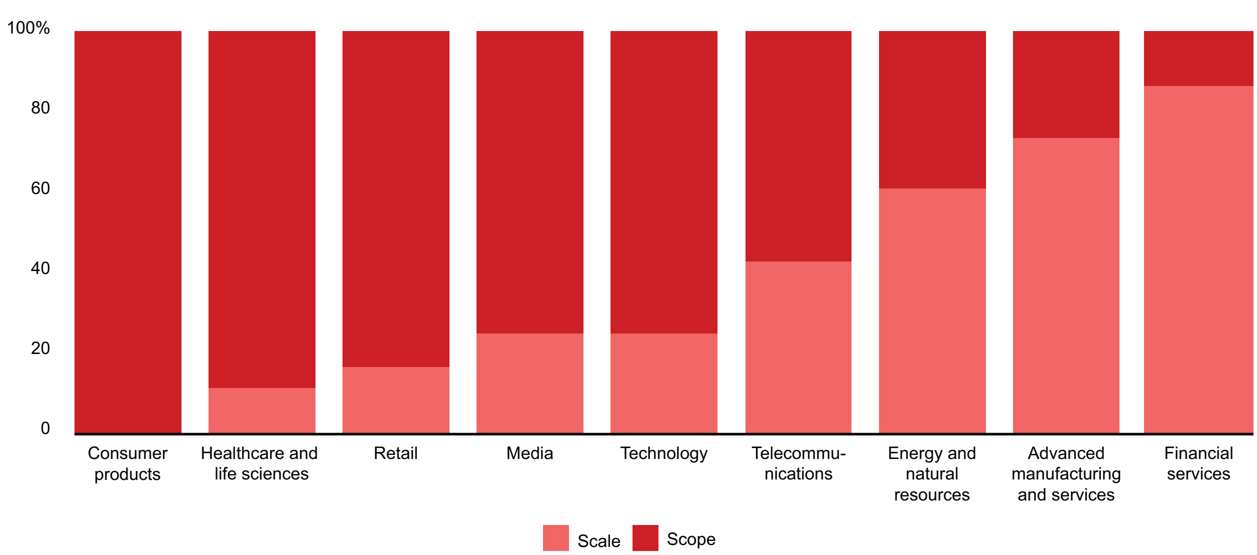
250 largest strategic deals with deal value greater than $1 billion



Notes: If more than 250 deals had a value greater than $1 billion in a given year, then only the top 250 deals were included; if fewer than 250 deals, only those greater than $1 billion were included; the top 250 announced strategic deals of the year from 2015 to 2021 exclude nonstrategic deals such as asset or property acquisitions, financial investment deals, government acquisitions, internal reorganizations, or minority stake acquisitions; deals classified by rationale using a proprietary classification framework, as per stated strategic rationale at the time of announcement
Source: Bain M&A database 2022 (N=2,845 companies)

Figure 7: Consumer products and healthcare and life sciences primarily saw scope deals, while financial services and advanced manufacturing were driven by scale deals

Percentage of scale and scope deals greater than $1 billion split by industry



Note: Based on the 197 deals valued at greater than $1 billion as of September 30, 2022
Source: Bain M&A database 2022 (N=2,845 companies)

definition of "anticompetitive" and has been more likely to challenge large consolidation deals in court. Consider the successful case against Bertelsmann-owned Penguin Random House's proposed acquisition of Simon & Schuster on the grounds that authors, not just consumers, would be harmed. While many scrutinized deals are ultimately approved, a longer pre-close period introduces the risk of deterioration in the base business and employee morale. On the margin, this risk may have tempered boardroom appetite for large transformative deals over the past year.

In the following chapter, "Looking Ahead to M&A in 2023," we explain why savvy executives will keep their feet on the M&A accelerator even as competitors slam on the brakes.

State of the Market

Looking Ahead to M&A in 2023

In an uncertain market, executives are making the bold moves that will define the future.

By David Harding, Kai Grass, Andrew Grosshans, and Suzanne Kumar

At a Glance

We've identified five M&A themes to watch for in the year ahead:

- Cash-rich companies making strategic, bold moves.
- A continued prevalence of small to midsize deals.
- A balance of scale and scope deals.
- Valuations coming under further pressure.
- Companies reshaping portfolios through separations and divestitures.

In 2023, savvy executives will keep their feet on their M&A accelerators, even as competitors slam on the brakes in the face of turbulence.

Experienced dealmakers are familiar with the cyclical nature of the M&A market. Deal values and deal multiples decline as sellers hold back and acquirers lose conviction. As uncertainty impacts both the base business of acquirers and targets, it becomes harder to make decisions about deals. It's no wonder why many executives lose their appetites for the deal process during turbulent times.

Yet history tells us that winners don't pause M&A during downturns, rather they take advantage of opportunities to reshape their industries. Companies that move quickly when others hesitate are rewarded.

Bain research on M&A in times of turbulence validates how M&A was part of the winning response in previous down cycles. We examined the acquisition activity of 2,845 companies from around the world during the global financial crisis and economic downturn of 2008–2009. We found that in the long run, companies that executed at least one deal per year during the economic downturn earned 120 basis points more in total shareholder returns than companies that were inactive in M&A. Moreover, as we explore in the chapter "M&A in Times of Turbulence: Lessons from the Last Recession," many industry-defining deals were made throughout the last downturn.

Deal practitioners are prepared to take advantage of this moment. We surveyed around 300 M&A executives globally about their outlook and priorities for dealmaking in 2023. Respondents anticipate closing a similar number of deals, if not more, in the year ahead, encouraged by more attractive asset availability and decreased competition. They express confidence in the ability for M&A to create value. Nearly two-thirds of respondents report that acquisitions completed in the previous three years have met or exceeded expectations.

Based on our observations from earlier down cycles, we have identified five themes to keep an eye on in 2023: cash-rich companies making strategic, bold moves; continued prevalence of small to midsize deals; a balance of scale and scope deals; further pressure on valuations; and portfolio reshaping through separation and divestitures.

Cash-rich companies making strategic, bold moves

In 2008–2009, numerous industry-defining deals positioned acquirers for faster, more profitable growth out of the downturn. In the current cycle, too, companies with a strong market position, cash on hand, and debt capacity will have the upper hand to execute transactions. These companies should be confirming their strategic M&A roadmaps, revisiting deal models, and laying the groundwork to move fast on desirable targets (large and small). Nearly every sector has a few cash-rich market leaders. Energy, industrials, and technology stand out as sectors in which the top players have solid balance sheets to make bold moves. Strong performing companies with an experienced track record of M&A will be the best positioned to do the largest transformational deals.

Sectors with struggling assets may find more tolerance among regulators for large consolidation deals.

Continued prevalence of small to midsize deals

Thousands of deals valued at less than $500 million make up the bulk of M&A activity each year. We expect this to continue. Companies look to M&A to address strategic needs to expand markets, build new engines for growth, and fill capability gaps. Smaller to midsize deals will be easier than megadeals to complete given relatively lower risk, less reliance on financing, and less regulatory scrutiny. Dealmakers in many industries may shy away from pursuing deals that could wind up in regulatory crosshairs as extended pre-close periods incur many direct and indirect costs. Sectors with struggling assets, such as banking in Europe and telcos in developing economies, may find more tolerance among regulators for large consolidation deals.

A balance of scale and scope deals

A high interest rate environment and weak economy put a premium on assets with cash flow and a line of sight to rapid synergies, supporting a near-term shift to scale deals. For example, in healthcare, moves such as Johnson & Johnson's $16.6 billion acquisition of Abiomed in November 2022 signal a return to category leadership. At the same time, our M&A Practitioners' 2023 Outlook Survey indicates that appetite will continue for deals to build and grow new businesses. These "Engine 2" deals offer speed to market and efficiency that organic moves can't match—see "When Buying (vs. Building) Is the Right Move for Engine 2." Energy companies are likely to be a prime example of this approach as they use cash to consolidate in existing markets while shifting to renewables via scope deals—see "M&A in Energy and Natural Resources: Beating the Odds in Energy Transition Deals." Similarly in retail, while we expect to see retailers pursue scale deals, such as the $25 billion Kroger-Albertsons deal announced in October 2022, they are also likely to use scope M&A to establish "beyond trading" Engine 2 businesses—see "Retail's New M&A Balancing Act."

Further pressure on valuations

Uncertainty regarding cost and availability of capital, as well as the overall macroeconomic outlook, will likely cause dealmakers to be more conservative in valuations. History suggests that valuations typically find a floor at around 9 times to 10 times enterprise value to EBITDA, another 2 to 3 turns lower than the 2022 median. Yet strategic buyers hoping for a steal should be prepared for increased competition from financial buyers as the year unfolds. Private equity firms are resilient in fragile economic environments and will continue to have record amounts of dry powder, an appetite for deals, and a willingness to pay for desired assets.

Portfolio reshaping through separation and divestitures

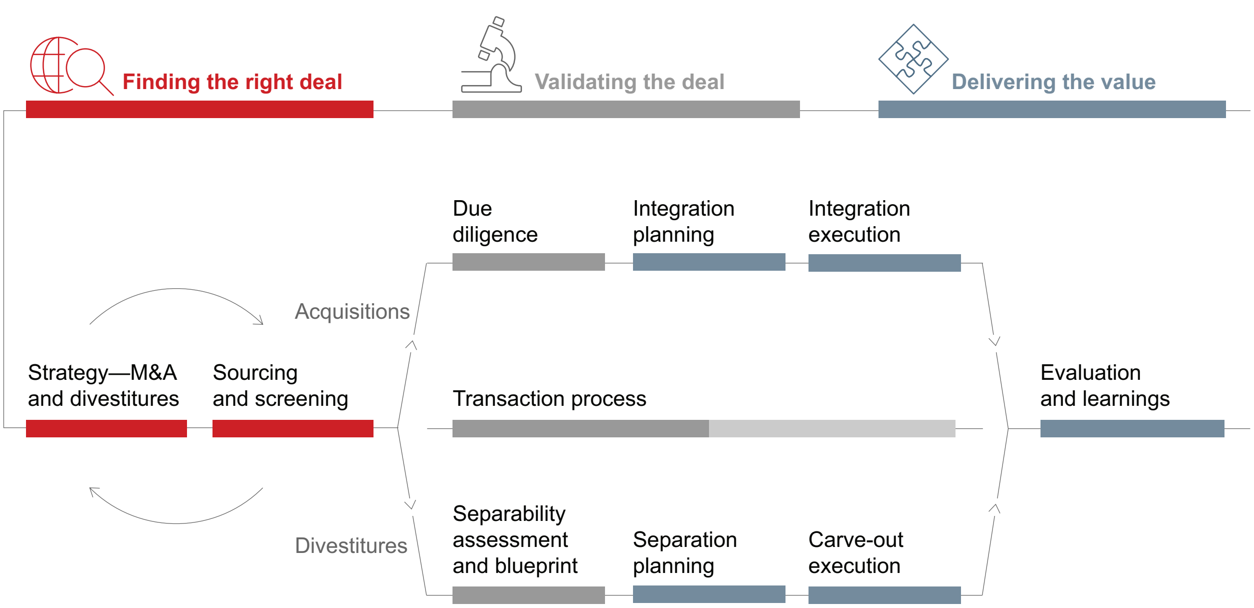
Down cycles and uncertainty force companies to reevaluate their portfolios under new scenarios. While we expect boards to consider divestitures more seriously, it takes a lot of conviction to do one in a downturn. Corporate executives often drag their feet on selling underperforming assets "at a loss." Yet this fear is often misplaced: at some point, no amount of multiple expansion can offset declining performance in the business itself, especially one that is no longer receiving attention or investment. We expect to see the most divestiture activity in sectors in transition, where divestitures can help fund new investments. For example, the shift to renewable energy from fossil fuels and internal combustion engines could spur more divestment activity in the energy and automobile industries—see "M&A in Automotive and Mobility: Finding Alternative Routes to the Future." Moreover, a quick sale unlocks not only capital but also leadership focus. For this reason, we expect the relatively high level of divestiture activity in consumer products to continue.

What does this mean for the M&A practitioner?

In a challenging macroeconomic environment and deal market down cycle, M&A executives should customize their toolkits to accelerate decision making, gain conviction in potential deals, and preserve value through integration (*see Figure 1*).

Figure 1: A strong M&A capability requires strategy-driven enablers to deliver value across the M&A value chain

M&A operating model



Source: Bain & Company

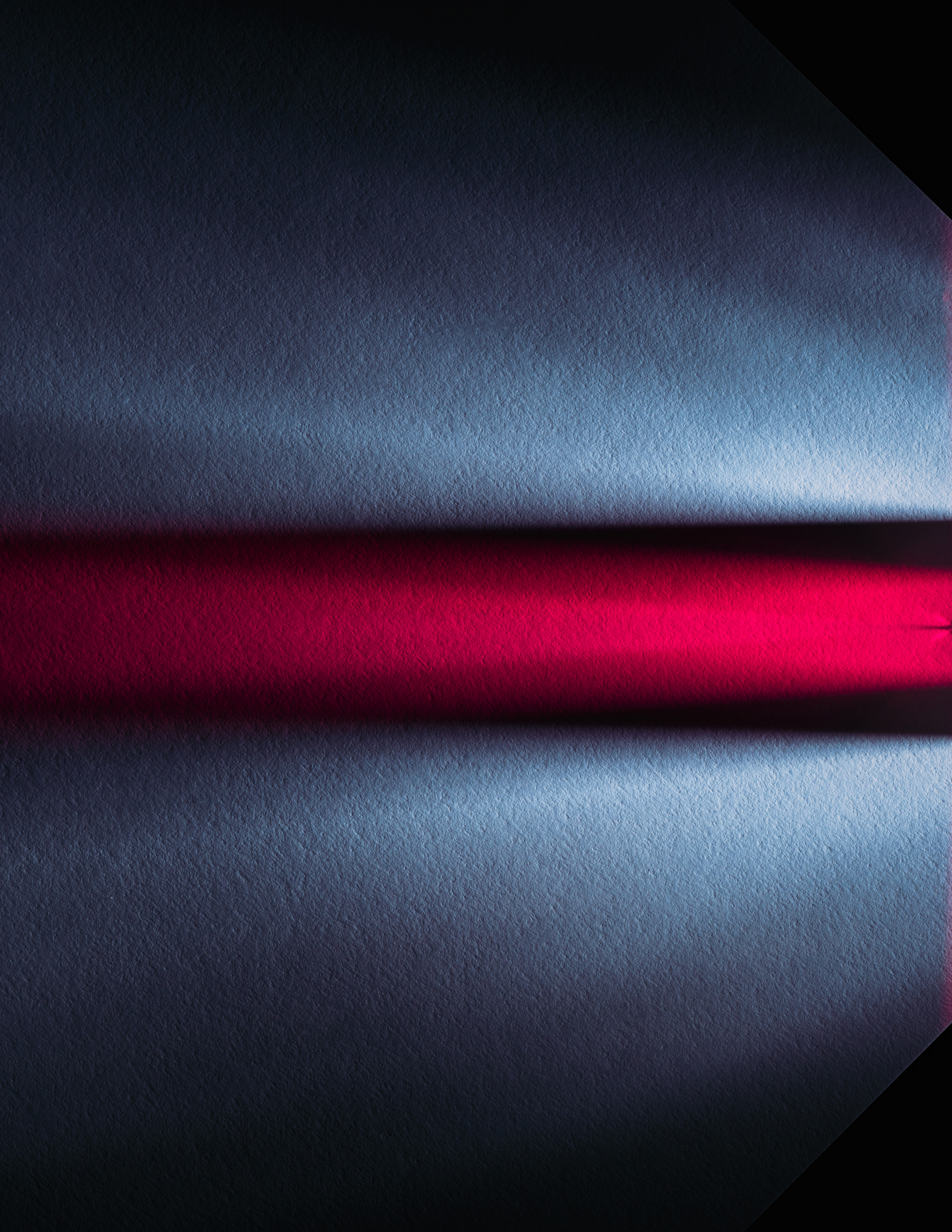
That means confirming portfolio strategies and refreshing M&A roadmaps to enable nimble decision making. Now is the time to revise scenario planning to account for cost and availability of capital, geopolitical disruptions, and other uncertainties. The best companies devote energy to scrutinize their competitors, determining which of them have both the cash and motivation to make bold moves. Winners also identify where and how they can use M&A to accelerate or scale innovation or build an Engine 2. And they expand the pipeline with a broader view of prospective targets. That gives them a faster response time when those targets come to market and prepares them with viable alternatives if their top choices don't work out.

They gain conviction quickly through rapid and strategic diligence and valuation. Market volatility means buyers need to be confident that their target will be resilient in several future scenarios, for example. And increasing interest rates mean buyers need to determine how to accelerate synergies. Moreover, at a time when speed counts more than ever, nearly 40% of surveyed M&A practitioners tell us that a volatile market is making the deal process take longer. All of this implies that companies need to come armed with proprietary insights from due diligence that is faster, deeper, and better focused than the approach taken in a more stable environment. Among the necessary moves: getting more detailed on the sources of value in the marketplace, revenue, costs, talent, and technology—and laying integration plans during the diligence, not afterward (see "Tougher Times: Putting the Diligence Back in Due Diligence").

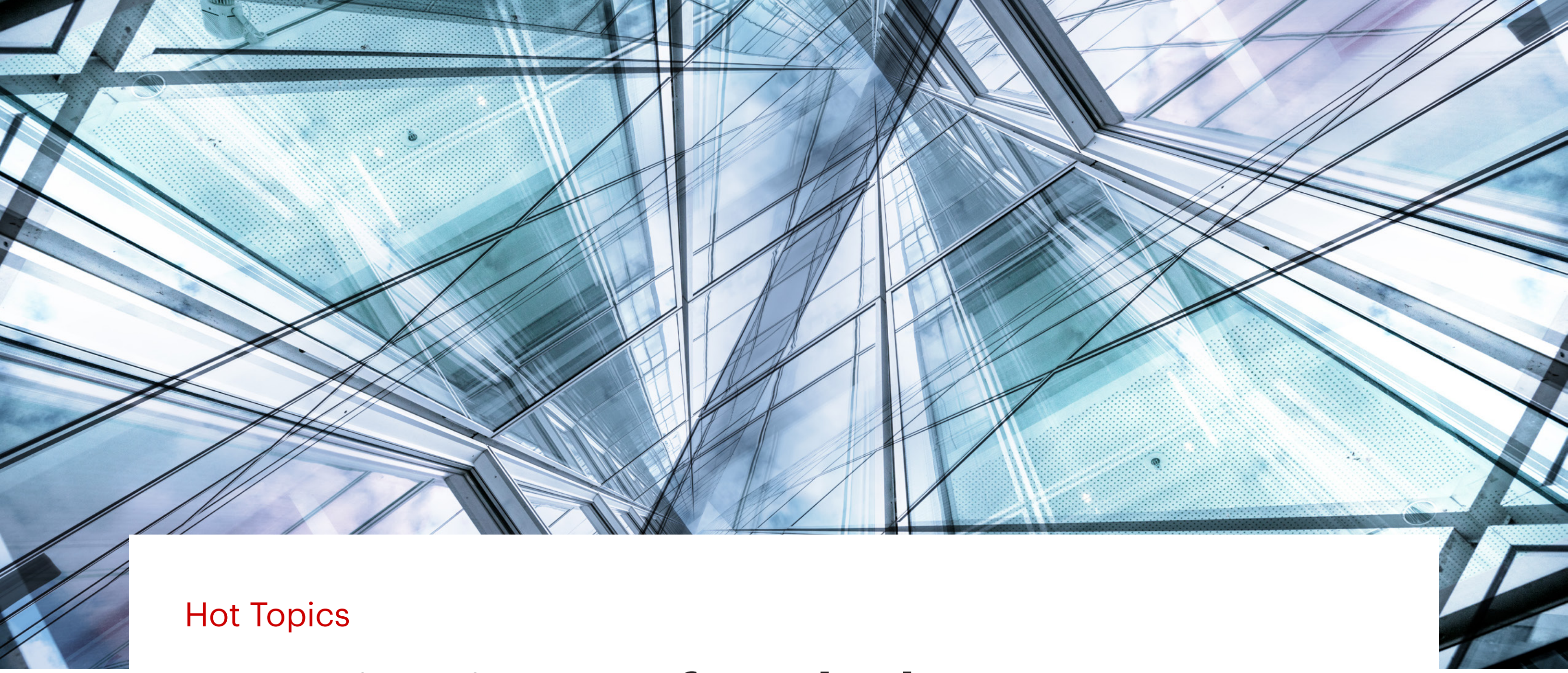
It's also now more critical to preserve and amplify value through integration. Our M&A Practitioners' 2023 Outlook Survey found that while culture is an early focus area for 80% of integrations, 75% of acquirers still struggle with cultural issues that require serious interventions. The answer is to focus on the specific issues most likely to disrupt the integration rather than the broader cultural landscape that could take years to address. We call these specific issues "cultural fault lines," which, similar to fault lines between tectonic plates, cause foreseeable, frequent, and disruptive frictions when and where they conflict. There are three common types of cultural fault lines in merger integrations: differences in purpose, decision making, and engagement (see "How to Avoid the Fault Lines Sending Tremors through Cultural Integration in M&A").

Some companies may consider bigger portfolio moves such as a spin-off. Such companies should develop a well-crafted separation thesis that helps them to focus and provides a roadmap to value creation. Bain's recent Spinoff Performance Study (2021) revealed that top-quartile separations performed exceptionally well, with 75% higher combined market caps two years after the separation. The other three-quarters of separations either failed to create value or destroyed value two years down the road (see the HBR.org article "Research: Few Corporate Spinoffs Deliver Value"). The existence of a clear and robust separation thesis was the single biggest difference between top- and bottom-quartile performers.

The following chapters in this report explore the insights that executives can learn from the best dealmakers and how M&A activity within industries and select regions reflects evolving sector strategies.



Hot Topics



Hot Topics

M&A in Times of Turbulence: Lessons from the Last Recession

The opportunity cost is huge for companies that stay on the sidelines.

By Andrew Grosshans, David Harding, Suzanne Kumar, and Joerg Ohmstedt

At a Glance

- Many companies are wary about acquiring during this downturn, but 2008–2009's active acquirers outperformed their less-active competitors over the long haul.
- More specifically, they achieved a greater compounded average annual total shareholder return than that of their less-active competitors.
- Being an active acquirer is not an end in itself.
- The most important objective is to execute the strategy—be it strengthening the core and increasing scale or creating strategic options via a scope deal.

Bain's bedrock beliefs on how to create value from M&A rest on fundamental truths that have stood the test of time: If you want to be successful at M&A, develop a repeatable model. Do it often, learn from your mistakes, and make it a material part of your business. Done right, it will generate higher shareholder returns.

This year, we look back at the global financial crisis of 2008–2009 and ask what lessons can be learned from different M&A behavior during times of turbulence.

Stay in the game through tough times to come out ahead

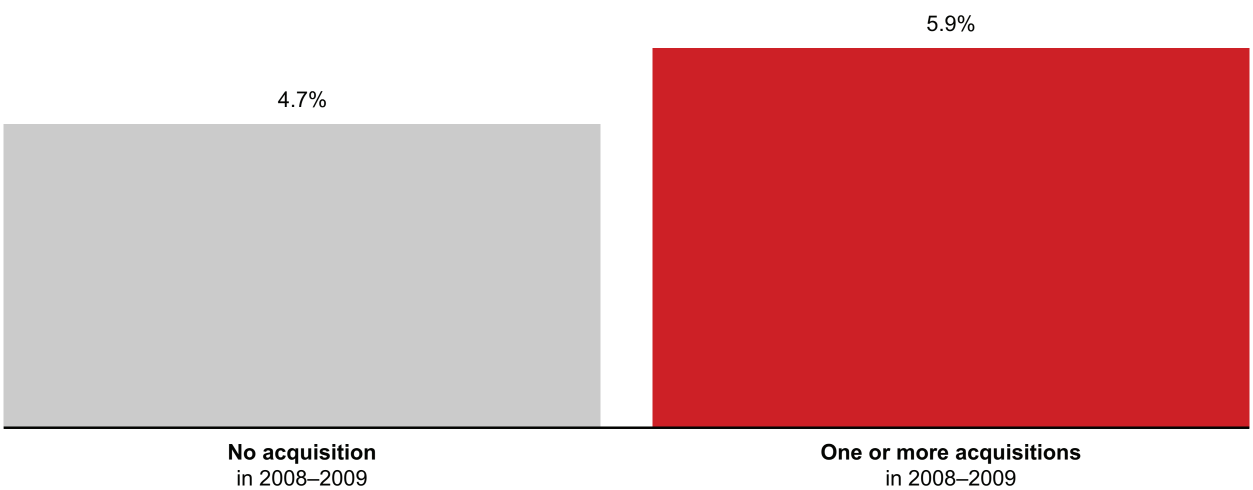
We assessed the returns to shareholders of different M&A strategies employed by a universe of 2,845 publicly traded companies from around the world for the period between 2007 and 2017.

In 2007, worldwide deals surpassed 40,000 for the first time; their cumulative value hit $4.6 trillion, 40% above the dotcom peak in 2000. It seemed like the M&A party might never stop. But when the global financial crisis brought the boom to an abrupt end and most economies went into recession sometime during 2008–2009, the hangover set in. Many business leaders grew leery of any kind of dealmaking—deal volume dropped by 14% from 2007 to 2009.

The reaction was understandable, but the opportunity cost for many was huge. Companies that were active in M&A during turbulent times, the data shows, consistently outperformed those that stayed away from deals. Companies that acquired during the last economic downturn achieved an average annual total shareholder return (TSR) of 5.9% compared with 4.7% for those that did not (*see Figure 1*).

Figure 1: Companies that acquired during the last economic downturn have tended to outperform significantly over the long term

Average total shareholder return (compound annual growth rate 2007–2017)



Sources: Dealogic; Bain M&A database 2022 (N=2,845 companies)

Several industry-defining deals were made throughout the last economic recession.

Of course, being an active acquirer is not an end in itself. The most important objective of M&A is to help execute a company's strategy—be it strengthening the core business and increasing scale or creating strategic options via a scope deal. During a recession, M&A also serves another purpose: creating strategic options. The post-recession landscape will be very different, and no one really knows how supply chains may change, what the financial system will look like, or to what degree consumers will have changed their spending patterns.

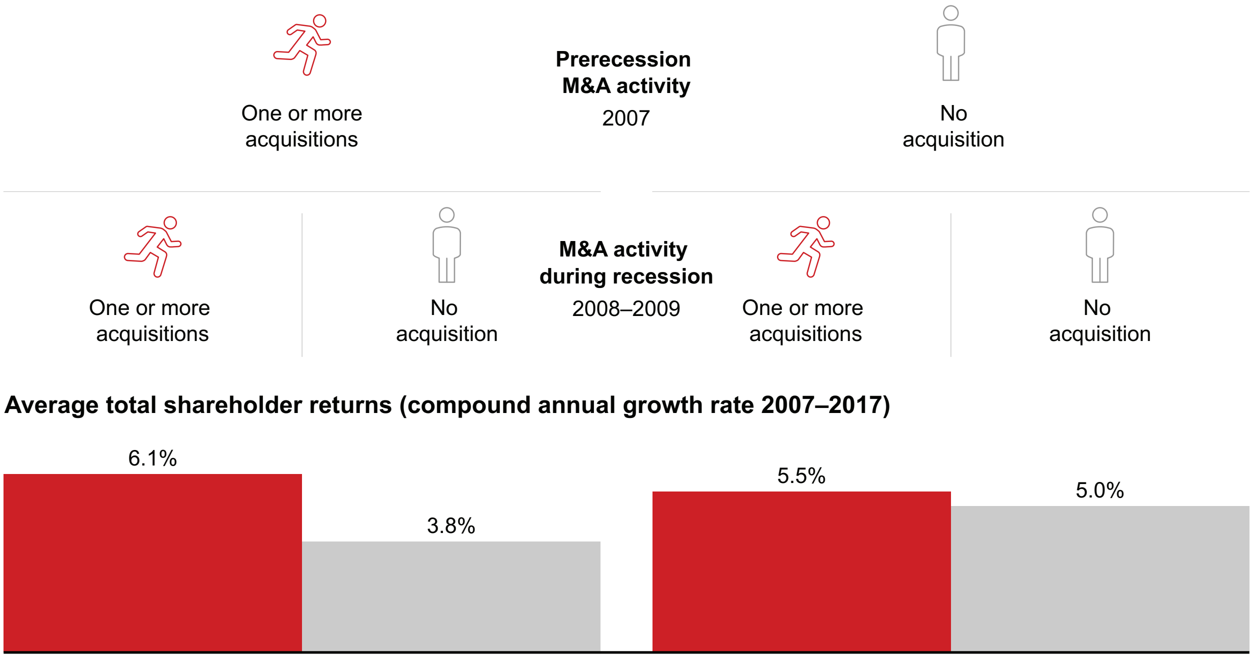
Several industry-defining deals were made throughout the last economic recession. In 2008, BASF acquired Ciba for $5.4 billion in what accounted for the largest acquisition in BASF's company history until that point, with the aim to fully integrate Ciba into BASF and a focus on realizing cost synergies initially targeted at 10% of sales (and subsequently raised). In 2009, Stanley Works—now Stanley Black & Decker—leveraged its strong M&A capability to significantly grow share by acquiring the larger Black & Decker. The merger was well-timed as the construction cycle exposure made Black & Decker vulnerable in 2009, leading to a 22% drop in revenue and a 41% drop in earnings before interest and taxes, which, in turn, lowered its valuation. Stanley was able to leverage a proven integration capability that it had built from an aggressive M&A program started in 2002 with the acquisition of 33 companies over the next several years.

Some companies used their resources to expand their strategic options through acquisitions despite the downturn. For example, Pfizer's agreement to acquire Wyeth for $68.4 billion in early 2009 bought some time for Pfizer as patents were about to expire on several of its leading medicines, and it gave Pfizer an opportunity to diversify its pharmaceuticals portfolio and expand its pipeline (with a particular focus on biopharmaceuticals and vaccines). In the second half of 2009, Disney acquired superhero stable Marvel for $4.2 billion, with the aim of putting these characters to work in its television shows, video games, theme parks, and movies.

Should companies adjust their M&A behavior during times of turbulence?

We have outlined the returns of different types of acquirers regarding their prerecession and recession-era M&A activity. Those companies that were active acquirers before the recession performed best by staying active—their average annual TSR was 6.1% compared with 3.8% for those that decided to move to the sidelines (*see Figure 2, left*). For those companies that were inactive before the recession, a change in their M&A behavior toward becoming an active acquirer resulted in an annual TSR of 5.5% compared with 5.0% for those that remained inactive (*see Figure 2, right*).

Figure 2: Active acquirers outperformed bystanders during the last economic downturn



Sources: Dealogic; Bain M&A database 2022 (N=2,845 companies)

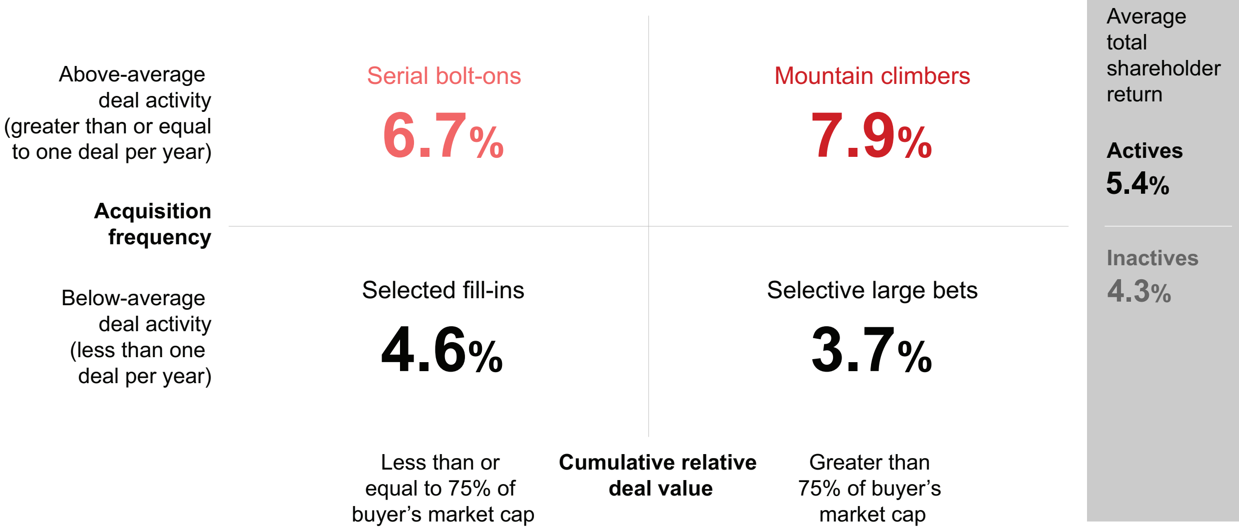
What can be learned from the most successful acquirers?

The core research underlying our belief in the concept of repeatable M&A (replicated multiple times over the past 20 years) shows that frequency (how many deals you do) and materiality (how much of it you do) define a lot of what differentiates M&A performance (*see Figure 3*). It does not take a lot of deals to become a frequent acquirer, about one per year. To be a material acquirer does require heft: 75% or more of your market cap from acquired companies over a decade. Those companies that are both frequent and material acquirers over a 10-year period—we call them "mountain climbers" (*see Figure 3, top right*)—create the greatest TSRs.

Consistent M&A activity over economic cycles contributes to higher TSR. This finding holds up year after year, across industries. Deal success and deal failure is more a matter of cumulative experience and capability in making a deal and less a function of standalone deal circumstances.

Figure 3: Companies that do M&A frequently and at scale outperform

Average total shareholder returns (compound annual growth rate 2007–2017)



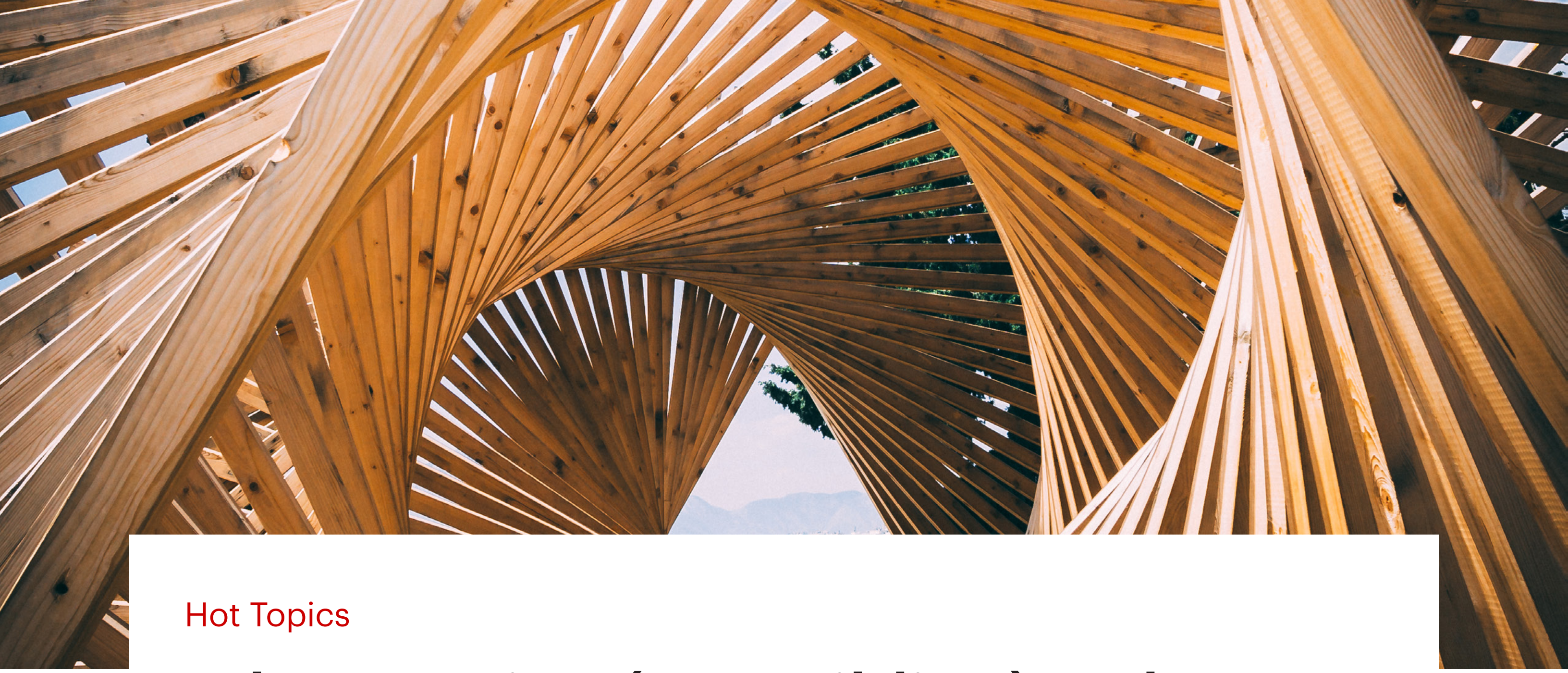
Notes: Cumulative relative deal value is the sum of relative deal size (deal value divided by market capitalization three months prior to announcement) across all deals between 2007 and 2017; deal size for deals with undisclosed value is estimated using median deal value benchmark calculated for each sector from disclosed deal values as a percentage of acquirer market capitalization; deals involving partial stake acquisitions, increase in controlling interest, and remaining interest acquisitions are excluded; multistep deals have been consolidated into a single deal; consortium, intracompany, and property portfolio deals excluded
Sources: Dealogic; Bain M&A database 2022 (N=2,845 companies)

A big learning from our study comes from the failure of companies that are infrequent acquirers but that undertake large deals relative to their market capitalization—we refer to such companies as "selective large bets" (*see Figure 3, bottom right*). While we outlined above why we are encouraging M&A during turbulent times, companies that have not been doing deals to build their M&A muscle should be more cautious when the opportunity of a lifetime comes along. Among all companies studied, selective large bets are the worst performers over time as their limited acquisition experience, combined with investment in a large deal, usually results in poor deal outcomes. They generated only 3.7% in annual TSR from 2007 to 2017.

Similar to most things in life, you get better at what you do when you do it repeatedly. Companies that acquire frequently, "serial bolt-ons" (*see Figure 3, top left*), tend to outperform the average company on TSR (6.7% annual).

Mountain climbers, those companies that not only acquire frequently but that also develop the capabilities to undertake larger deals, do even better. Their 7.9% annual TSR leads the class. Investors have come to recognize this.

With the drop of M&A activity in 2022 and all the current turbulence, some executives will no doubt sit on the sidelines thinking it is safer not to play. Experience suggests that their performance will suffer accordingly. The winners will be those that stay in the game—and learn how to play it well.



Hot Topics

When Buying (vs. Building) Is the Right Move for Engine 2

Three ways that companies turn to M&A to scale new businesses faster, cheaper, and more effectively.

By Alexandra Ramanathan, Vincent Vandierendonck, and Mikaela Boyd

At a Glance

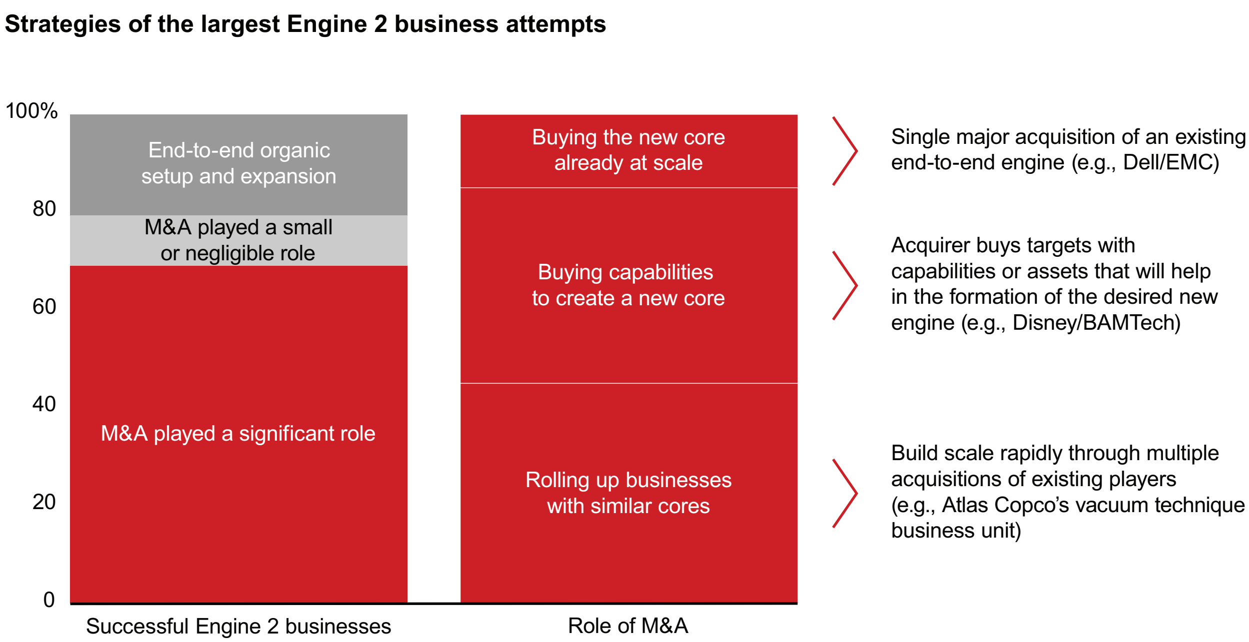
- Companies looking for a new "Engine 2" to prepare for future growth are considering the best ways to make the move amid macroeconomic uncertainty.
- Our analysis found that among the 58 most successful Engine 2 businesses, 40 used M&A as a significant part of their scaling plans.
- Most Engine 2 deals are rolling up businesses with similar cores, buying capabilities to create a new core, or buying the new core already at scale.

As they face macroeconomic uncertainty in their industry, most business leaders acknowledge that it's more vital than ever to develop and accelerate an alternative engine of growth for the future. We refer to these new businesses within existing companies that use the scale benefits of the core business to grow faster than an independent start-up could as "Engine 2s." And downturns are the times when companies make the bold moves that enable them to emerge stronger than their competitors.

While it can be tempting to build a new business from the ground up, our new research strongly supports the case for buying. We looked at hundreds of Engine 2 businesses over the past 25 years, and of the 58 most successful, 40 used M&A as a significant part of their scaling plans. It's an important finding at a time when lower valuations and less competition for deals makes it a buyer's market *(see Figure 1)*.

The first major advantage to buying involves speed. Building a team organically can take years longer than buying, which may put the company behind in a fast-moving competitive environment, allowing others to secure a strategic edge. The speed advantage is multiplied for acquirers that are skilled at integration and that design ways to begin delivering shared value on day one. The second advantage involves effectiveness. Without in-house expertise for the new business, a company could be set back by several mistakes along the scaling journey. Integration and alignment challenges are typically easier to overcome than trying to build a new business without the veteran insights. A final advantage is cost. M&A comes with premiums, for sure, but there are high premiums required to lure critical talent away individually. And building a business also often comes with costs associated with false starts, reorganizations, and executive interventions that may be necessary before the organically built organization begins to deliver on its mission.

Figure 1: M&A has been used to accelerate roughly two-thirds of the most successful Engine 2 businesses



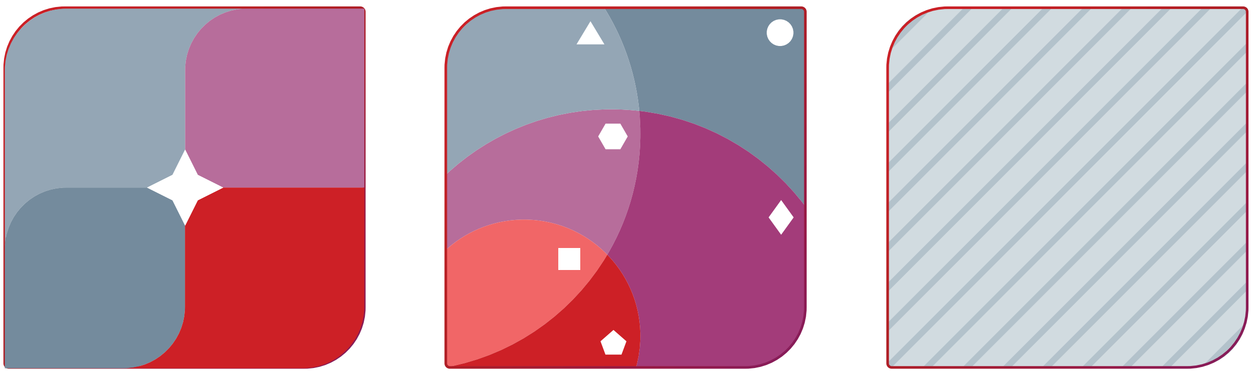
Source: Bain analysis

Figure 2: Three common archetypes for successfully buying and scaling an Engine 2

1 Rolling up businesses with similar cores

2 Buying capabilities to create a new core

3 Buying a new core already at scale



Source: Bain & Company

The key to successfully buying and scaling an Engine 2 starts with understanding that the unique assets of the target and the scaling journey of the acquirer will vary. Most, however, will generally fall into one of three common archetypes. While these archetypes all share the ultimate goal of scaling a new business, they use different acquisition strategies to get there—and each requires tailored priorities and areas of focus. We'll look at these archetypes one by one *(see Figure 2)*.

Rolling up businesses with similar cores

In these cases, an acquirer typically has some experience in the desired Engine 2 business and is looking to build scale rapidly through multiple acquisitions of existing players. This traditional business-building strategy has been more difficult in recent years because of mounting competition from well-funded private equity acquirers. To succeed, the buyer needs to be especially strong in diligence, confirming the strength of the business and how well the asset fits with the new engine. It's also critical to emphasize integrating the new asset into the larger engine with minimal IT dis-synergies and minimal losses of customers and key talent.

Atlas Copco was interested in moving beyond its core of compressors with a new Engine 2 in vacuum technique. It knew from experience in similar industries that the market was poised for growth and that there would be great value in scale leadership. To build out quickly, the company acquired Edwards Group, and the subsequent success reinforced its conviction. Atlas Copco added verticals and geographic coverage to the engine with acquisitions of Leybold, CSK, Brooks Automation's semiconductor cryogenics business, and more than 10 service and distribution assets over the past three years. Success was the result of a combination of the right strategic plan and outstanding execution, including extensive due diligence and efficient integration to scale up the new engine and build a leadership position in a growing market.

There are a few critical steps for boosting the odds of success in roll-up acquisitions. Buyers need to assess process and technology alignment to prevent deal-breaking IT/systems surprises that could add major expenses or delay integration after signing. It's also critical to be cautious about any changes that could have possible negative impacts with customers or sales teams, especially those resulting from IT/systems integration. The best buyers craft the systems integration roadmap with intentional choices that prioritize the long-term goals of the new engine over short-term desires for speed.

Buying capabilities to create a new core

In these situations, the M&A target is strategically attractive for capabilities or assets that will expand a new growth engine the company has in mind. The target may have critical talent, data, infrastructure, or domain knowledge that the acquirer lacks and that can be applied to existing or future new growth engines. These acquisitions are most common in technology, in which serial acquirers such as Google and Microsoft have bought hundreds of smaller companies with the aim of applying learnings and expertise into new and enhanced products and services. For example, Google Maps resulted in large part from the acquisitions of several mapping, visualization, and routing companies. Using this approach, assets may be smaller and have relatively lower price points, allowing for more attempts and variation in outcomes. The most skilled practitioners apply lessons from these acquisitions across multiple engines and business units, creating new value in unpredictable ways. Running this strategy successfully requires excellent talent retention, culture integration, and a patient board willing to wait out a possible multiyear journey with twists and turns.

Consider the route taken by Disney when it envisioned the potential for streaming content as a new growth engine. Disney started on that path in 2009 by investing in Hulu, but its direct-to-consumer ambitions were greatly accelerated with its 2017 acquisition of BAMTech, a technology service and video streaming company previously formed by Major League Baseball. Disney started by applying BAMTech expertise to WatchESPN, which became ESPN+. That set the stage for ambitions beyond live sports, including the potential to distribute its flagship content through proprietary streaming. The BAMTech acquisition gave Disney several vital elements for what would eventually become Disney+, including robust back-end technology, insights into customer needs, and essential talent to tie together the value proposition with the new technology. These and other capabilities acquired through BAMTech enabled Disney+ to become a vital Engine 2 for the iconic media company.

So what are some of the differentiators for successful capability acquirers? They test the degree to which the value of the asset can be lost if critical talent leaves. They use available data to look for the cultural fault lines that could make culture integration and talent retention more challenging. They invest in culture integration that goes far beyond day one. And they test and learn new ways of working together in the integration management office and integration environment before broadening to the entire company.

Buying the new core already at scale

In these deals, a company makes a single, major acquisition of an Engine 2 business that it plans to aggressively grow. China's TCL ran this motion successfully when it bought Zhonghuan Semiconductor to add a large-scale Engine 2 of solar materials and modules with runway to grow even larger under the consumer electronics leader's direction. Instead of rolling up smaller businesses or engineering a new core through a "string of pearls," this approach involves buying the whole necklace. For example, if Disney had pursued this strategy, it might have considered buying Netflix to build its streaming business. Using this strategy, the acquirer must feel confident that it can rely on its existing resources and capabilities to grow the new business in ways that make the high acquisition costs worthwhile. That's typically achieved by adding value that wasn't possible when the target was on its own. For example, the acquirer may have sales relationships, R&D resources, unique assets, access to data or users, or operational excellence that can be used to bring the target to new heights. While this approach usually is the fastest path to scaling a new Engine 2, it also can be the most expensive, incurring the largest acquisition premiums. Additionally, it requires the highest degree of integration difficulty because of the complexities of large-scale transactions and change.

Dell's purchase of EMC in 2016 set the standard for large-scale Engine 2 acquisitions, and it still stands as one of the most successful in history. Dell knew the market was moving toward connected storage and servers, but it struggled to get traction with its organically developed storage products. EMC looked to be a perfect target. It was the market leader not only in storage and virtualization (with VMware) but also with enterprise customers, which Dell wanted so that it could make more of a push for its existing core. Among many potential integration priorities, Dell started with cross-selling and moved rapidly to enable its sales team to bring EMC's storage and VMware's solutions into Dell accounts (and vice versa), turbocharging both Dell's traditional core and the acquired businesses. Again, the acquisition and integration strategy were viewed as huge successes, achieving synergy targets in half the expected time and hastening Dell's ability to realize its Engine 2 ambitions in a fast-moving and highly competitive environment.

Companies that are most successful when buying a new growth engine at scale test specific value creation theses with potential customers to confirm the magnitude of the potential benefit. They also build an operating model and management system that enable the right points of overlap to deliver new Engine 2 value while retaining the unique elements that made the asset valuable in the first place.

Four fundamental steps to successful execution

These archetypes for buying vs. building are all viable approaches to accelerating a new growth engine. What separates the success stories from the also-rans is execution. Many companies have learned that the priorities and choices that work for core businesses do not always translate to establishing and scaling a new business. Regardless of the archetype a company chooses, we see four fundamental steps that no acquirer should overlook.

- Start with a laser-focused due diligence that tests the asset's fit with the elements that will be most important to your scaling.
- Draft a clear integration thesis, and perform the integration with the aim of preserving the unique assets and capabilities that made the target desirable while also moving rapidly to the new customer value proposition for Engine 2.
- Design the integration plan to focus on the pivotal decisions that unlock customer value for the new engine, not just for the fastest path to day one. Work backward from the clear killer app you envisioned at deal signing, and invest integration energy in the choices and functions that will bring that vision to life. This may require a more deliberate integration with more executive attention than in-core integrations.
- Go beyond merely financial incentives for the critical talent you identified in the integration. Include them in planning the integration and defining the vision for how to scale the new engine—both to increase retention and to leverage their unique insights, which may not exist elsewhere.

As more companies opt to buy to speed Engine 2 growth, more success stories are emerging—and the details that contribute to that success are coming into sharper focus. Winning companies will be those that take these lessons to heart as they make bold moves in the downturn. They'll take advantage of lower premiums and less competition for deals to accelerate their new growth engine, outpacing competitors more effectively and for less total cost.

Hot Topics

Tougher Times: Putting the Diligence Back in Due Diligence

Uncertain economic times call for more robust diligence to support a deal's price tag—or identify risks that warrant walking away from a deal.

By Benjamin Farmer, Adam Haller, and Amy Wall

At a Glance

- To succeed in a volatile market, be armed with proprietary insights from a world-class diligence that goes deeper, with more focus, and in less time than your competitors.
- Initiating diligence before entering the M&A process helps companies avoid being distracted by potential deals that may not be a good fit.
- Winners go beyond high-level benchmarks in diligence, using the full universe of data available to confidently underwrite deal value.
- The most successful acquirers think through integration implications (how long, what cost, who to engage) during, not after, diligence.

A manufacturing company relied on its historical experience to estimate cost synergies for a potential acquisition. Facing competition for the deal, it realized it needed to dig deeper for potential sources of value and conducted an outside-in diligence, drawing on additional benchmarks, primary research, and scraping external data sources. The extra effort led the company to uncover more than twice the original estimate of cost synergies and make an offer that allowed it to win the asset. Ultimately, the combined company exceeded the synergies estimated in diligence, making the deal an unqualified success for shareholders.

A technology company's investment thesis for a potential acquisition relied on the capabilities of the target's talent base. The acquirer used outside-in mapping of the talent base (more than 10,000 employees) to understand the technical skills and training of the target's employees. The analysis uncovered that the talent base was missing many of the technical skills that they were looking to acquire. It was a key factor in convincing the company to walk away from the deal.

Multiples are in extremely volatile territory, and if history tells us anything, it's that winning companies don't sit on the M&A sidelines, waiting for the market to bottom out; they do deals. But in the race to acquire in a volatile market, it's more important than ever to have confidence in your deals. The surest way to succeed is to come armed with proprietary insights from a diligence that is faster, deeper, and more focused than your competitors. Better diligence allows you to be bold where others might hesitate.

Market leaders use due diligence in three ways to win (or avoid) deals in today's environment: They're proactive; they amplify value through proprietary insights; and they plan for successful integration during diligence, not afterward.

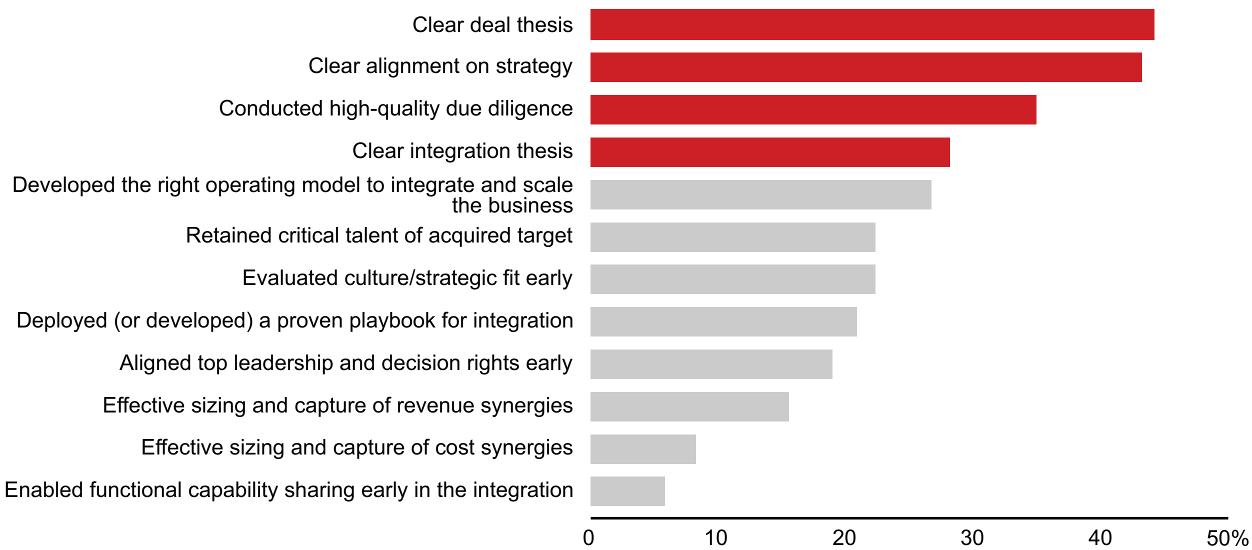
Be proactive

Market leaders will not be reactive, but will initiate diligence before even entering the M&A process. This helps them avoid being distracted by potential deals that may not be a good fit with their strategy. Our M&A Practitioners' 2023 Outlook Survey found that a clear deal thesis and clear alignment to strategy are the two most important factors leading to successful deals (*see Figure 1*). Developing that thesis as early as possible allows the acquirers to move quickly when deals are available. The best companies regularly refresh their sector screen and have an evergreen short list of priority targets that are aligned to strategy. They develop an outside-in view of value so that they can move quickly if opportunity arises—or take the offensive and approach the target proactively with conviction, understanding that the industry may be forever changed if a competitor makes the first move.

A leading life sciences company maintains a running list of its top 15 to 20 targets. Using outside-in diligence, the company systematically creates a deal thesis and detailed financial model for each potential deal, updating that view as market conditions change. The company regularly refreshes its short list, looking at more than a hundred targets a year to understand the market landscape and assess its priorities. Similarly, a leading global beverage company uses a data-driven view of its market to stay focused on core targets. This includes understanding competitive positioning and whitespace by geography and maintaining a view of potential synergies, cost to achieve, and speed bumps (regulatory review, capital availability, management bandwidth). The disciplined process ensures that resources are focused on the deals they want to make happen without wasting time on deals that don't move the ball forward on strategic priorities.

Figure 1: A clear deal thesis is the top contributor to successful acquisitions

Considering all the targets that your company has acquired over the past three years, for any deals that **exceeded expectations and created value**, what were the **main reasons**? Select up to three.



Note: Answered only by respondents who indicated that they had made acquisitions that exceed expectations
Source: Bain M&A Practitioners' 2023 Outlook Survey

Amplify value through proprietary insights

With increasing interest rates and macroeconomic volatility, acquirers need to sharpen their pencils, ensuring real confidence in the deal thesis and looking past the obvious to identify all possible sources of value. Winners go beyond high-level benchmarks in diligence, using the full universe of data available to them to create proprietary insights that will allow them to confidently underwrite deal value. This includes using advanced analytics tools, scraping external data sources, and applying primary research creatively to address blind spots.

A major consumer goods company recently explored the potential for expanding into the alternative milk space. Lacking visibility into the out-of-home market that represented more than half of the target's business, it conducted in-person barista interviews and observations at coffee shops in major metro areas. In only five days, the company was able to unlock insights that allowed it to measure a statistically significant share of alternative milk offerings in the coffee shop channel and truly understand the market opportunity.

A medical diagnostic company recently considered walking away from a deal when it couldn't agree with the target on price. When it decided to conduct additional diligence on pipeline products not yet in the market using extensive expert and customer interviews, it was able to build enough confidence in the potential value to put forward a sweetened offer and complete the acquisition.

Plan for successful integration during diligence, not afterward

In diligence, the focus is often on getting the deal done, with execution an afterthought. We see the most successful acquirers thinking through integration implications, including how long integration will take, what it will cost to achieve, as well as who to engage in the process.

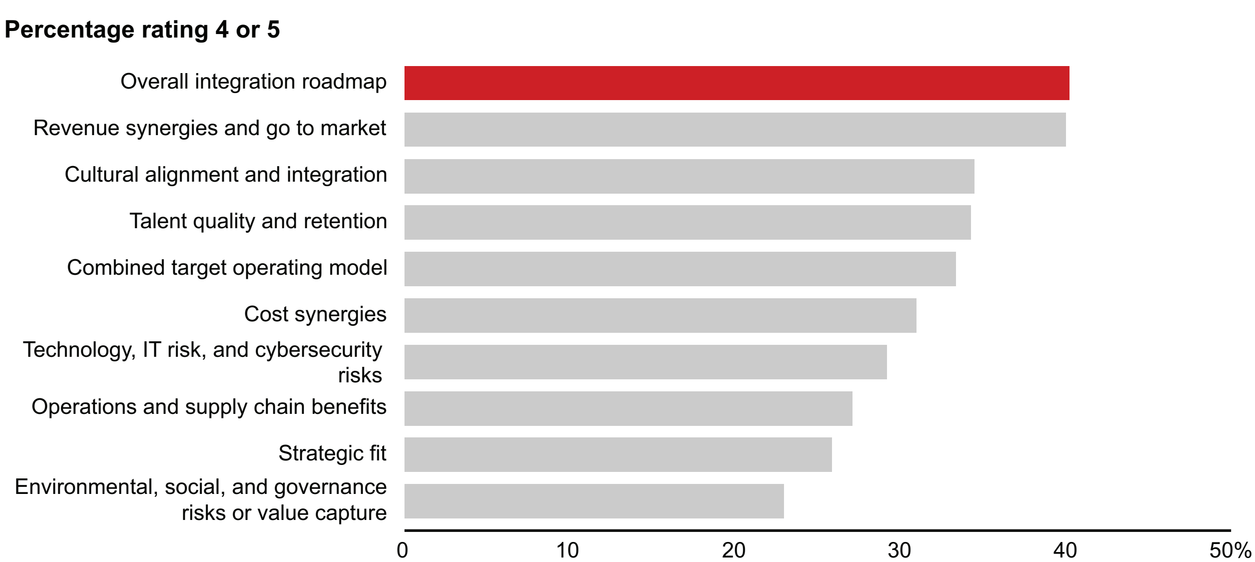
The best companies identify the critical issues that underpin the value and build an early integration thesis. They strive to be realistic about costs to achieve, building estimates into the financial model and setting aside the requisite funds solely for the intended integration purposes.

Unfortunately, this area of diligence is one that frequently falls short. In fact, our recent M&A practitioners' survey found that the integration roadmap was the most underdeveloped aspect of diligence (*see Figure 2*).

One helpful solution is to engage leaders who have led prior integrations in the deal process, especially if they focused on synergy valuation and timing. Ideally, these companies sign one of them up to lead the integration during diligence and have them weigh in on the deal thesis/financial model along the way.

Figure 2: The most inaccurate areas of diligence are integration roadmaps, revenue synergies, and people issues

Over the past three years, how often were the following estimates **meaningfully inaccurate during the due diligence process**? Please rate them on a scale from 1 (almost never inaccurate) to 5 (almost always inaccurate).



Source: Bain M&A Practitioners' 2023 Outlook Survey

In a recent diligence, an alcoholic beverage company focused primarily on the market fundamentals, brand health, and synergies. It became apparent during the process, however, that the target had a very different culture and ways of working (see "How to Avoid the Fault Lines Sending Tremors through Cultural Integration in M&A"). The company quickly focused resources on culture integration and change management to anticipate key friction points and prioritize integration considerations, which then were connected back to synergy values based on what areas of the business would or would not be combined. To integrate cultures, a key decision was made to bring together leadership from different regions into a single headquarters.

Past recessions have been shown to be pivotal times for companies. Our long-term research proves that proactive dealmakers are more likely to emerge from downturns as winners. But in the race to make bold moves, companies need to not only invest in the diligence process but also use the diligence process to outpace the competition.

Hot Topics

How to Avoid the Fault Lines Sending Tremors through Cultural Integration in M&A

It's possible to predict the ways in which cultural differences can upend a promising deal.

By Marc Berman, Erin Gillman, Sinead Mullen, and Scott Nancarrow

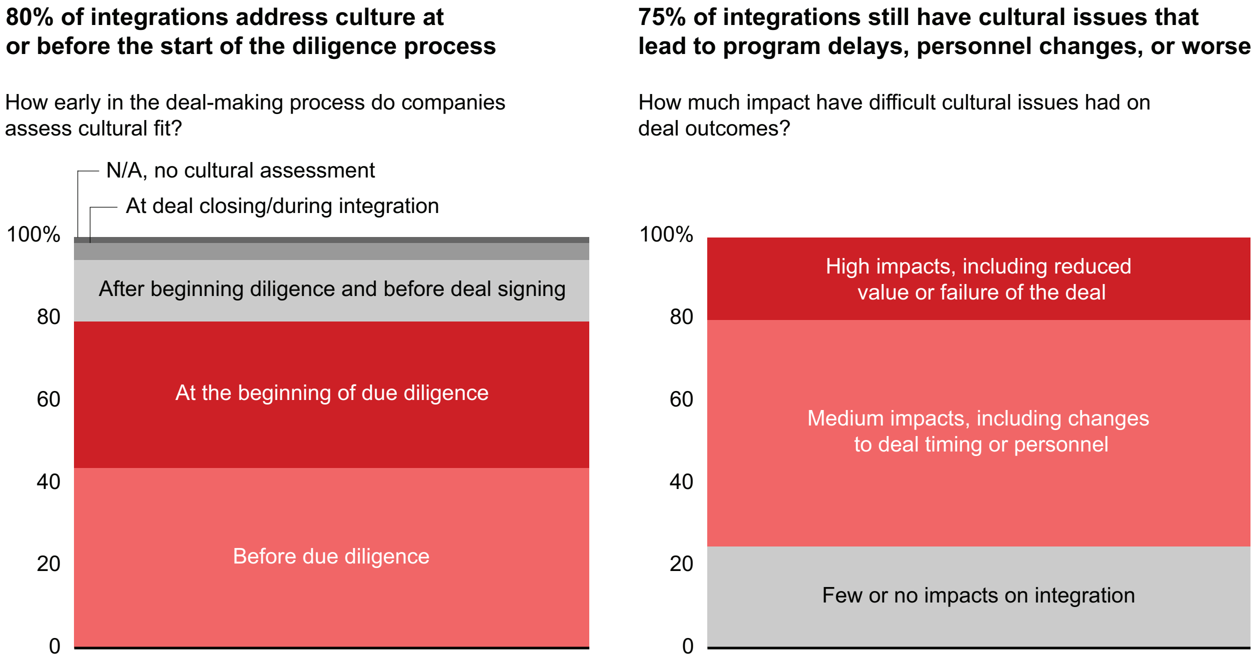
At a Glance

- Difficulty with integrating the cultures of merging companies is one of the most common factors contributing to failed M&A.
- Although there are countless potential cultural differences in an integration, a smaller set of identifiable fault lines causes the most disruptive frictions.
- Companies need a systematic plan for addressing differences, with a clear, actionable approach to ensure successful integration.

Cultural integration is hard. In Bain's M&A Practitioners' 2023 Outlook Survey, nearly half of the respondents listed cultural fit or difficulty integrating management teams as a primary reason why their past deals had failed. Today's workplace dynamics have made the joining of cultures even more difficult for several reasons.

For many, the recent shift to remote work environments limits personal interactions and amplifies the differences that teams encounter when they're working face-to-face. On top of this, a company's purpose and values have become more important to employees, with specific concerns rising regarding an employer's positions and actions on social and political issues—and merging

Figure 1: Although culture is an early focus area for 80% of integrations, most acquirers still struggle with cultural issues that require serious interventions



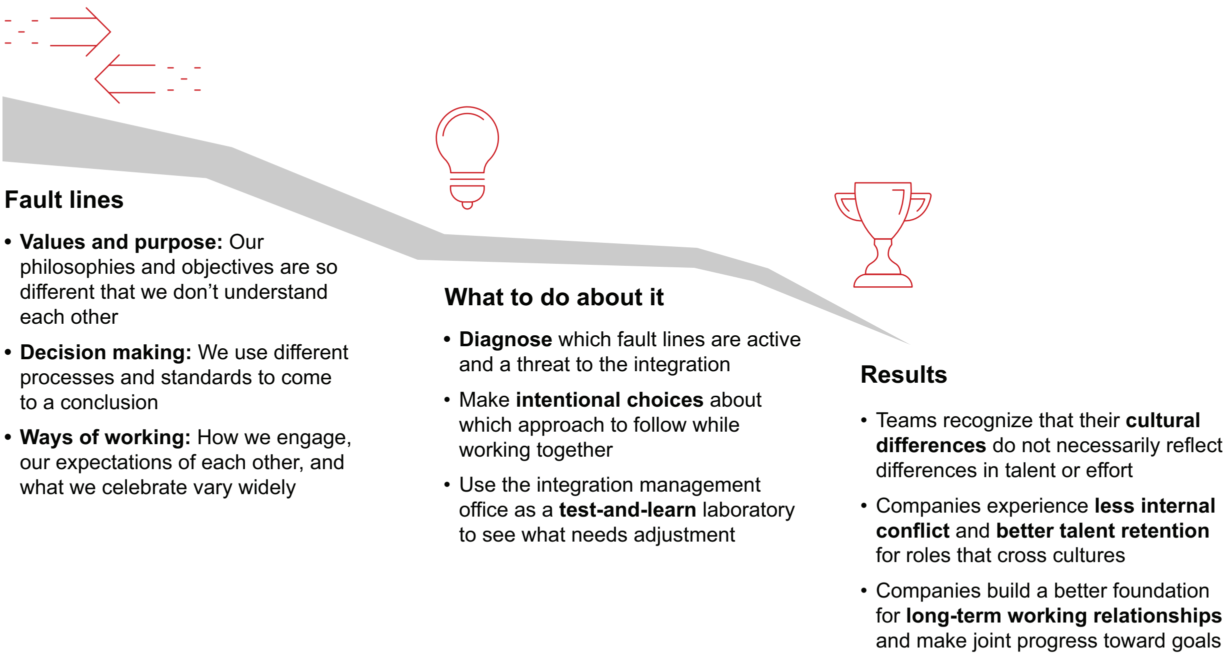
Source: Bain M&A Practitioners' 2023 Outlook Survey

companies don't always see eye to eye. We also see critical talent more willing to look elsewhere becoming a key risk for scope and capability deals. Finally, regulatory review sometimes extends the pre-close period, creating a sense of limbo that leaves key talent uncertain about staying. Our M&A practitioners' survey found that while culture is an early focus area for 80% of integrations, 75% of acquirers still struggle with cultural issues that require serious interventions (*see Figure 1*).

Three steps to successful cultural integration

Can companies overcome these challenges plus the many familiar obstacles to cultural integration? The answer is yes, but doing so requires companies to focus on the specific issues most likely to disrupt the integration rather than the broader cultural landscape, which could take years to address. We call these specific issues "cultural fault lines," which, similar to fault lines between tectonic plates, cause foreseeable, frequent, and disruptive frictions when and where they collide (*see Figure 2*). There are three common types of cultural fault lines in merger integrations: differences in purpose, differences in decision making, and differences in engagement. Many integrators push forward without addressing these fault lines directly, but doing so creates frustration and resentment that taxes every interaction, creating setbacks that either seriously delay integration, drive away talent, or lower the odds of a deal's ultimate success.

Figure 2: Focus your integration efforts on cultural fault lines



Source: Bain & Company

We see three steps companies can take to navigate cultural fault lines in any integration.

Step No. 1: Identify and mitigate the innate fault lines most likely to cause integration disruptions. Among the countless differences across companies, certain types are more likely to create integration difficulties:

- differences between the underlying purposes and values that guide each merging company (beyond the written mission statement);
- differences between the expectations and processes for decision making, which typically reflect deeply rooted norms on data, risk, and power; and
- differences between working styles on how to interact to accomplish goals, along with the expectations each company has for employee engagement.

These fault lines are the most difficult and most important to address in an integration setting. If unaddressed, teams feel like they are talking past each other, ultimately stalling progress, and can drive away critical talent—sometimes taking their team with them.

Identifying innate fault lines starts with looking for relevant differences during due diligence and continues throughout the pre-close period. Leaders who pinpoint these fault lines can help teams tackle them directly and realize that the issues are cultural and not personal before divisions become too great and limit the deal's success.

When two professional services firms in the same field integrated, they were surprised by how differently they approached decision making. Although both saw themselves as collaborative, the acquirer lived that value by teaming individually with clients to make careful decisions only after securing broad consensus. The acquired company was more accustomed to solving urgent problems of financial distress by getting vital players in the room to make hard choices fast. These innate differences, shaped by the diverse portfolios of clients that they served, meant it was important to establish norms for the integration teams to use and to be clear that the more consensus-driven approach was an intentional, well-considered change vs. how the acquired company was accustomed to operating. Doing so helped take blame, confusion, and frustration out of the process and made it clear that this was a cultural (not personal) approach within the new parent company.

Identifying innate fault lines starts with looking for relevant differences during due diligence.

In an integration of two technology companies, a sticking point about benefits revealed a potential fault line on values. Although both companies had generous benefits packages, the acquired company's package was truly exceptional in its generosity. The acquirer saw reducing these down to be in line with its own benefits (still well above average for the industry) as a potential source of value, but every employee conversation seemed to gravitate back to the benefits package. The acquirer realized that the target's benefits package was actually central to its identity; its conception of environmental, social, and corporate governance; and a part of how it sold its external brand.

It was also clear that there was a lot to lose on culture and critical talent by picking a fight on the issue. The company created momentum for the integration when it announced that, instead of reducing the target's generous benefits, it would be extending those benefits to all employees as one of many steps in preserving and expanding its unique culture.

The best companies identify fault lines as part of diligence, assessing the degree of difficulty and potential impact to the value of the deal. They evaluate the ownership structure as well as how the company creates and measures value; they also consider outside-in data on employee engagement and company priorities, historical norms ingrained over decades, and other factors. Although it may sound extreme to walk away from a deal over innate cultural issues, that may be the best move for companies that don't invest in a mitigation plan.

Step No. 2: Act before misperceptions deepen the fault lines.

Misperceptions can be a major obstacle to integrating teams. Teams that start with misperceptions of the other side ("they are arrogant") may incorrectly reinforce them during the many ambiguous situations common to integrations ("they're never available to meet live"). If not addressed early, these misperceptions will be cemented and create huge rifts. Integrators must surface misperceptions early, and quickly create opportunities for teams to interact and demonstrate how they are inaccurate.

The acquiring company team was blunt, with one asserting, "You see us as old white dudes."

In a large software integration, there were clear differences between the leadership teams. The smaller, acquired company was passionate about issues of race, gender, and equal voice, and the composition of its leadership team reflected these priorities. But, at first glance, the acquirer's leadership team didn't look like they had the same priorities regarding diversity, equity, and inclusion (DEI). There were troubling undercurrents until the companies held a perceptions workshop in which both teams were able to get the issue on the table. In the first exercise, each team separately wrote their perceptions of the other team and what they thought the other team perceived in them. The acquired company team raised the issue politely, while the acquirer team was more blunt, with one asserting, "You see us as old white dudes." The acquirer CEO was able to handle this masterfully by simply acknowledging the gap: "You're way ahead of us, and we can't wait to learn from you," he said.

By acknowledging the difference, he was able to demonstrate authenticity and win over the other side while also dispelling the false perception that only one side cared about diversity. The acquirer company's leadership committed to being open about issues of representation and to take the lead from the acquired company, while also empowering both sides to talk about the issue without fear or awkwardness. In this example, a situation that could have created a barrier to integration instead became a way for the leadership team to gain new credibility by embracing DEI efforts.

How to surface perceived fault lines? Use the right kind of surveys and interviews early (well before close) that allow for the sharing of unfiltered views about the other company—its culture, skills, geographic differences, demographic differences, and priorities based on its reputation or interactions the companies had prior to integration. Talk about it. Foster dialogue. Blow up the myths. That means discussing perceptions head-on, ideally in the supportive environment of a workshop. Comparing how we perceive ourselves, how we perceive the other side, and how we think the other side perceives us opens the dialogue and enables teams to move past the wrong ideas that can be debunked by working together.

Step No. 3: Use the integration itself to foster cultural alignment and mend fault lines.

Integrations are moments of truth that can either advance how teams work together or destroy credibility. Success requires building alignment among the leaders who will carry messages to their teams and ensuring they project that alignment. Ideally, they use the integration to role model the new culture and help the teams move forward.

The trouble is that integrations often aggravate fault lines. All integrations create stress for teams, both in terms of additional work and unanswered questions about how their jobs will change—or if they even continue. Certain elements and messages are more highly charged and, if not managed well, can lead to resentment and cultural conflicts. These self-inflicted wounds often result from insufficient planning and a basic lack of insight into the potential impact. For example, communications that are late, ambiguous, or absent will cause teams to assume the worst. Integration team planning, if not inclusive, may favor certain teams or fail to build strong relationships. And actions that are inconsistent with previous messaging create mistrust.

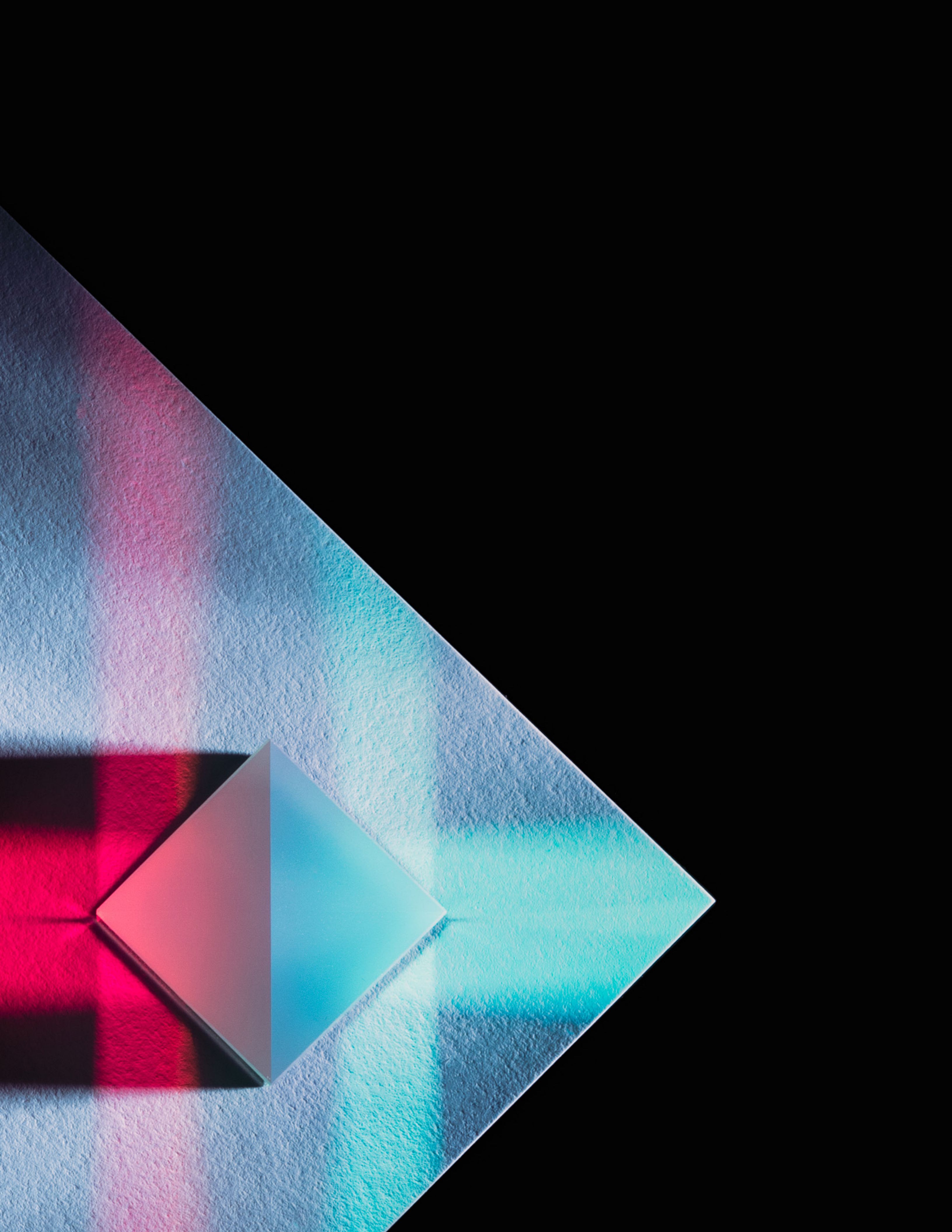
What to do about it? Invest more integration effort into crucial moments of truth for employees. This spans integration activities but is especially true for communications that set the tone for the integration. Follow through with consistent actions. Also important: Use the integration as a culture lab to test and learn which cultural choices and adaptations will work best for the combined company.

When two trade service providers merged, leadership chose to prioritize one culture and move all employees over to it. To accelerate the assimilation, every manager from the company being assimilated was fast-tracked through the other company's leadership training. The companies created a group of integration ambassadors that became a sounding board for the field. In addition to engaging the newly trained leaders, it provided the integration team with a vital source of information (which included its blind spots) in areas such as IT integration and synergies. This was information that integration planners likely would never be able to get from a survey.

Integration is also an opportunity to use the integration management office as a laboratory to test and learn how to work through issues together before the broader team faces them on day one. This can include mitigations such as agreeing to explicit decision-making norms and reminding teams of the desired attitude toward risk and stretch goals when target setting.

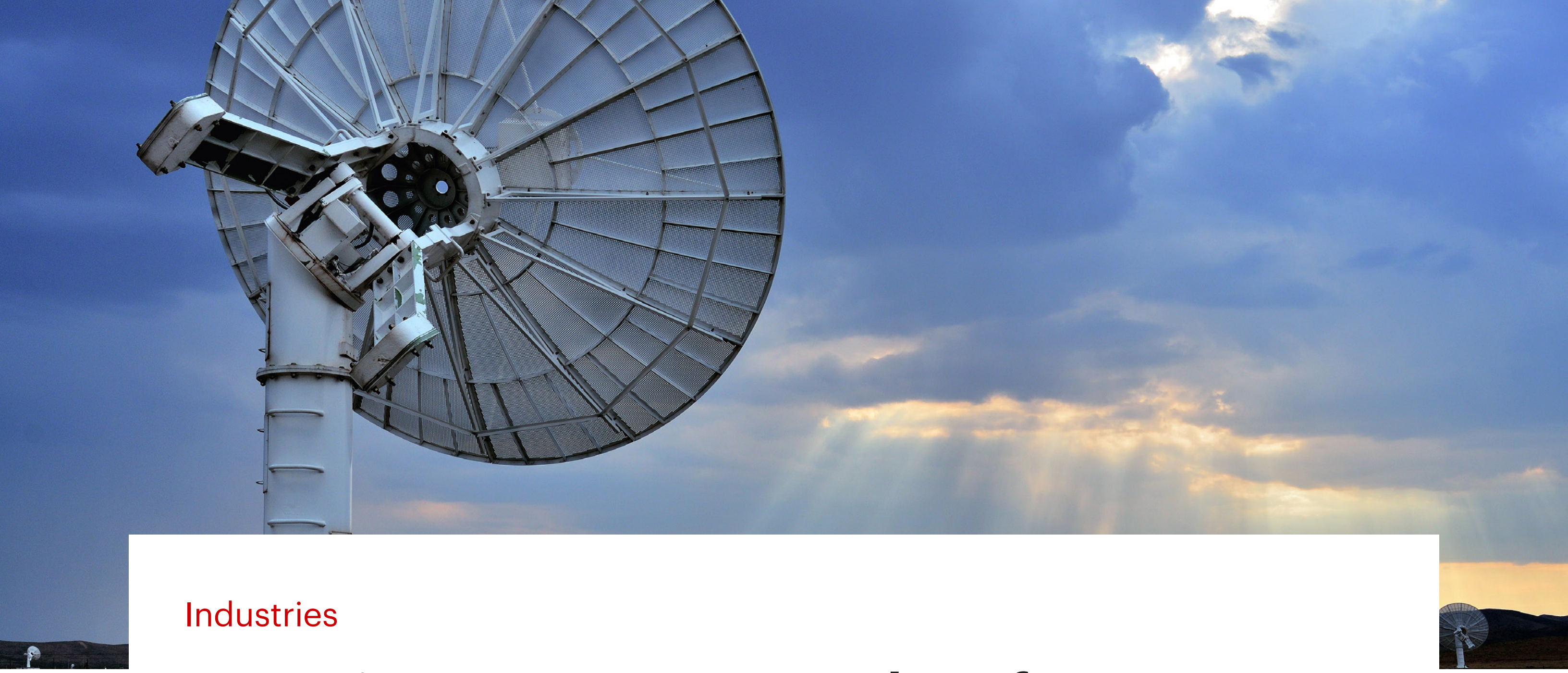
Not all integrations present the same number of cultural fault lines and extent of risk. And many companies can muscle through with only the limited insights from traditional assessments. That approach, however, typically makes the entire process of integration harder. Unaddressed innate cultural fault lines and misperceptions as well as integration missteps result in slowed progress and diminished work quality. The traditional approach may require years (and sometimes several personnel changes) before teams are working with pre-integration efficiency and satisfaction.

The best integrators address fault lines early. Those that wait until teams are openly complaining have a much larger problem to solve—and less credibility with which to solve it.



Industries

Industries



Industries

M&A in Aerospace and Defense: New Types of Deals in a Dynamic Industry

With defense missions and commercial flight markets being disrupted, historic leaders risk losing portions of their profit pools if they don't react.

By Clark Herndon, Mike Sion, and Austin Kim

At a Glance

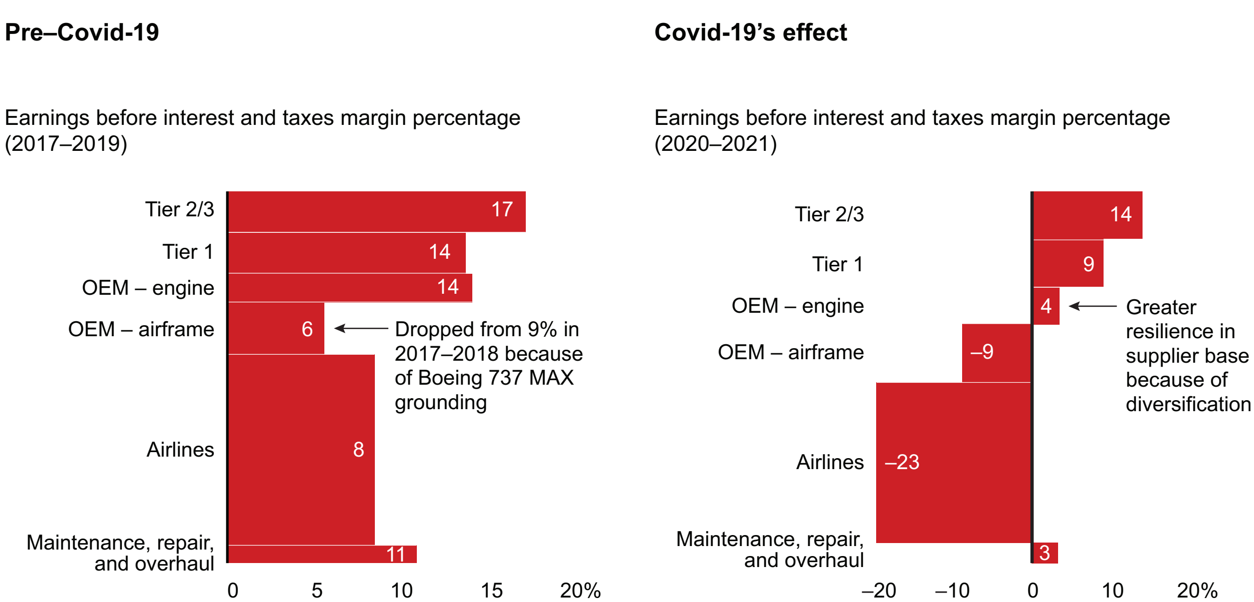
- With challenges to volume and margins, commercial aviation profit pools have been under pressure.
- Despite relative stability in the defense market, budgets still face a crowding-out effect from inflation, sustainment needs, and competing fiscal priorities.
- Companies in both commercial aviation and defense will pursue deals to diversify or consolidate.
- We anticipate private capital to participate more (less antitrust risk, substantial dry powder), seeking out pockets of undermanagement and stable/growing volumes.

For years, aerospace and defense (A&D) was a relatively stable industry with steady air travel penetration growth, long-term increases in defense budgets, and long-duration programs. Now, executives and investors face new strategic questions as the industry changes due to the lasting impact of the Covid-19 pandemic, macroeconomic and geopolitical uncertainties, and technological and regulatory disruptions. Companies must confront disruption, consider diversifying exposure, and grow volume and scale within an environment of lower volumes and margin pressure. M&A is likely to be a key tool many employ to achieve these objectives.

As commercial aerospace rose above the most acute pandemic clouds, it emerged into a less-than-hospitable macro environment. China's recovery has been uneven at best. In Europe, environmental, social, and corporate governance pressures and potential regulation stand to intensify air travel headwinds. Worldwide, pilot shortages are creating a bottleneck. These and other changes hurt volumes at a time when margins are already feeling the impact of cost inflation and the growth of risk-transfer products such as power-by-the-hour maintenance. Commercial aviation profit pools have been under pressure (*see Figure 1*).

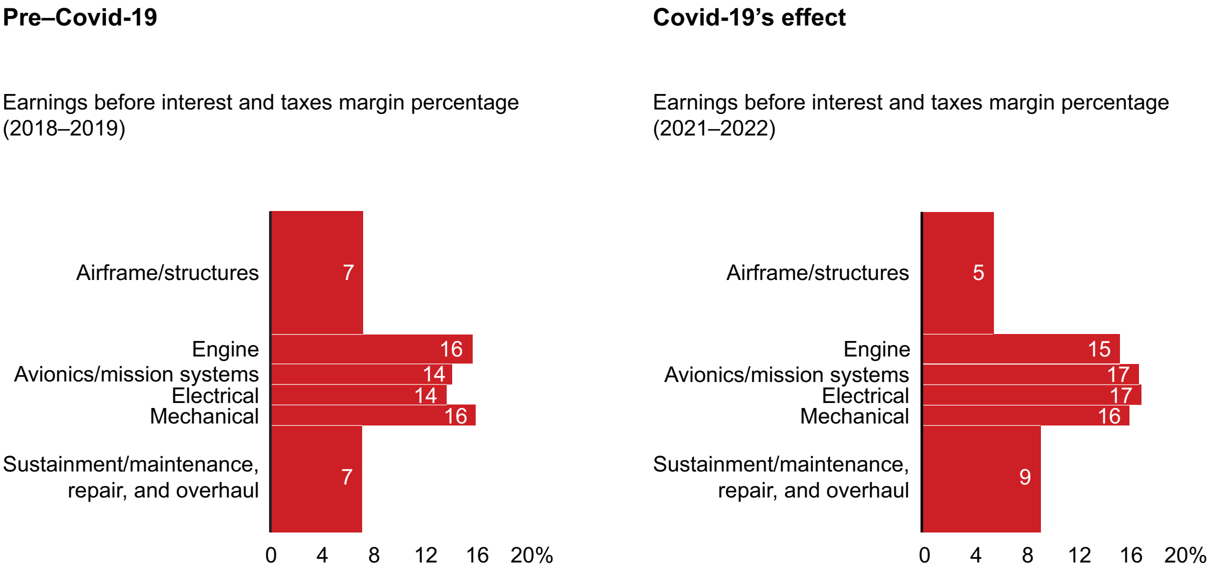
Conversely, the defense market has been relatively stable throughout Covid-19, and changes in the geopolitical environment along with lower levels of fiscal constraint have led to volume and budget tailwinds. Prepayments and government support helped stabilize the supply base during pandemic closures and supply chain disruptions. Russia's invasion of Ukraine has increased spending commitments in Europe, and rising competition with China has the US and close allies (particularly Japan, South Korea, and Australia) shifting their spending priorities and increasing total spending. These countries are collectively building their own defense capabilities and deterrents, which will diversify what has been a US-oriented market. Using military aircraft suppliers as a proxy for the broader industry, profit pools have been much more stable as a result of these trends (*see Figure 2*).

Figure 1: Commercial aviation profit pools have been severely affected by the pandemic



Notes: OEM=original equipment manufacturer; public company financials used to estimate margins at the business segment level; aftermarket/maintenance, repair, and overhaul businesses kept in other categories unless explicitly split as reported segment; Tier 1 and Tier 2/3 overall sizing estimated based on overall OEM – engine and OEM – airframe total size
Sources: S&P Capital IQ; IATA; Bain analysis

Figure 2: Defense aircraft profit pools have remained relatively stable



Notes: 2022 data is annualized for each company; some company financials may include nonmilitary/defense or nonaircraft data because of the lack of publicly available information; pre–Covid-19 data for primes has been collected from 2015 to 2019 to account for abnormal business events; sustainment/maintenance, repair, and overhaul market size includes only labor cost but is not military or defense specific
Sources: S&P Capital IQ; Airframer; Forecaster International; Bain analysis

The shift to near-peer competition in the defense market has broader implications for the supply base. Requirements are growing, but budgets still face a crowding-out effect from inflation, sustainment needs, and competing governmental fiscal priorities. A macroeconomic downturn would likely exacerbate this disconnect between requirements and funding. The challenge for primes and suppliers is to meet demand for new capabilities in areas where commercial innovation and foreign spending are outpacing government investment—for example, cyber, autonomy, artificial intelligence, computing, and connectivity. Companies with exposure to these markets will find meaningful tailwinds, though they will also see competitive pressure from commercial players with innovative solutions that government buyers are increasingly willing to purchase.

We see several important M&A trends as companies and financial investors navigate the marketplace.

- **Platform/segment diversification:** Financial and strategic acquirers alike will continue to turn to M&A to diversify in attractive segments in commercial aviation (e.g., narrowbody, next-generation engines) and stable/growing segments in defense (e.g., major programs of record, advanced mission systems).

- **Defense adjacency growth/capability acquisitions:** Companies in the defense industry will look to buy or partner for the capabilities they need to compete in nascent, high-growth markets. That was the reported objective of Raytheon Technologies' acquisition of Blue Canyon in 2020 and SEAKR Engineering in 2021 in the space market as well as L3Harris's 2022 purchase of Viasat's tactical data links. We will see continued deals and partnerships seeking to benefit from faster time to market and lower development costs.

- **Commercial value chain consolidation:** Scale matters in the aerospace supply chain, and consolidation is likely in segments that are fragmented despite benefits to site- or company-level scale. The recently announced Paradigm Precision and Whitcraft deal is a good example of this trend, and it is reasonable to expect further activity in Tiers 2 and 3. Another likely area of consolidation is maintenance, repair, and overhaul (MRO), which is fragmented today despite customer and operational benefits to site-level scale.

- **Consolidation in maturing markets:** As nascent defense and commercial markets continue to grow, we expect to see consolidation as winners and losers emerge in crowded and highly competitive markets. For example, with space launch frequency increasing, vehicles and services will become more commoditized and smaller players will look for scale deals to lower costs and preserve margins.

Given these trends, M&A is likely to be a critical tool in A&D in 2023 and beyond. We expect some activity in prime contracting/original equipment manufacturers and Tier 1 players (for example, L3Harris's recent announcement of an agreement to acquire Aerojet Rocketdyne), although dealmaking is likely to be more muted vs. the past few decades because the degree of consolidation that regulators will permit remains an open question. We also expect more deals further down the supply chain, where margins can be attractive and there is fragmentation despite benefits to scale.

And private capital will likely increase its participation in the sector, in line with recent trends. We expect more activity from both generalist funds as well as those that have traditionally focused on the sector. Private equity has less antitrust risk, substantial dry powder to invest, and is likely to seek out pockets of undermanagement and stable or growing volumes. And the industry has some fundamental traits that financial investors like—for example, enduring customer relationships, high backlog visibility, and stable cash flows.

But not all investments will be winners. Below are the factors that can boost the odds of a successful deal.

- **Diversified exposure across platforms, programs, geographies:** Recent disruptions caused by Covid-19 highlighted the advantages of diversified exposure. But the act of buying a company just to diversify won't work unless there is a distinct parenting advantage—the acquirer won't be able to justify the deal competition's high multiple. Companies must have a clear deal thesis tied to a specific parenting advantage that unlocks value.

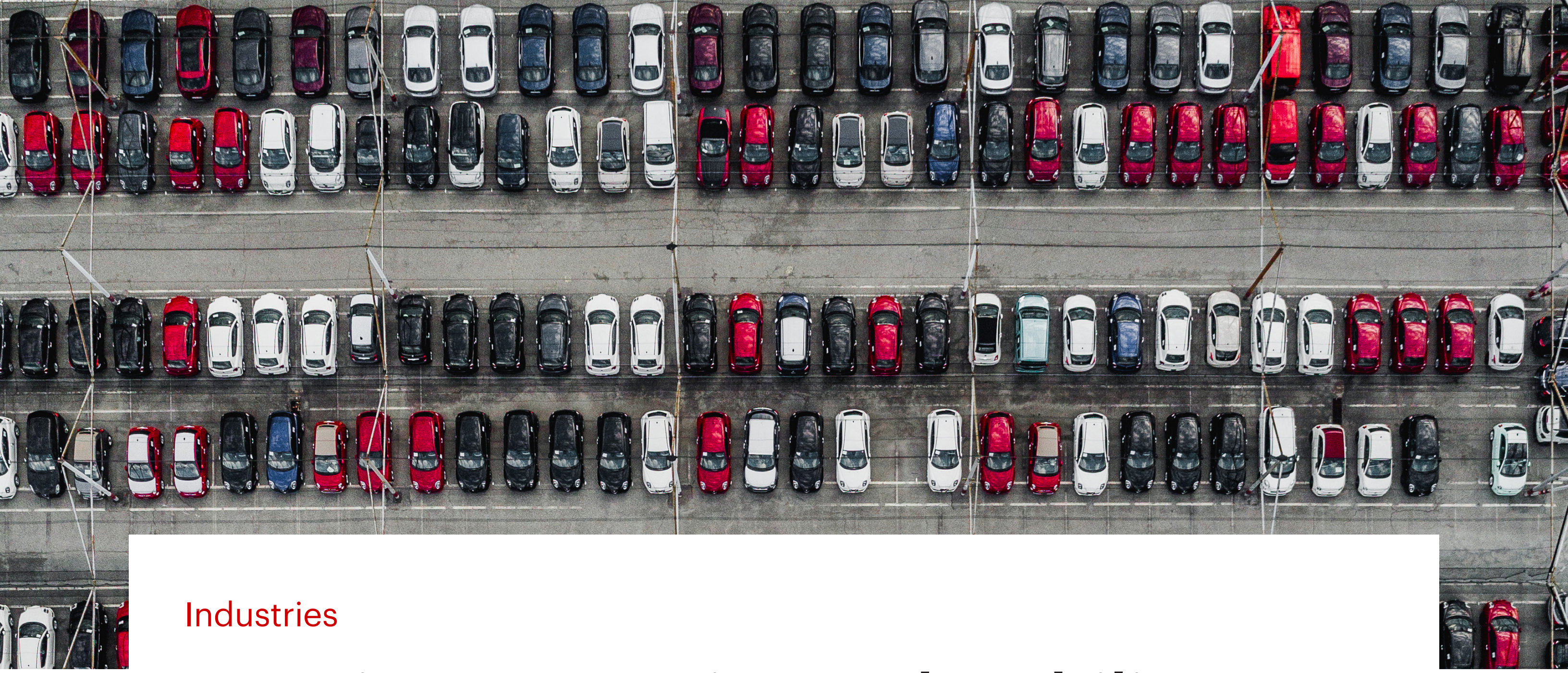
- **Exposure to narrowbody (commercial) and large programs of record such as the F-35 (defense):** Backlogs are large and stable in major narrowbody and defense programs of record (e.g., Airbus's A320, CFM's LEAP, Pratt & Whitney's PW1000 and F135, Lockheed-Martin's F-35, and Northrop Grumman's B-21); companies with exposure to these programs will tend to have scale advantages, higher margins, and more cash to reinvest in next-generation technologies.

- **Defensible intellectual property (IP):** Suppliers that own critical design IP will continue to have an advantage and are more attractive targets, demanding higher multiples compared with contract manufacturers. Proprietary components and systems tend to generate higher margins, both in production and in the aftermarket.

- **Operational excellence:** Operational excellence is the differentiator in this industry and a key to margin expansion, particularly with long-running programs. Yet acquirers need to ensure that the operations expertise is fit for the mission. Some programs maintain low rates for long periods of time, and others benefit from high-rate production expertise that drives out cost through scale.

- **M&A/integration as a capability:** The most successful acquirers in any industry are those that repeatably drive value and growth from acquisitions. From due diligence through to post-merger integration, a sound M&A strategy and execution capabilities that are disciplined and thesis focused are critical.

M&A can be a valuable tool for diversification and access to new capabilities in aerospace and defense. For example, more diverse end-market exposure can help stabilize earnings and expose companies to higher growth segments (such as commercial narrowbody aircraft and major defense programs of record). In industries characterized by long program durations and sticky customer relationships, M&A can be a critical growth lever. And disruptions in both markets make acquisitions that deliver new capabilities to improve defensibility in a company's core potentially attractive. For all of these reasons, winning aerospace and defense companies will develop focused, tailored investment theses that support and reinforce their broader corporate strategies—and pursue acquisitions that strengthen resilience and add value.



Industries

M&A in Automotive and Mobility: Finding Alternative Routes to the Future

Companies that make the right deal decisions now can massively benefit over the long haul.

By Dominik Foucar, Klaus Stricker, Ingo Stein, Ping Yi, and Pedro Correa

At a Glance

- Real customer focus, autonomous driving, connected and digitized vehicles, electric powertrains, and shared mobility will define the industry's future.
- With stakes so high, substantial capital requirements, and the need to speed up R&D, teaming is helping companies to advance after years of many going it alone.
- Access to financing has tightened, so cash-rich original equipment manufacturers, major suppliers, and tech companies will account for most of traditional M&A.
- During this decisive time, anything is possible—and necessary.

The automotive and mobility industry is advancing in different directions as part of a full value chain transformation, and companies are steaming ahead to deliver what we call the "5 Races":

- **R**eal customer focus;
- **A**utonomous driving;

Some companies are making electric vehicle adjacency moves, seeking out new profit pools and critical technology control points.

- **C**onnectivity and digitization of vehicles;
- **E**lectrification of powertrains; and
- **S**hared mobility.

The changes required to compete in the 5 Races are so broad and dramatic that companies will benefit by not going it alone.

On this path, leading companies are quickly leveraging the full array of M&A. That means both traditional acquisitions and mergers, as well as a growing mix of alternative deals. Original equipment manufacturers (OEMs), suppliers, technology companies, and mobility players are forging alliances and partnerships, spinning out divisions, and investing in corporate venture capital (CVC) to get a head start on technology development. Anything is possible (and necessary) depending on a company's strategy.

Let's look at the range of activities and the strategies behind them.

Legacy internal combustion engine component suppliers are consolidating—that is, when regulatory constraints and the ability to implement harvest strategies allow. In partially commoditizing segments, such as lighting, for example, companies can stay profitable from scale synergies and harvest cash to fund the development of next-generation products or build up new engines of growth. Plastic Omnium acquired AMLS and Varroc Lighting Systems to integrate lighting and provide a differentiated offer that meets the growing demands of OEMs, for example.

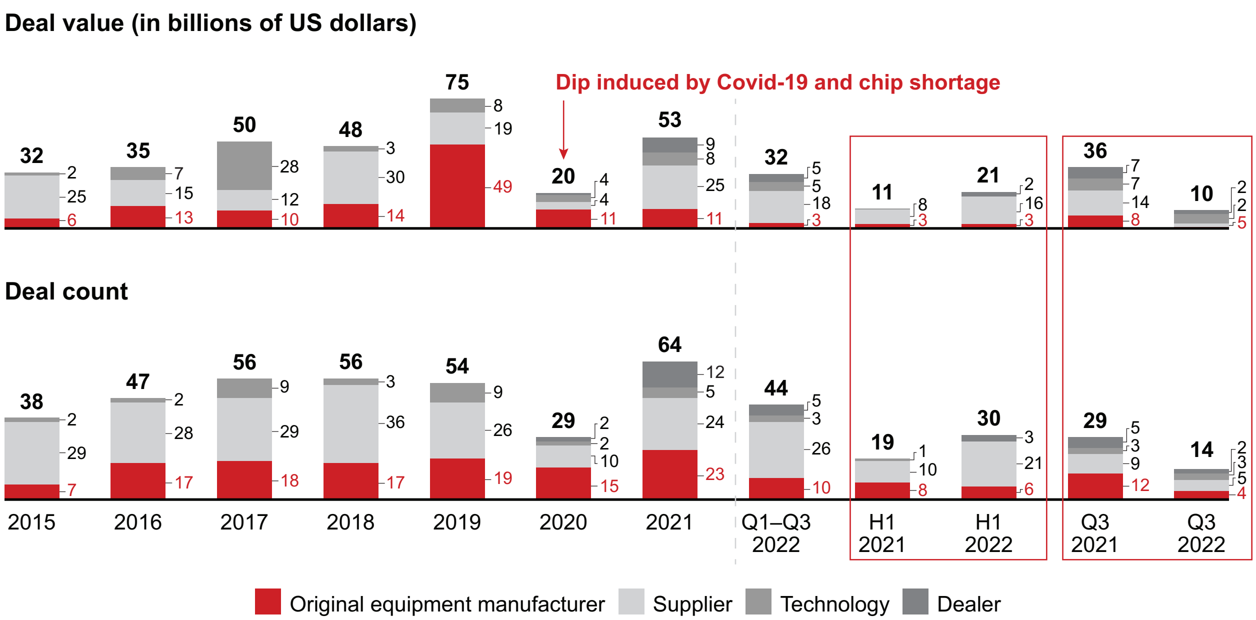
In some areas of the industry, companies are making electric vehicle (EV) adjacency moves, seeking out new profit pools and critical technology control points. This requires not only evaluating what to buy but also how to integrate a new asset. In some cases, such as in EV batteries, the minimum scale needed to play is too large and risky for one player, and many are turning to partnerships.

Consider the strategic partnership that allowed British company GKN Automotive to move into the e-drives business: GKN is contributing its expertise in engines and transmissions, while Delta Electronics, based in Taiwan, is manufacturing the power electronics.

Companies from Ford to Harley-Davidson are also separating electric vehicle assets to get share price appreciation and to access growth capital for the business. That was the objective of Ampere, Renault's new standalone company for its EV and software activities. The spin-off will allow the company to get better valuation and access to capital, attract talent, and have better focused teams. Renault has carved out its internal combustion engine business to build a 50/50 company with Geely that will be a worldwide automotive supplier producing combustion and hybrid propulsion engines and targeting an annual revenue of €15 billion per year. The intent is to share maintenance and R&D costs, rationalize capacity, and tap the slower-to-decline Chinese market.

It's not as if automotive and mobility companies aren't engaging in traditional M&A. Similar to their counterparts in other industries, auto companies put deals on pause during Covid-19–plagued 2020. Activity resumed in 2021, a comeback year that saw 64 deals worth a total of $53 billion. Then 2022 brought with it a host of new economic challenges. Overall, deal volume dropped slightly during the first nine months of 2022 compared with the same period a year earlier, with a strong first half that cooled off in the early weeks of the third quarter (*see Figure 1*). While some scale deals were announced, the majority of the activity, 73%, represented scope deals (*see Figure 2*).

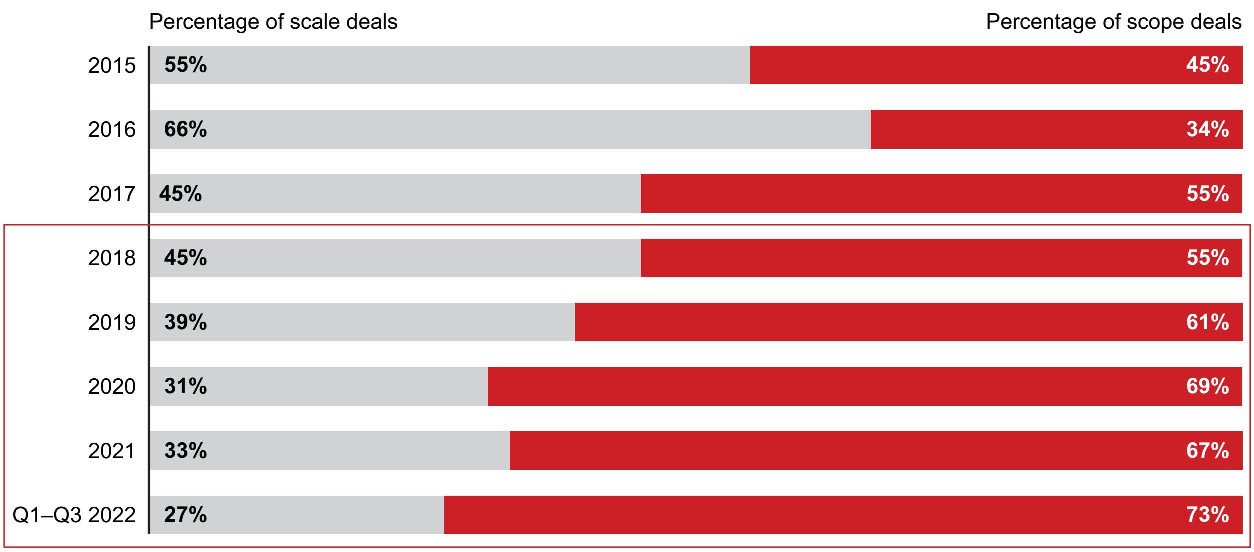
Figure 1: M&A activity dipped slightly in 2022, with a first-half surge in deal value giving way to significant contraction in the third quarter



Notes: 2019 includes Stellantis deal; deals classified by rationale using a proprietary classification framework, as per stated strategic rationale at the time of deal announcement; numbers may not sum due to rounding
Sources: Dealogic; Bain analysis

Figure 2: Over the past five years, expanding scope has been the major impetus for strategic M&A deals in the industry

Strategic deals with greater than $100 million in deal value



Note: Deals classified by rationale using a proprietary classification framework, as per stated strategic rationale at the time of deal announcement
Sources: Dealogic; Bain analysis

But across the value chain, from suppliers to OEMs to technology companies to dealers, the industry is finding that partnerships can be a suitable option, depending on the situation. For example, joint ventures can be a first step toward reining in noncore assets and sharing risks. Alliances can enable purchasing to cope with increasing market pressures from material costs. Cost synergies, benefiting both companies, have been a key objective of Hino and Traton's procurement agreement. These alternatives to traditional acquisitions are less binding and can be easier and quicker to set up. They also come with limitations. Among the most important potential shortcoming: a lack of control.

In areas with high technology uncertainty and where heavy investments are required, such as autonomous driving, companies are finding that participating in CVC can help them secure early access to technology and accelerate development.

Going forward, we expect the number of M&A deals to continue increasing, though likely with a smaller average deal value. As access to financing has tightened with rising interest rates, cash-rich OEMs, major suppliers, and tech companies are expected to account for the largest share of acquisitions. These players see it as a good time to strengthen themselves even more, and there will be affordable targets in the form of companies looking to divest to focus on a core business or revitalize capital structures. Market turbulence will result in more companies falling into distress and becoming potential targets.

This is a decisive time, and companies that make the right decisions now can massively benefit over the long haul. To succeed in this new M&A game, automotive and mobility players must reinforce their M&A capabilities, adjust structures and processes, and build up resources and capabilities for CVC. Five important areas will help ensure M&A success:

- Embed M&A in corporate strategy, and take a thorough future-back view of your portfolio.
- Broaden your screening, including early detection systems and investment opportunities via a venture capital approach.
- Expand your M&A toolkit, tailoring the tools and approaches you use to the situation, including strategic divestments, spin-offs to drive valuation, and alternative partnering options.
- Improve your commercial diligence skill set and integration capabilities, particularly for evaluating adjacency moves and partnerships.
- Capture the full potential, which, in some cases, will be heavily focused on managing down costs and capital employed; in other situations, it will mean taking on the marketing of acquired software or hardware from the smaller company, preserving the core of an acquired business.

Industries

What Consumer Goods Companies Are Learning from Alternative Deals

As more companies try corporate venture capital deals and alliances, they're also learning how to avoid the pitfalls.

By Peter Horsley, Joost Spits, Sam Rovit, and Maria Kurenova

At a Glance

- Our survey found that a vast majority of consumer goods companies expect the number of deals, including alternative deals, to stay the same or increase over the next three years.
- But alternative deals don't always deliver, with nearly 40% of partnerships and corporate venture capital investments in the industry underperforming expectations.
- Some of this may come from a lack of strong senior management commitment, unclear governance, poor cultural fit, mistrust, or vague key performance metrics.

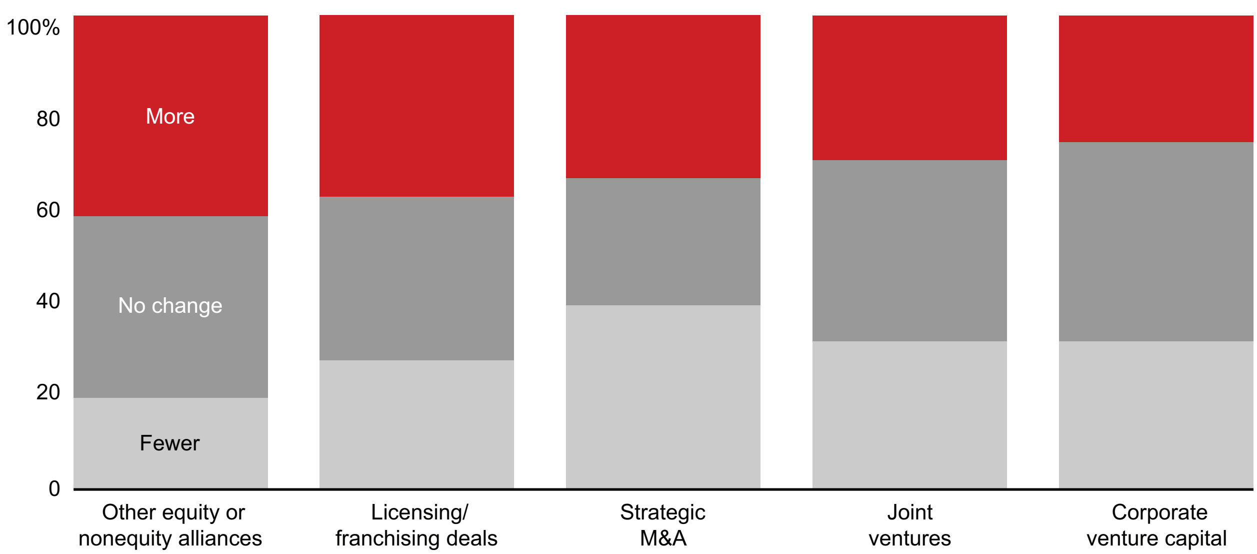
Kraft Foods wants to quickly bring new plant-based products to market, so it begins a joint venture with food tech start-up NotCo, using the company's artificial intelligence capabilities to develop cobranded products. AB InBev wants to unlock new revenue streams in e-commerce and distribution, so it creates the BEES business-to-business platform and marketplace, partnering with other consumer packaged goods companies to offer a whole suite of products as well as value-added services to customers, thus driving growth and providing a lifeline to small businesses in many parts of the world.

The strict antitrust environment in consolidated sectors and regions makes scale deals iffy and take longer to complete.

It may be too soon to call it a boom, but in growing numbers, traditional consumer goods companies hoping to achieve their strategic goals are eschewing scale M&A for a range of alternative deals, such as partnerships and corporate venture capital (CVC), that are better suited for the times. When we analyzed the top 15 consumer goods deals in 2022, we saw an increase in such M&A options. And in a survey of industry business leaders, a vast majority see the number of deals staying the same or increasing over the next three years (*see Figure 1*).

Figure 1: Consumer products companies expect more alliances and licensing deals over the next three years

Within consumer products, what do you expect in terms of frequency of dealmaking by category over the next three years?



Note: Answered only by respondents who indicated they worked in consumer products
Source: Bain M&A Practitioners' 2023 Outlook Survey

What's behind this shift? The increasingly strict antitrust environment in particularly consolidated sectors and regions of the consumer goods industry makes scale deals iffy and take longer to complete, especially in categories with strong leading companies. Alternative deals position a company to explore a broad range of inorganic growth options without making a majority investment. Some companies divest a brand to a joint venture to manage balance sheets. And alternative deals can help mitigate risk inherent in traditional scale M&A by allowing management teams to get to know each other via a partnership or minority investment prior to acquisition.

Indeed, while scale deals still deliver critical value in the right areas of the business, more companies are relying on a broader suite of M&A options. In the first nine months of 2022 alone, we've seen divestitures or spin-offs announced by Kellogg, Vista, Grupo Bimbo, Unilever, and a host of others. While distribution-focused partnerships still abound to build scale in new markets, the past few years have introduced new reasons for joining forces. For example, companies are forming joint ventures and alliances to more hastily address environmental, social, and corporate governance concerns. Kraft's recent joint venture with NotCo allows it to bring plant-based products to market quickly and with lower up-front investment than an outright acquisition.

Likewise, large consumer goods companies are turning to CVC to create new platforms and to deal with digital disruption, e-commerce evolution, and consumer trends in fast-changing categories such as health and wellness. Another benefit of CVC: Companies learn how to partner with others in the venture portfolio to boost the odds of success for start-ups, bringing new insights and products back into their own business.

Partnerships and venture investing help companies explore new ways to rapidly build resiliency in the face of uncertainty. For example, as consumer attitudes and tastes swiftly evolve, alternative deals allow companies to be thoughtful about where they place their bets by exploring these trends with limited up-front financial investment.

As alternative deals become an increasingly viable option, companies are adapting their M&A playbooks to accommodate. The best companies ensure that strategy dictates what types of deals should be pursued, always giving partnerships and CVC teams clear mandates that tie back to strategy. They keep the screening aperture open and active while they look for potential deals and partners. They build a platform team with the objective of bringing value back into the firm, and they develop learning loops across the M&A team and the business to improve the process over time. Importantly, they adapt the corporate culture and build the skills to handle the complexities of these deals—investing to learn how to structure joint ventures, for example, or where and how to insert executive talent.

But many companies are learning that even though alternative deals may be more popular, they don't always succeed. Our survey found that nearly 40% of partnerships and CVC investments in the consumer products industry fail to meet or exceed expectations. Digging deeper into the reasons, we found four common pitfalls—and the best ways to avoid them. It starts with asking four fundamental questions.

What's the strategic imperative? Nearly 40% of executives surveyed cited lack of strong senior management commitment as a top reason for failure of partnerships. In the best cases, senior leaders show commitment by clearly articulating its purpose. They paint a picture for their teams of how the alliance or joint venture advances company strategy and purpose and the role it will play in achieving core objectives in the coming months and years. This holds true for CVC as well. We've heard from several practitioners that without a clear rationale, they feel as if they're doing CVC just to do CVC.

Do we have a repeatable model with clear governance? Another failure point shared by participants was "unclear governance structure/decision rights." Based on our conversations with practitioners, this frequently takes two forms. First, multinationals pursuing alternative deals sometimes fail to ensure regional coordination. Regional regulations often require coordination among central and regional business units and legal teams as part of setting up an alliance. Coordinating decision rights, regulatory timelines, and other critical elements of a deal can speed up the alliance creation across the organization and prevent roadblocks early in the partnership. A second issue: Defining governance and decision rights among the partners themselves is critical up front. Winners address these as part of their playbook for repeatable M&A.

Are we concerned enough about cultural fit? Our survey found that more than 45% of M&A practitioners in consumer products viewed "lack of strong cultural fit and/or trust" as a top reason for unsuccessful alliances and joint ventures. Many practitioners assume that cultural fit isn't as important in partnership deals as it is in traditional scale M&A. That's an oversight that is especially damaging when incumbents create alliances or joint ventures with insurgents. Just as in a scale deal, cultural fit should be a criterion assessed up front. Companies can leverage some of the same diligence best practices from the M&A process and tailor them to a partnership setting (see the chapter "How to Avoid the Fault Lines Sending Tremors through Cultural Integration in M&A").

How are we measuring success? Key performance metrics that were unclear or not aligned with value was cited as a cause of CVC failure for 45% of survey respondents. It was a particular challenge for CVC deals. Companies making these investments need to apply a lesson from venture investors—they always have solid metrics to determine success across the entire portfolio of investments. But there's a complication. Financial return is not the only (and often not the most important) reason consumer goods companies should be doing venture-stage investing. They can increase the probability of success for portfolio companies through targeted access to the networks, client bases, and product expertise, as well as to talent, technology, and other capabilities. At the same time, the parent company can benefit from the portfolio company's innovations and talent. With that in mind, the best practitioners set financial and qualitative metrics (e.g., number of partnerships with business, adoption of technology) that measure all these benefits in a way that connects to their strategic goal. Picking the right metric starts with a clear articulation of the CVC's alignment with strategy.

As they look to alternative deals, more consumer goods companies are learning that success requires a solid understanding of how these deals are different, how to build the right set of skills, and how this new game of M&A, more than traditional dealmaking, can help them advance their strategy to outpace competitors.

Industries

Retail's New M&A Balancing Act

Even as they acquire for scale, retailers also need deals for new sources of nontrading revenue.

By Vincent Vandierendonck, Mike Parshley, Yael Mohan, and Stephanie Koszyk

At a Glance

- We expect companies to draw on record levels of cash amassed during the Covid-19 pandemic and take advantage of decade-low multiples to pursue M&A deals in 2023.
- With growth in their traditional businesses slowing, retailers will need to turn to beyond-trading activity for growth, which is poised to become the biggest force in retail M&A.
- Beyond-trading revenue will account for 40% of retailers' revenue and more than half of industry profits by 2030.
- Retailers can pursue beyond-trading revenue via category expansion, third-party marketplaces, consumer service ecosystems, and business-to-business services.

In many ways, the retail industry's rapid evolution feels like a blur. Traditional retailers are more aggressively upping their digital game while digital natives (think Warby Parker, Gopuff, and Deliveroo) are racing to hone the classic retail capabilities patiently built up over decades by incumbent rivals. This is happening at a time when profit pools are on the verge of massive changes that will make them virtually unrecognizable as more and more retailers see a future in nontrading activity.

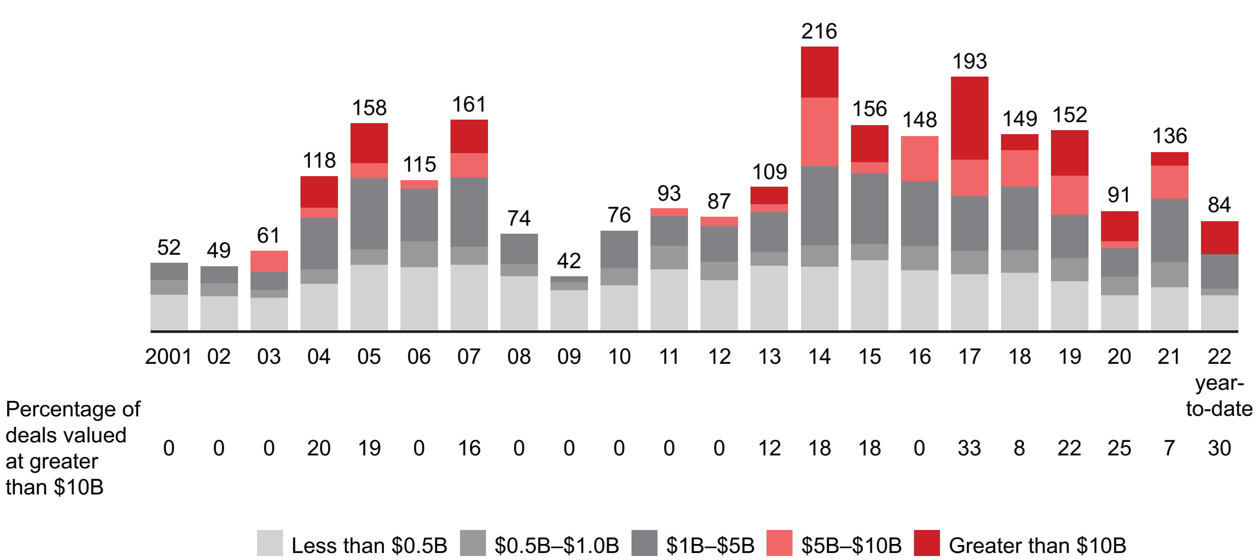
Indeed, as growth from their traditional business continues to slow, retailers are moving in new directions—for example, to marketplaces that generate commissions by linking third-party sellers to customers; or to business-to-business (B2B) services and products that bolster new revenue streams from existing assets, including logistics infrastructure services, customer data monetization, and underexploited advertising channels on apps and websites via new retail media networks. Overall, we forecast that such beyond-trading activities will account for 40% of revenue and more than half of industry profits in 2030.

As retailers shift their business mix toward beyond-trading revenue, M&A has a critical role to play. Retailers will rediscover scale deals to build local and global leadership positions and generate the cost synergies that can help them invest in adjacencies that will produce the lion's share of future growth. At the same time, they are seeking out scope deals to help them grow beyond their traditional trade business. They're attempting this balancing act as they navigate an uncertain macroeconomic environment that makes it imperative to excel at the basics of retailing.

Retailers that achieve outsized total shareholder returns get two things right: They engage in frequent and material M&A (in our long-term study of M&A trends, we call such companies "mountain climbers"), and they take advantage of economic downturns to make bold moves in M&A. Indeed, in the last half of 2022, we began to see early signals of a resurgence of scale deals as evidenced by

Figure 1: Given the dip in large-scale retail deals over the past few years, the industry is ripe for a rebound

Retail strategic deal value (in billions of US dollars)



Notes: By announcement date; strategic M&A includes corporate M&A deals (which includes private equity exits) and add-ons
Source: Dealogic as of October 31, 2022

the headlines generated by the Kroger-Albertsons merger announcement. Companies are beginning to draw on record levels of cash amassed during the Covid-19 pandemic and decade-low multiples—lower than in any other major industry, in fact—to pursue scale deals (*see Figure 1*).

As companies make these scale moves, they also are playing an equally ambitious game to assess and buy new capabilities and technologies in scope deals. While the majority of retail M&A value over the past two years involved scale deals, the majority of large deal volume was actually in scope deals. Much of that was aimed at hastening the convergence of traditional store-first retailers playing catch-up with their digitally native disrupters in innovation and technology—all while tech-first digital natives bought companies to develop capabilities that would enable them to build a successful physical store presence.

The quest for beyond-trading revenue streams by traditional retailers could be the biggest force behind scope M&A in the years ahead. With the tailwinds from Covid-19 waning and organic growth slowing, we'll see more retailers buying to diversify into higher-growth revenue streams—in some cases leveraging an existing asset that they've been sitting on (e.g., their data). It's been eight years since Kroger acquired the majority of Dunnhumby, the data analysis firm that provides it with valuable customer insights. Now, Kroger is referencing alternative profit businesses such as retail media and customer insights as core components of the deal thesis for its proposed deal for Albertsons. There are relatively small deals with a beyond-trading aim, too. Consider American Eagle Outfitters' purchase of Quiet Logistics for approximately $350 million in 2021. To get into the game of developing a new growth engine (what we refer to as an Engine 2 business), some companies are divesting parts of their business that no longer support their strategy or that have become operationally inefficient.

The quest for beyond-trading revenue streams by traditional retailers could be the biggest force behind scope M&A in the years ahead.

This major shift to beyond-trading revenue comes in four varieties. We'll look at them one by one.

Category and format expansion beyond traditional retail: This was the route taken by Nike in late 2021 when it acquired RTFKT, a company that relies on game engines, nonfungible tokens (NFTs), blockchain authentication, and augmented reality to deliver innovative virtual products and experiences. And there's a consistent push by retailers acquiring their way into healthcare, with Amazon's intent to buy One Medical last year on the heels of Best Buy's purchase of Current Health in late 2021. In another variant, duty-free retailer Dufry and Italian airport and motorway caterer Autogrill announced a deal to merge in 2022.

Third-party marketplaces: In these deals, companies enable businesses to sell through their own platforms. When eBay announced its deal for NFT marketplace KnownOrigin in June, it described the purchase as being part of its “tech-led reimagination.” A host of retailers, such as Macy’s, Galeries Lafayette, Auchan, and Carrefour, are using Mirakl to bolt on marketplaces.

Consumer service ecosystems and super apps: Retailers turn to M&A to pursue revenue from broader consumer discretionary spending and to become the go-to app for every consumer need. For example, Meituan’s one-stop shop app maximizes stickiness, making it harder for customers to leave the ecosystem. That was the reasoning behind South Korean search company Naver’s announced plans to acquire secondhand apparel marketplace Poshmark for $1.2 billion last year.

Expanding into B2B revenue streams: In this growing shift, retailers are leveraging their existing assets and capabilities for external commercialization to generate alternative B2B revenue streams. Amazon pioneered this activity with Amazon Web Services, which provides on-demand cloud computing platforms. India’s Flipkart accelerated its move in this direction last year by initiating a multiyear strategic alliance with Google Cloud. The examples of retailers rapidly entering retail media are many: Walmart Connect, Target’s Roundel, and Lowe’s One Roof Media Network all provide suppliers personalized and targeted activation of their broad consumer bases; JD.com’s JD Logistics and Amazon’s Amazon Global Logistics provide supply chain and logistics services.

Growing beyond traditional trade is a must-have for all retailers. The question is: How do you do it best? Winning retailers will use data to identify which beyond-trading opportunities will promote growth, which to target, and how to get there (i.e., whether to build or buy or partner). Even the biggest retailers are finding that building can be too slow, capital intensive, and, when they lack in-house talent, especially risky. That’s why more are opting for partnerships or outright acquisitions.

Whether the goal is to build scale for leadership or to pursue scope M&A to add new revenue and profit streams, the best M&A deals will start by asking a handful of fundamental questions:

- How much more headroom do we have in our current core business, and what is our best path toward gaining local or global relative market share?
- Are there affordable assets on the market that would accelerate our path to build scale?
- What will our addressable profit pool look like in three years? Five years? Ten years? How will customer needs shift, and do we have what it takes to compete and win share in that future?
- How will we get our fair share of the accelerating beyond-trading profit pool? Which diversified revenue streams are we best positioned to win in?

- What are our capability gaps, and what is on the wish list of priority capabilities? Do we have the ability to develop those capabilities internally, or is it a good time to be refreshing our M&A shopping list (with a future-back lens) given the price of assets?
- How should we prioritize?

Industries

M&A in Diversified Industrials: ESG Plays Drive Breakthrough Capabilities

Diversified industrials are adapting their M&A playbooks to take on more deals that advance environmental and social agendas.

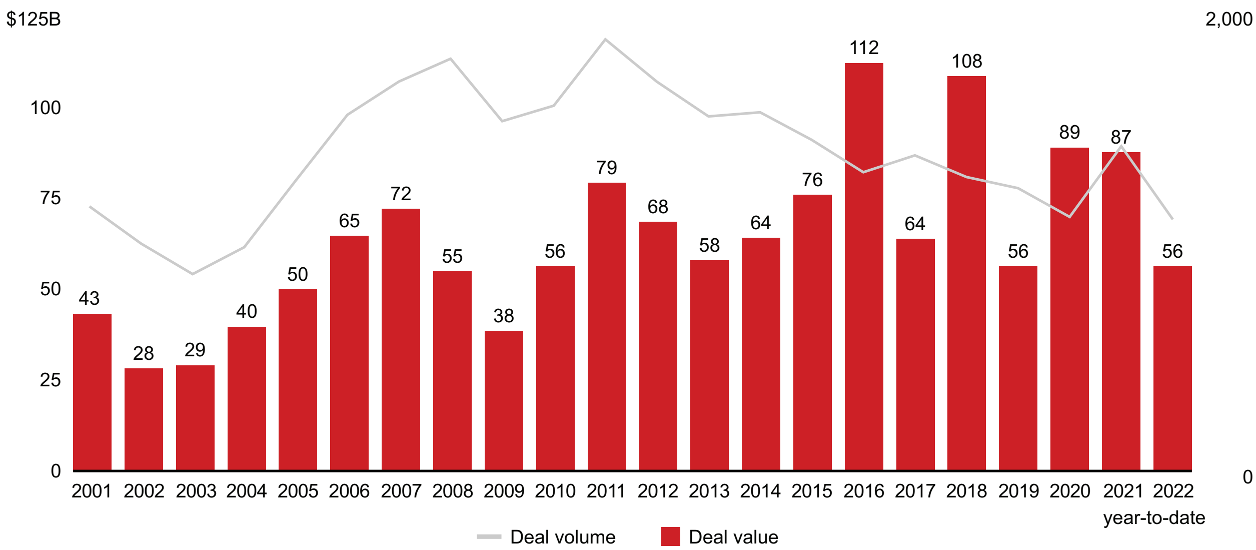
By A.J. Brown and Clark Herndon

At a Glance

- Diversified industrials' overall strategic M&A value and volume declined in 2022.
- But acquisitions focused on helping companies meet their environmental and social targets are picking up steam.
- Industrial players bought quick access to favorable green markets, and they acquired capabilities to accelerate reductions in water and carbon usage.
- To support such deals, link corporate strategy with the M&A roadmap, focus diligence on what will drive growth, and tailor the integration thesis to each specific deal.

While the macroeconomic uncertainty of 2022 caused the volume of industrial company deals to drop from its six-year high in 2021, and while few deals even came close to the $5 billion or greater value that represented more than half of all industrial M&A in 2020, there was one type of activity that grew in popularity—namely, deals that promised to push companies farther along on their environmental, social, and corporate governance (ESG) journeys (*see Figures 1 and 2*).

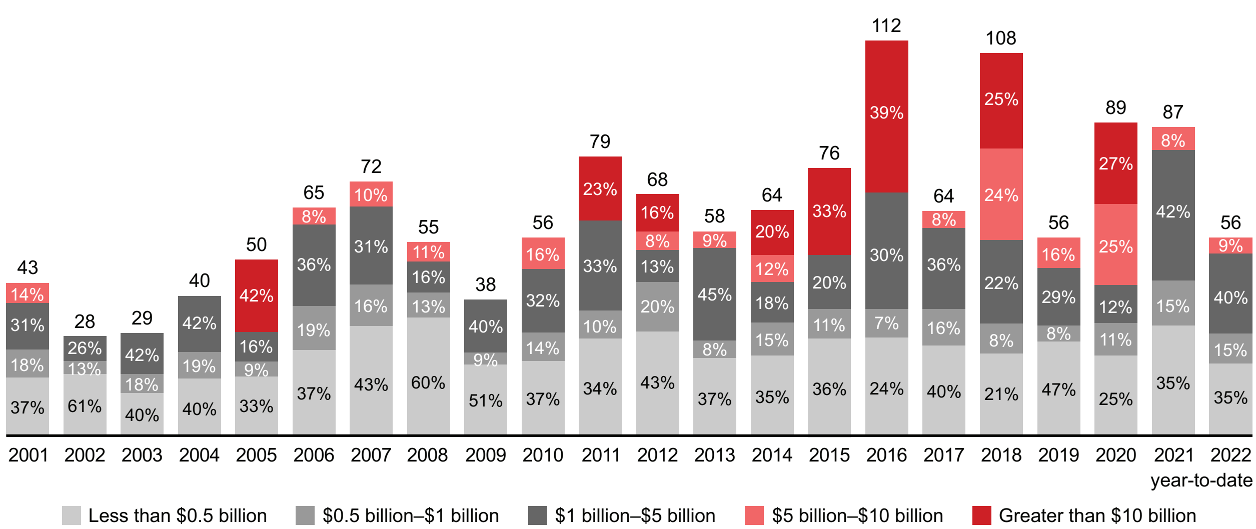
Figure 1: Diversified industrials' deal volume fell from 2021's six-year high in 2022



Notes: By announcement date; strategic deals include corporate M&A deals (which include PE exits) and add-ons
Source: Dealogic as of October 31, 2022

Figure 2: More than half of all diversified industrials' strategic deal value came from deals valued at greater than $5 billion in 2020

Diversified industrials' strategic deal value (in billions of US dollars)



Notes: By announcement date; strategic deals include corporate M&A deals (which include PE exits) and add-ons
Source: Dealogic as of October 31, 2022

Overall deal transactions are down, but we see an increasing number of ESG-driven acquisitions among industrial players looking to accelerate broader environmental and social objectives. While it's hard to quantify M&A activity based on ESG dimensions, we believe that 1 in 10 deals in diversified industrials now has an ESG component, more than the average across all industries. As ESG priorities continue to take mindshare of CEO and board agendas, industrial players are actively pursuing deals to accelerate capability acquisitions. As a result, two major trends are emerging in ESG-led acquisition plays.

First, industrial players are acquiring adjacent businesses that quickly grant access to favorable market segments. Similar to auto companies' entry into batteries to help accelerate electric vehicle development, so, too, are industrial players looking to gain quick access to new green markets.

For example, Canadian engineering, procurement, and construction company SNC-Lavalin set aggressive decarbonization and sustainability targets as part of its engineering net-zero ambitions. To achieve these objectives, the company acquired Flex Process, a leading digital process simulation player that helps optimize asset life and reduce emissions for customers across the industrial, chemical, and power industries. Rising attention to address and report on decarbonization is creating an attractive market for remediation efforts. The acquisition helped rapidly accelerate SNC-Lavalin's technology capabilities to become a meaningful player in the growing decarbonization segment of remediation, as opposed to relying on internal R&D to build the necessary tech stack requirements. SNC-Lavalin had a clear link between its broader strategic objectives and M&A roadmap, a critical factor when building capabilities away from the base business.

Second, companies are looking to acquisitions to help improve their production or manufacturing capabilities in pursuit of their own ESG objectives. For example, construction materials companies are pursuing innovative adjacent solutions to help address carbon footprint goals. Saint-Gobain's acquisition of Chryso technologies introduced new additive solutions for sustainable construction into Saint-Gobain's portfolio, helping to manage carbon emissions across its concrete manufacturing footprint. In addition to diversifying its portfolio, the acquisition helps Saint-Gobain improve existing product quality and capabilities, increasing synergies from the deal. In support of these scope deals, ESG is playing a bigger role in upstream diligence activities. In addition to market and synergy assessments, industrial players are broadening ESG diligence efforts (beyond traditional environmental studies) to inform acquisition plays and manage downside risk. Net-zero plans and sustainability announcements can materially impact deal valuations.

Companies are acquiring to improve production or manufacturing in pursuit of their own ESG objectives.

Evolving the industrial M&A playbook

As ESG priorities grow, companies will need to change their M&A approaches to ensure ESG-driven scope/capability deals are successful additions to their business portfolios. Pivoting M&A capabilities to support these types of deals will require three critical changes:

- proactively linking corporate strategy with the M&A roadmap;
- updating the diligence playbook, focusing on what matters to drive scope growth; and
- tailoring the integration thesis for each specific deal.

A similar new playbook is required as companies look to marry ESG priorities with M&A strategy. ESG pursuits cannot be an afterthought to M&A strategy. Moving upstream in the process—that is, assessing gaps in current ESG strategy and partnerships to fill them while pursuing a robust ESG lens in diligence activities—will ensure that capability matches are complementary to strategic pursuits. Integrated ESG diligence and screening efforts also guarantee that ESG priorities are enmeshed with capability pursuits and therefore not just an afterthought.

Looking ahead, we expect momentum to slow for M&A activity within the industrial sector as long as market uncertainty and recessionary fears remain. Valuation uncertainty may continue to push industrial players into smaller targeted acquisitions to help shore up deal theses and continue expansion into ESG pursuits. Those willing to take a more proactive stance in the face of uncertainty will need to be focused on end-to-end management of the M&A value chain. Deals will require a clear strategic rationale, a well-defined deal and integration thesis, diligence across both cost and revenue synergies, stringent planning, realization, and follow-through of value creation post-close.

Industries

M&A in Energy and Natural Resources: Beating the Odds in Energy Transition Deals

What can companies be doing better in scope deals for their energy transition?

By Whit Keuer and Arnaud Leroi

At a Glance

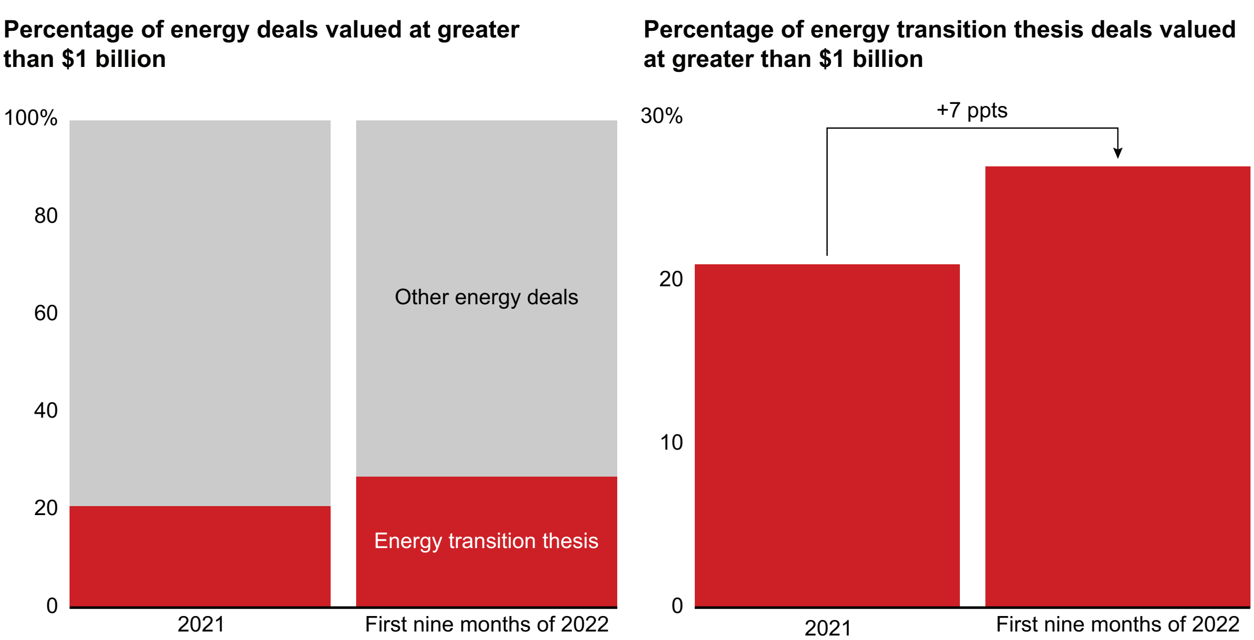
- Acquisitions to advance an energy transition now represent 27% of all deals in energy and natural resources.
- This comes at a time when energy and natural resources companies are more flush with cash than any other industry, depending on the sector or region.
- Energy transition deals have different risk/return profiles than previous deals, and they require fundamentally different approaches to value creation.
- It is critical to focus attention on revenue synergies, identifying business model opportunities by geography, product line, market, and specific customer.

How rapidly are energy and natural resources (ENR) portfolios changing? Our recent survey of M&A practitioners found that 80% of energy industry respondents have proactively evaluated separating or spinning off parts of the business. In the first nine months of 2022, divestitures activity totaled $250 billion—that's more than any other industry.

Indeed, companies are racing to dispose of carbon-heavy assets. Enel, a global energy company based in Italy, recently announced plans to sell assets valued at $21.5 billion, representing 15% to 20% of the company's enterprise value. The move was part of a strategy to streamline its business and push electrification across the full value chain in Europe, the US, and Latin America as well as to cut debt. In oil and gas, TotalEnergies is spinning off its Canadian oil sands operations and plans to list the new company on the Toronto Stock Exchange. The assets simply don't fit with the company's new low-emissions strategy.

While these spin-offs are happening, acquisitions related to the energy transition as a percentage of all deal volume is steadily growing, from 21% in 2021 to 27% in the first three quarters of 2022 (*see Figure 1*). We think this trend toward portfolio rebalancing will accelerate in 2023 and the coming years. In the Bain M&A Practitioners' 2023 Outlook Survey, 72% of energy and natural resources respondents said the most common investment thesis will be either expanding into new areas of business or building new engines of growth. (We refer to them as an Engine 2, a new business within an existing company that uses the scale benefits of the core business to grow faster than an independent start-up could.) This comes at a time when ENR companies are flush with more cash than any other industry ($300 billion), although with some discrepancies between sectors and regions. This will fuel their investments in the energy transition.

Figure 1: Energy transition is increasingly driving M&A deal theses



Sources: S&P Capital IQ; Bain analysis

New types of deals, new challenges

In last year's M&A report, we talked about why these deals are becoming so important. Now, we focus on the how. The new wave of M&A—namely, scope deals to enable energy transition—is becoming more competitive and has a different risk/return profile than previous deals, requiring fundamentally different approaches to value creation. Scale deals succeed based on rapid overall integration, capture of cost synergies, and full cultural integration. Scope deals, however, require a much more tailored approach when it comes to deciding what to preserve, what to integrate, and how to evolve the business strategy to make the most of the core strengths of the acquirer (if possible).

In the chemical industry, for example, LyondellBasell formed a joint venture called Source One Plastics to build an energy-efficient, advanced plastic waste sorting and recycling facility in Germany, using LyondellBasell's proprietary MoReTec technology and working with its customers, who are increasingly demanding renewable and circular solutions. Recognizing that the business model requires greater investment in technology and interaction with customers than its legacy commodity business, LyondellBasell created a separate business unit with its own leadership team, management processes, and salesforce.

Bain's experience from hundreds of scope M&A transactions indicates that while returns can be comparable to scale M&A, there is a much wider range of outcomes. Three features of scope deals make them more difficult:

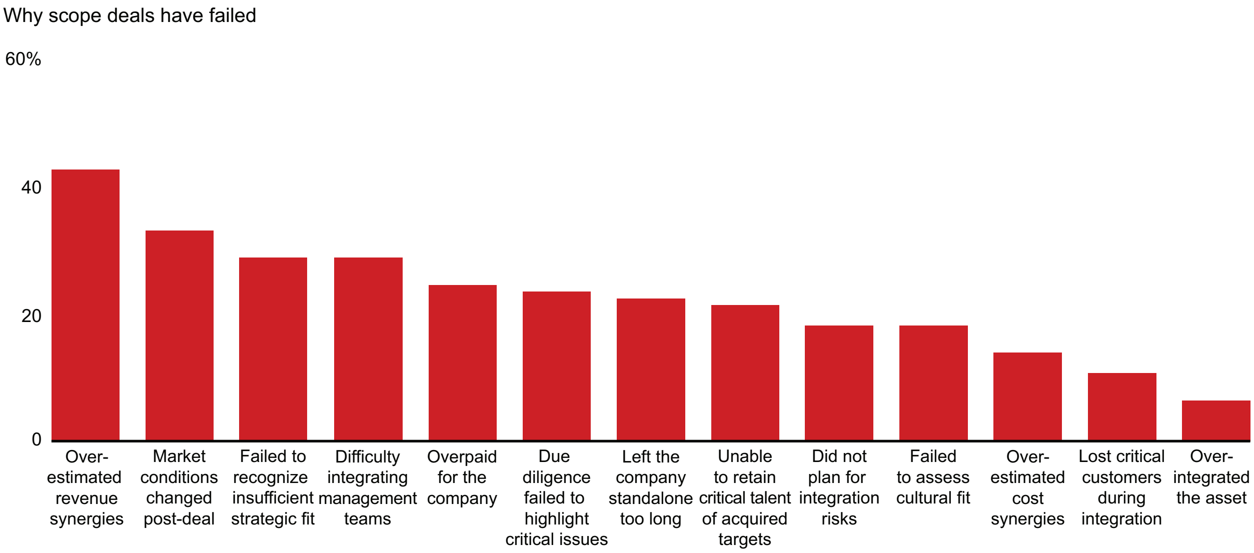
- By definition, scope deals occur outside the acquirer's core business, geographies, or competencies. The risk is that the acquirer stumbles as it learns to manage an unfamiliar business.

- Scope deals often involve finding and knitting together new capabilities that serve as the source of competitive advantage in Engine 2 activities. This requires the acquirer to think several steps ahead and identify other potential businesses and companies to bolt on to the one currently being acquired. As transaction multiples have increased in recent years, we've observed the more aggressive acquirers being willing to incorporate anticipated synergies from future acquisitions into the purchase price of their initial deals.

- Scope deals are typically aimed at generating revenue synergies, which inherently come with more risk and less control than cost synergies. In a 2021 Bain survey, M&A practitioners in energy and natural resources cited overestimated revenue synergies as the top reason for deal failure (*see Figure 2*). Among the causes: In scale transactions, companies are selling into familiar territory, often global commodity markets with established supply and demand patterns; in scope deals, customer needs and market dynamics are not as well known.

Figure 2: Scope deals most often fail because of overestimation of revenue synergies, changing market conditions, and insufficient strategic fit

From 2021 survey: Consider your **least successful deal** over the past three years. What were the **primary reasons it was the least successful**? Please select up to four reasons.



Note: Scope deals most often succeeded because of clear deal theses and clear alignment on M&A strategy with all stakeholders
Source: Bain & Company Global M&A Report 2022 (N=94)

Evolving the M&A playbook for energy transition scope deals

Energy companies are relatively less experienced in energy transition scope deals than scale deals, but the reverse is becoming true in other industries as scope transactions represented roughly half of all deals valued in excess of $1 billion in 2021. Those industries have gained a head start in evolving a strong playbook for scope transactions. As a result, energy and natural resources industry dealmakers can learn from what works in other industries.

Reimagine your entire M&A process. Every element of the deal cycle, from M&A strategy to deal thesis to diligence and valuation to merger integration, must be managed differently. The starting point is a rigorous due diligence process. Revenue synergies, for example, have traditionally been treated in diligence as something of an art by dealmakers compared with the relatively more scientific approach common to cost synergies.

In scope transactions, it is critical to devote much more attention to revenue synergies, identifying opportunities by geography, product line, market, and specific customer. In the energy transition, customer requirements are changing, and it is important to develop a proprietary view into where and how that demand is changing—and over what time period. This can be developed through in-depth customer research and speaking to teams on the front line, as well as by using the pre-close period to develop more granular revenue targets for the new combined salesforce. For example, construction chemicals company Sika used focused sales plays to achieve ambitious revenue synergies. Immediately after closing the Parex deal, Sika systematically prioritized and introduced flagship stock-keeping units in these distribution channels, generating quick revenue synergies from a laser focus on what to cross-sell and to whom.

Build an integrated value chain to deliver energy transition products and services. Too many scope deals become one-off acquisitions as companies hope to gain access to new profit pools or high-growth markets but then fail to build out a complete portfolio. It's necessary to define the desired target portfolio of integrated assets and then identify what will be accomplished organically and inorganically. Consider how Shell is building out its footprint of electric vehicle (EV) charging stations globally through its acquisition of ubitricity and others. Shell acquired Greenlots, which provides a software operating platform for EV charging companies that includes real-time charger health status, utilization data, dynamic pricing capabilities, and predictive analytics. Shell also bought a minority stake in microgrid developer GI Energy. Shell has an integrated oil and gas value chain that extends from production, refineries, pipelines, and ultimately through its retail gas stations. These recent EV-related acquisitions in combination show how Shell is following a similar integrated value chain approach, this time for renewable power generation all the way through delivery to the ultimate end user.

In another example, many energy companies are exploring carbon capture, utilization, and storage (CCUS) technologies to both abate the carbon emissions of their existing portfolio while they also develop new lines of business. In 2020, Petronas announced its ambition to achieve net-zero carbon emissions by 2050, recognizing the important role CCUS would have in achieving these targets. Petronas identified 19 potential sites to manage a carbon storage portfolio for emissions produced by its operations and establish a regional storage hub for carbon emissions as a revenue generator. Since that initial announcement, it has engaged in different acquisitions or partnerships, giving Petronas access to new and cost-effective CCUS technologies to capture the carbon emissions as well as transportation to market liquified carbon dioxide in the Asia-Pacific and Oceania regions. Petronas's goal is to create a full CCUS ecosystem, and M&A and strategic partnerships have been a critical accelerator of these plans.

Start with a clear integration thesis, and integrate where it matters. Scope deals succeed when the acquirer preserves the unique attributes of the company it has just bought, integrating the two only where it matters—as well as when the two businesses begin to cross-pollinate, creating platforms for future growth. Shell is using its capabilities for developing oil and gas projects in harsh environments to build offshore wind farms. In November, Shell formed a partnership with Alternergy, a renewable energy company, to develop an initial one gigawatt of generation capacity in the Philippines. Shell's experience with megaprojects brings industry-leading project capabilities and a global supply chain to more rapidly scale the new development.

As the industry turns to M&A to speed the energy transition, companies that achieve the most success will be those that acknowledge how different these deals are from the traditional scale deals that proliferated in their industry for decades. And they will master a new playbook, one that is thoughtfully revised for this time of historic possibilities.

Industries

M&A in Banking: Three Types of Deals for 2023

Banks are pursuing three types of deals to navigate a changing industry.

By Daniele Funaro, Katrina Cuthell, and Matt Keith

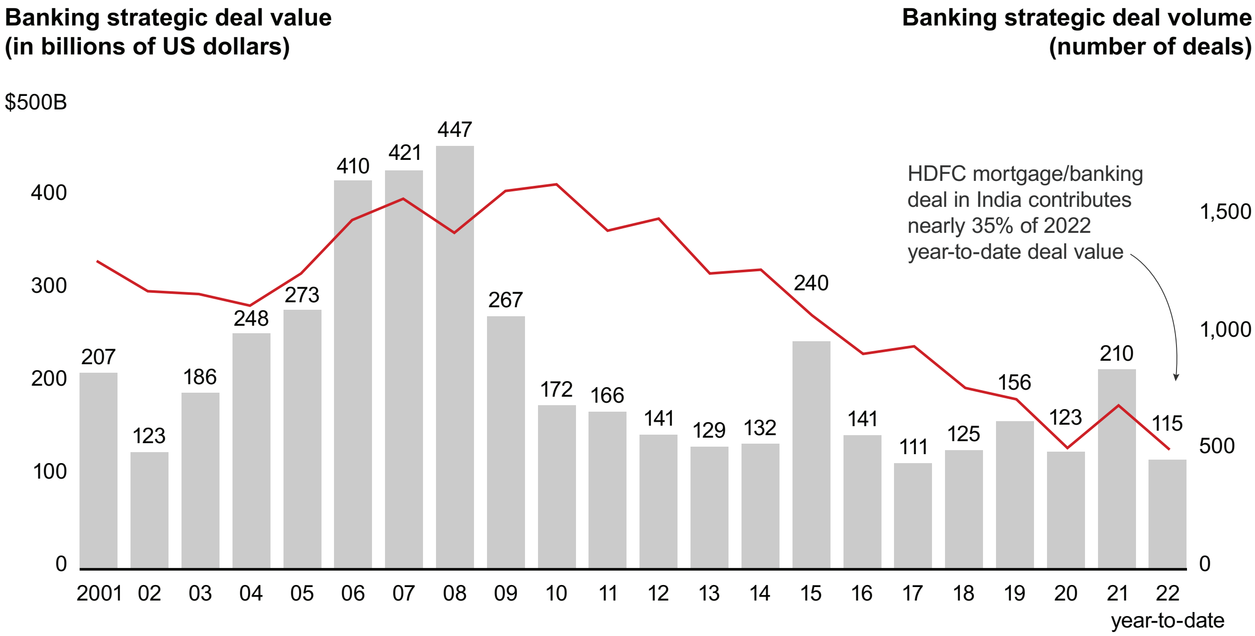
At a Glance

- More than half of total banking M&A in 2022 involved deals valued at greater than $5 billion vs. around 25% throughout the previous 10 years.
- To improve operations in the downturn, many banks will sell off or find partners for units that are noncore or subscale, requiring significant investment.
- More banks are acquiring to establish a new growth engine, expand current product and service offerings, and gain distinctive capabilities and competencies.

Similar to so many other industries, banking saw M&A activity stall in mid-2022 amid rising interest rates and mounting macroeconomic concerns (*see Figure 1*). But we expect the year 2023 to be one in which more banks turn to M&A to deliver on strategies that will better position them as the industry continues to rapidly evolve.

As digital options emerge and customer needs change, banks are determining where they want to play and how they want to compete.

Figure 1: Banking deal value and volume declined from 2021



Note: Strategic banking industry includes corporate deals and private equity add-ons
Source: Dealogic as of October 31, 2022

Several trends will make M&A an attractive option. Higher interest rates will bolster top-line growth for healthy banks while a downturn could make it necessary for less sturdy banks to merge or sell. In Europe and other regions where banking is fragmented, regulators are showing support for scale deals. As digital options emerge and customer needs change, banks are determining where they want to play and how they want to compete. They are looking to sell noncore assets and buy new capabilities to deliver their portfolio strategy faster, cheaper, and more effectively than they could on their own. Expect more deals similar to National Australia Bank's 2021 acquisition of neobank 86 400 to spur the growth of its UBank digital-only bank.

We expect to see three types of strategic deals in 2023: scale deals for consolidation, scope deals to focus on the core, and deals for a new growth engine. More than half (51%) of total banking M&A in 2022 involved deals valued at greater than $5 billion compared with around 25% throughout the previous 10 years.

Scale deals for consolidation

We've already seen BMO Financial announce a $16.3 billion purchase of Bank of the West from BNP Paribas, enabling the Canada-based bank to almost double its presence in the US. The deal also allows BNP to make a strategic move by exiting the US to cash in and invest significant resources in potential deals in other geographies. Another 2022 scale deal involved Toronto Dominion Bank's announced $13.4 billion acquisition of First Horizon, which also is aimed at enabling a Canadian bank to expand its US footprint.

Banks pursuing scale M&A in the current uncertain macroeconomic environment require a clear understanding of how healthy their business is and how well their operating infrastructure can integrate new assets. They also require a deeper focus on due diligence than they are accustomed to taking (see "Tougher Times: Putting the Diligence Back in Due Diligence"). For example, acquirers need to stress test the potential deal's ability to create value in different scenarios. That means ensuring the quality of the target's capital will hold up. It's also critical to understand whether the target's digital infrastructure (i.e., how it manages data) is suitable and easily integrated. Buyers need to make sure the best talent will be protected and integrated the right way. And even in geographies where regulators are encouraging consolidation, it's important to invest the time up front to anticipate and satisfy any possible regulatory concerns.

Scope deals to help a bank focus on its core

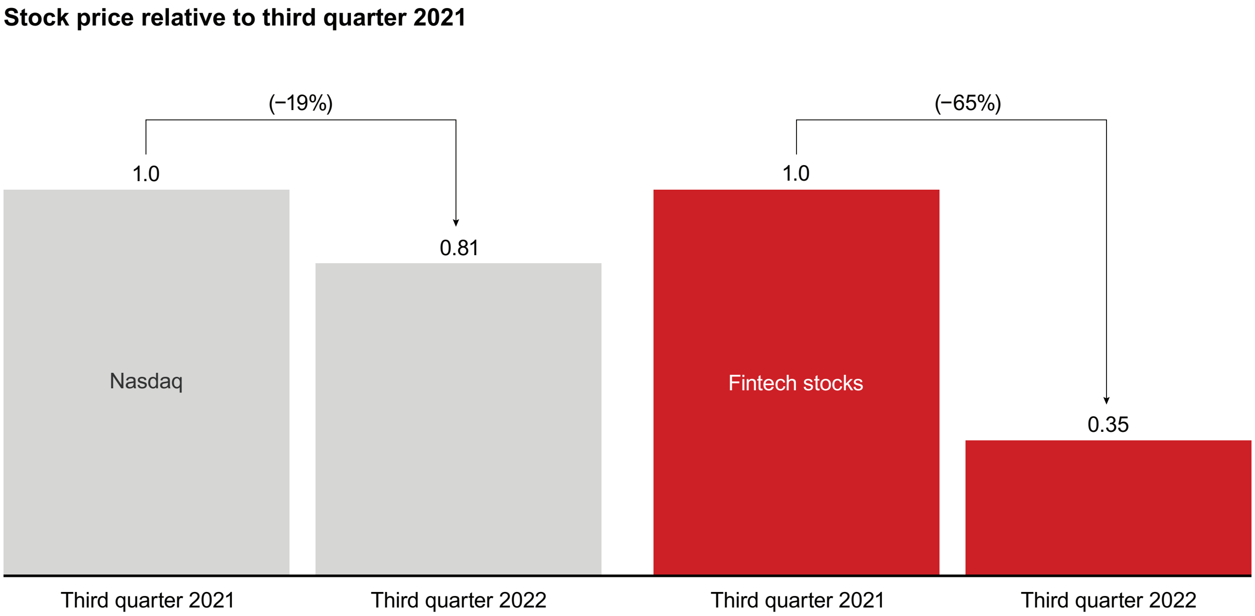
Downturns are a time for companies to improve operations and sharpen the focus on where they should invest resources. The answer for many will be to sell off or find partners for units that are noncore or subscale, with no clear competitive advantage, and that require significant investment. Consider that in Australia, all banks have either divested their wealth management assets or are in the process of doing so. Specialized players and private equity funds are increasingly willing to invest in such deals, taking advantage of less competition and more favorable valuations in a downturn.

Sellers need to make sure what they're selling is consistently performing and that there are clear asset boundaries in the agreement. Also important: finding a buyer with a strong parenting advantage and that could become a source of future business.

Deals for a new growth engine

We call them Engine 2 businesses. They are new businesses within existing companies that use the scale benefits of the core business and of their client base to grow faster than a new start-up could. Some banks are pursuing innovative fintech assets that enable them to expand their current product and service offerings as well as provide them with distinctive capabilities and competencies. Either way, it's an opportunity to diversify and improve revenue streams. Valuations for fintechs have dropped significantly in 2022 (*see Figure 2*).

Figure 2: Fintechs have experienced significant declines in their valuations



Note: Fintech stocks represented by ARK Fintech Innovation ETF top 10 holdings (47% of total assets), including Square (now Block), Shopify, PayPal, Sea Limited, Zillow, JD.com, Twilio, Coinbase, MercadoLibre, and Pinterest
Sources: CB Insights; Yahoo Finance

More banks will follow the path of JPMorgan Chase, which in 2021 bought Nutmeg, an independent digital wealth management adviser, to complement the launch of its Chase brand in the UK online banking market. It followed up that acquisition in 2022 with the purchase of cloud-native payments tech firm Renovite. The move helps JPMorgan Chase modernize its tech infrastructure and create greater flexibility for its merchant acquiring capabilities globally. In another 2022 deal, Société Générale agreed to buy a majority stake in payment fintech PayXpert. Acquiring that asset strengthens the bank's payment solutions in Europe for retail and online merchants.

These deals require special considerations. Number one is ensuring the quality and distinctiveness of digital components and how they will be integrated into a buyer's strategy. Also, since there's a high risk of losing talent in scope capability deals, the best companies create a specialized approach to retaining talent. For example, to the extent possible, they develop a program to engage mission-critical talent as if they were entrepreneurs—that is, with independence and tailored compensation.

More banks will turn to M&A to help them navigate a rapidly changing industry in a downturn. The banks that emerge as leaders will be those that rigorously prepare for the challenges that are unique to the types of deals they pursue.

Industries

M&A in Insurance: There Are Insurtech Deals to Be Done, but Proceed with Caution

The potential of innovative businesses does not always match the reality.

By Simon Porter

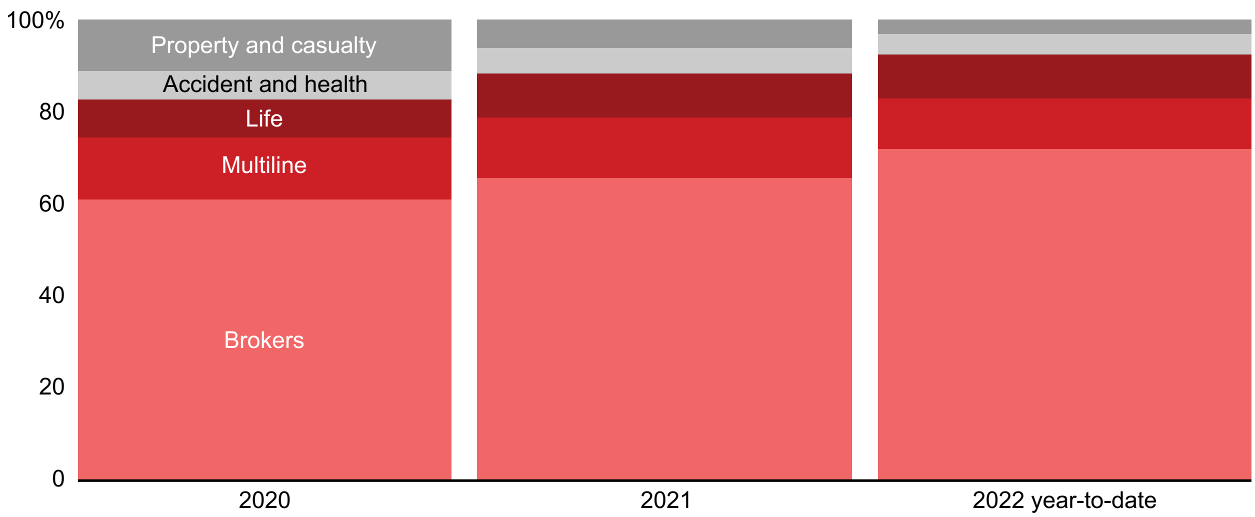
At a Glance

- While 2022 insurance deal volume was roughly flat, the mix shifted toward more brokerage deals and fewer carrier deals.
- Insurtech acquisitions have remained strong, even as marquee public insurtechs have struggled.
- Insurers looking for innovative capabilities must do their due diligence to make sure they are getting what they think they are buying.

This time last year, we expected to see insurers continue to use M&A to expand their capabilities and distribution reach in 2022. While the total volume of insurance deals for the first three quarters of 2022 was roughly equal to the volume for the similar period in 2021, there was a meaningful shift away from carrier deals and toward brokerage deals, with the reduction in property and casualty (P&C) carrier deals being the most pronounced (*see Figure 1*).

Figure 1: As deal volume remained relatively constant, there have been fewer carrier deals and more broker deals

Insurance M&A by acquired business type



Note: 2022 year-to-date includes data through the third quarter of 2022
Source: Bain analysis

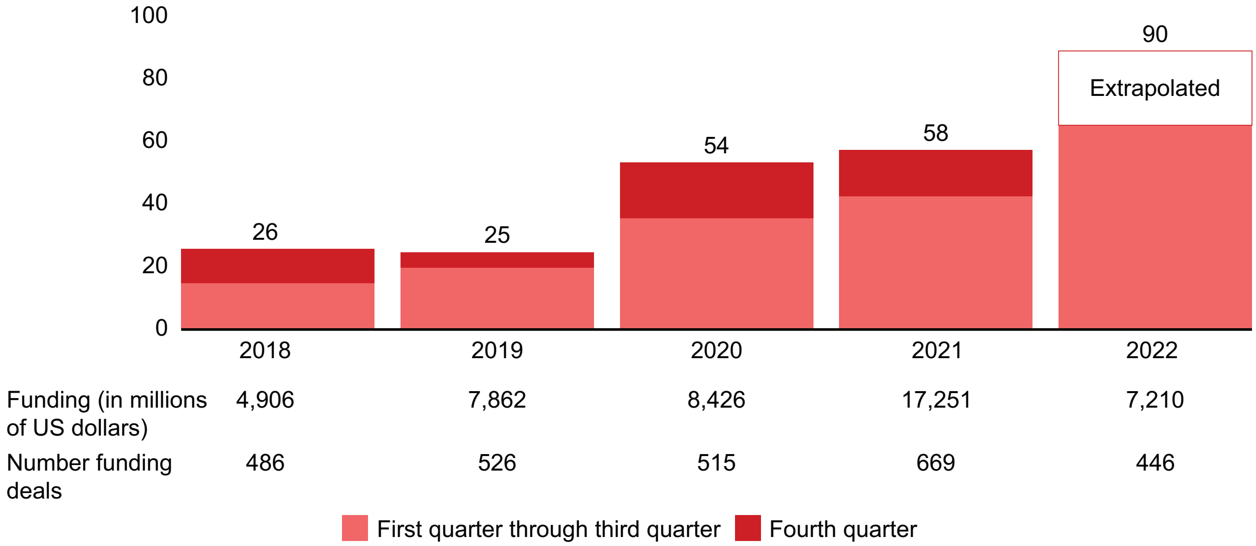
Integration and value realization is never easy, but on balance, brokerage acquisitions tend to deliver more of a known entity (contracts, clients, sales teams) than carrier deals, which can include a complicated mix of legacy blocks, aging technology, and systems and processes that may or may not be a good fit with the acquiring company. The shift in deal mix may reflect caution on the part of the carriers—or in the case of the P&C carriers that saw the sharpest decline, it could merely reflect the economic challenges within the core business as losses have increased over the past two years.

Interest in insurtech continues, with increased scrutiny

While the overall share of carrier deals has declined, insurtech deals are continuing to increase (*see Figure 2*). Insurtech has been particularly hot in recent years, with a 70% increase in investment from 2018 to 2020 (from $4.9 billion to $8.4 billion) and doubling between 2020 and 2021 (from $8.4 billion to $17.3 billion).

Figure 2: Insurtech acquisitions count has continued to increase as funding has receded

Insurtech acquisition count



Source: CB Insight Insurtech Report, Q3 2022

Even as insurtech funding decreased in 2022 from an exceptional year in 2021 ($7.2 billion through September 2022 vs. 2021's $17.3 billion), insurtech acquisitions have continued to accelerate, with strategic buyers still on the hunt for advanced capabilities.

At the same time, it is important to take lessons from the struggles of public insurtechs. The potential of innovative businesses does not always match the reality; customer acquisition costs are high, and effective underwriting is hard. This is especially true when market conditions change. The market capitalization of 2020 and 2021 marquee IPOs have fallen dramatically. For example, Lemonade's market cap dropped by 48% from July 2020 to October 2022, and Root's fell by 98% from October 2020 to October 2022. By comparison, incumbents have grown market capitalization by about 50% from July 2020 to October 2022.

As we work with our clients, we see increased scrutiny of potential deals—and for good reason. In a recent commercial due diligence on an exciting and seemingly promising fintech asset, the potential acquirer discovered that behind the early client successes, there was little more than Google Forms. Our client's enthusiasm for the asset rapidly evaporated with the realization that while the story was exciting, this business was far from a platform from which to build.

In another recent commercial due diligence on a high-profile insurtech asset, our work found that despite a compelling story for unlocking future growth via revolutionary technology, the business was actually creating the impression of a breakthrough technology stack while solving its problems through old-fashioned, human brute force. While still an interesting business, the upside potential that our client was looking for clearly did not exist—and they walked away better informed.

We are also seeing clients think harder about pursuing innovative assets for innovation's sake. One client recently suspended pursuit of a recognizable insurtech, stepping back to ask essential questions about whether it would really advance the company's strategy. Yes, the capabilities were intriguing. But were they really going to help the insurer achieve its ambition?

Caveat emptor

Given the challenging times and reduced funding for both well-known and emerging insurtechs, there are certainly deals to be done, but it is essential to go in with your eyes open. Below are three essential steps.

Step No. 1: Make sure you have a clear strategy and understanding of capabilities before pursuing deals. M&A is a tool to advance your strategy, not a strategy in and of itself. It is certainly not a silver bullet solution. If you have conviction about where you are headed and the capabilities you need, M&A can be considered (alongside internally building and partnerships) as a viable path toward acquiring the required capabilities. Without this clarity, however, you are inviting buyer's remorse if you just blindly go shopping.

It is certainly true that many incumbents struggle to develop innovative capabilities; finding the right asset at the right price and then successfully integrating it, however, brings an additional range of challenges that most organizations struggle to pull off successfully.

Step No. 2: Do a real diligence before you agree to a deal. In Bain's M&A Practitioners' 2023 Outlook Survey, financial services deal teams led all industries for pre-close estimates that were materially inaccurate for revenue and go-to-market synergies (60% of the time) and technology (48% of the time).

Drawing a link to the above point on strategy, diligence must focus on the issues that will have the biggest impact on a deal's success.

If you are seeking a capability or technology, is the target's technology robust and scalable? Once you look behind the curtain, is the great and powerful Oz truly as impressive as it initially seemed? Or is it just a glorified spreadsheet similar to what our client discovered in the example above?

If you are seeking access to distribution and customers, what is the cost to acquire customers? What is the customer lifetime value? What is the retention to date, and what's expected with a change of control? Going forward, will the sales motions that built the target's early success work with or alongside the motions of the rest of your organization?

If you are seeking talent, are the people who were attracted to this “exciting fintech disrupter” going to thrive within your “boring insurance company”? While this certainly is a perception challenge, the bigger issue is the high likelihood of dramatically different ways of working. The prudence that protects 100-year (or more) legacies generally involves decision-making processes that are the opposite of moving fast and breaking things.

The goal of diligence is not to kill the deal—although this is sometimes the most valuable outcome—but rather to make sure that you have a clear understanding of what you are getting into and can begin to plan to address the inevitable risks and challenges.

Step No. 3: Be honest about what it will take to integrate assets and realize full value, and tailor your expectations and approach. Adding to the dubious distinctions in our M&A practitioners' survey, financial services deal teams also led the pack in materially overestimating synergies and their ability to manage the integration roadmap (50% of the time).

Scope and capability deals generally have lower cost synergies than scale deals. You should absolutely pursue these synergies. But be sure to set the right aspirations, and don't just rely on benchmarks from previous scale deals.

We believe it is essential to tailor the integration approach to the specifics of the deal at hand with a clear integration thesis.

Your integration thesis should clarify the following:

- ambition (degree of transformation and specific financial and nonfinancial targets);
- where to focus (critical value drivers, pivotal decisions, and risk);
- what to integrate (by business unit, function, and geography, with a specific view toward the operating model and an appreciation of technology and process requirements); and
- when and how to deliver (clear view of phasing and milestones, operating principles, structure, and governance for the integration).

A strong integration thesis helps ensure that you pursue the integration with the same focus and rigor with which you pursued the deal and that you are grounded in maximizing and realizing value. An integration approach disconnected from this pursuit of value can create early friction at a critical time when organizations are still learning about each other and how to best work together going forward. Once again, blindly applying generalized best practices can get you into trouble.

With valuations and funding down, it may be a great time to buy insurtech assets, but you must do so with open eyes. Know what you are looking for and why, make sure you are getting what you think you are buying, and have a clear plan to ensure that you realize the value.

Industries

M&A in Payments: Four Ways That M&A Will Propel This Dynamic Sector

As the boom in "buy now, pay later" deals ended, the bulk of dealmaking shifted to other areas.

By David Gunn, Sen Ganesh, and Tevia Segovia

At a Glance

- Market volatility and rising interest rates hurt the buy side, and declining valuations meant that companies that didn't need to sell simply avoided the market.
- Bold companies in the payments sector will pursue capabilities to integrate into offerings and extend propositions via scale deals and cross-border grabs.
- Banks are well positioned to become acquirers in the payments sector, and they have a head start in defining this rapidly evolving industry.

The distinct M&A slowdown in the payments sector after record deal value and volumes in 2021 masks an important reality: This is a dynamic industry that likely won't maintain its rapid evolution without M&A.

Consolidation deals are showing up in all varieties.

Dealmaking took a pause in mid-2022 for all the same reasons that it stalled in so many other industries. Market volatility and rising interest rates hurt the buy side while declining valuations on the sell side kept quality assets from coming to market. The big area of growth that we extensively reported on last year—that is, the boom in deals to fuel the "buy now, pay later" sector—all but dried up in 2022, but for different reasons. Headwinds in the form of rising credit losses, greater competition, and increased regulatory scrutiny made both buyers and sellers nervous. It's a fragmented end of the business that is still growing fast and will require consolidation. But with falling valuations, again, companies that don't have to sell are avoiding coming to market.

Instead, the bulk of dealmaking is shifting to four other areas where the biggest opportunities are emerging for companies willing to make the bold moves that help them shape an industry.

Scale deals to consolidate

Despite the small number of scale deals made in 2022, consolidation across the payments ecosystem was a major contributor to deal value. Consolidation deals are showing up in all varieties. Although it was dwarfed by Square's (now named Block) $29 billion purchase of Afterpay in 2021, the biggest deal of 2022, Global Payments' $4 billion takeover of EVO Payments, was a global consolidation—albeit with the added benefits of acquiring new business-to-business (B2B) capabilities and eliminating their US overlap. Worldline's acquisition of Axepta Italy and Nexi's joint venture with Alpha Bank in Greece represented regional consolidation. There was local consolidation, too—think of DNA Payments' purchase of Card Cutters in the UK. We expect to see all flavors of consolidation continue, particularly in the (relatively) commoditized merchant acquiring sector in which large incumbents need to drive down unit costs to compete with faster-growing challengers.

As the consolidation race heats up, winners are fast emerging—and focusing on their core business. For example, in Europe the two emerging powerhouses are Worldline and Nexi, with Worldline shedding its legacy physical terminals business to focus on e-commerce.

Cross-border capabilities grab

The cross-border payments sector continues to see many capability-focused deals. The increasing requirement to provide a standard set of global corridors and pay-in/pay-out rails (including local automated clearinghouse connections and wallets, for example) has been the impetus behind a number of recent deals, including Fleetcor's acquisition of Global Reach Group, iBanFirst's purchase of Cornhill, and Ebury's decision to buy Bexs (Brazil). While some of these deals also provide an opportunity to scale up, the capabilities are the real prize for now.

It’s not just the cross-border specialists that are capturing multinational alternative payment methods (i.e., noncard payment capabilities); we are also seeing a continuation of the 2021 trend in which multinational gateways and B2B providers expand their global coverage to include an ever-increasing range of local payment methods. In 2022, that quest for expansion led to deals such as PayRetailers’ purchase of Paygol and Pago Digital, Revolut’s acquisition of Arvog Forex, and the Banking Circle-SEPAexpress deal.

Buying payments capabilities to integrate into software offerings

The US independent software vendor (ISV) market has led the way in integrating payments with wider software solutions highly focused on specific industries. It’s a trend that is gradually expanding to other regions—Europe, and particularly the UK, are at last showing signs of going in a similar direction—opening up opportunities for M&A. This will take several forms. For example, ISVs will acquire payments capabilities—that’s what happened when Access PaySuite bought Pay360. Also, incumbent payments companies will buy software capabilities, as FIS/Worldpay did when it acquired Payrix, with its capabilities for embedding payments into software-as-a-service (SaaS)–based platforms. And finally, challengers will look to provide payment services to ISVs. That was the approach taken when Payroc bought Worldnet.

Acquiring capabilities to extend SaaS propositions

Banks continue to eye opportunities to provide banking-as-a-service (BaaS) propositions for third parties, including payments services. As they do, the market for service providers that support these banks remains robust. And the service providers are looking to broaden their offerings. That was what Ximedes did when it bought Ginger. It gained payments-as-a-service capabilities to offer to banks for a broader BaaS proposition.

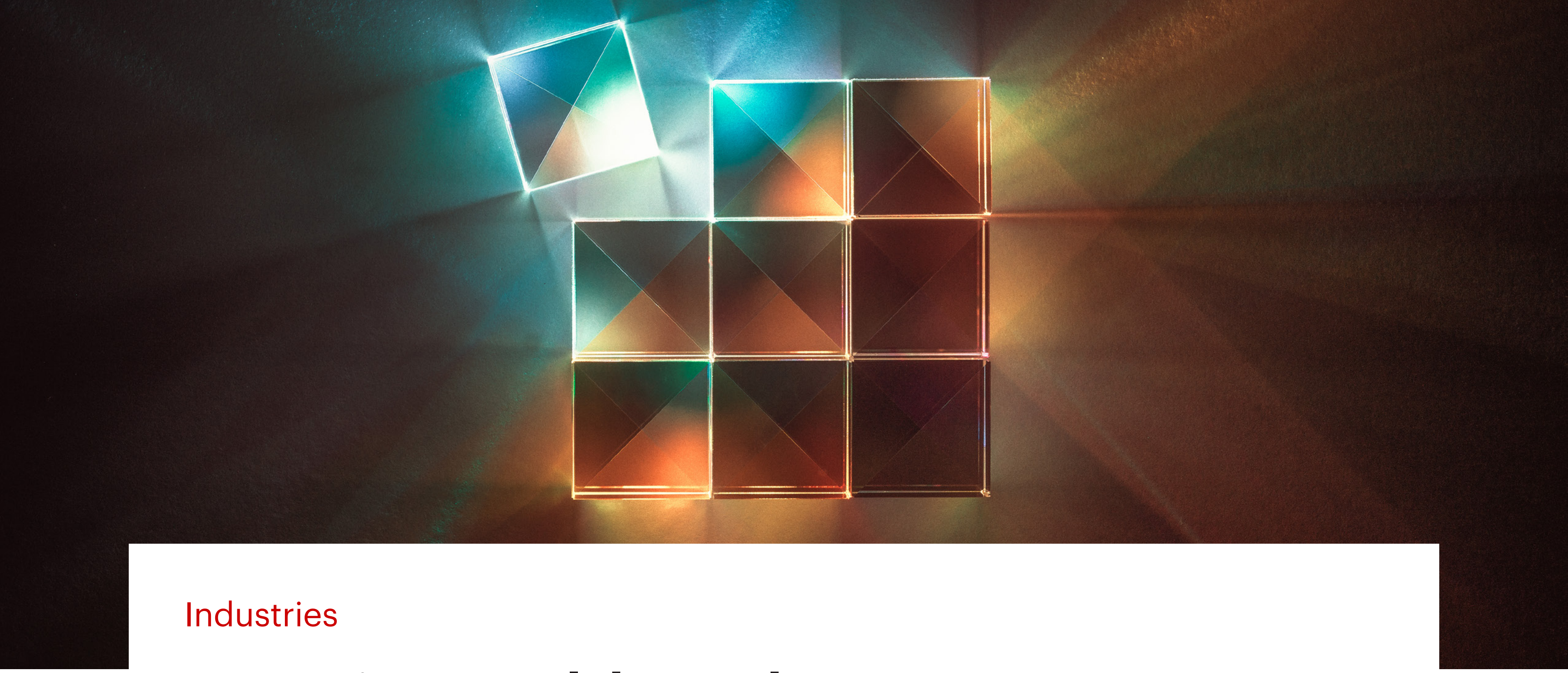
Banks are positioned well to become acquirers in the payments sector, and they have a head start in defining this rapidly evolving industry. Their situation has changed substantially since last year. Yes, they will need to wrestle with more credit losses, but their balance sheets are generally healthy and rising interest rates mean that the liabilities side of their balance sheets is now generating income. Furthermore, last year’s trend toward stock deals is less evident, so banks looking to buy their way into interesting payments markets are now much more well positioned.

There is also less competition from private equity for deals as the cycle turns and multiple expansion becomes more difficult to achieve. This offers opportunities for banks and other buyers to acquire (for either scale or scope reasons) at relatively attractive rates, but we also expect to see fewer quality assets coming to market as sellers bide their time. If not forced to sell, many will simply wait it out.

This raises unique challenges for potential acquirers in the payments sector in 2023. For the capability hungry, acquiring high-quality assets will require bold approaches to companies that are not necessarily looking to sell—and striking a fine balance on offers that get them to the table without overpaying. Also critical is a disciplined approach to due diligence, ensuring that the asset quality really is what they say it is (with a willingness to walk away if the signs are negative).

For the consolidators, there is a window of opportunity to absorb competitors at less stratospheric prices, particularly those that are unwilling or unable to invest to maintain their competitiveness. This may unlock new opportunities to carve out banks' underinvested merchant acquiring businesses, for example.

For potential sellers, the key will be getting to maturity and profitability (or at least on a clear path to profitability) as fast as possible. The environment has much less tolerance for cash-burning models.



Industries

M&A in Wealth and Asset Management: How Deals Will Shake Up the Industry

Companies are turning to the deals that will create winners and losers.

By Markus Habbel, Avishek Nandy, Stephan Erni, Daniel Jones, and Manuela Frey

At a Glance

- Wealth and asset management will undergo a dramatic evolution by 2030, and firms will turn to both scale and scope M&A to seize growth opportunities.
- Wealth and asset management deal value for 2022 is projected to decline by 42% from 2021's record levels, mostly driven by smaller average deal values.
- We expect to continue to see a smaller share of deals valued at greater than $1 billion.
- We also expect a rise in scope deals, especially those made to gain digital capabilities, expand offerings and ecosystems, and continue vertical integration.

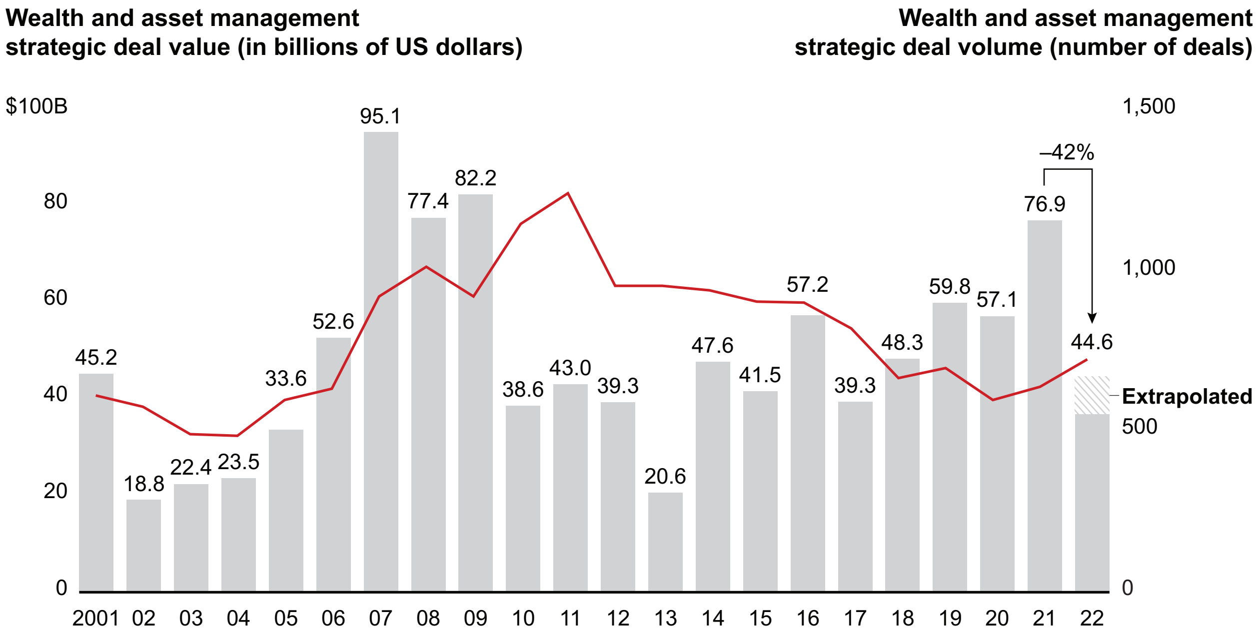
Wealth management and asset management companies are facing such significant disruption that by 2030—with new customers, new delivery models, new offerings, new ways of working, and new economics—both financial services sectors will be virtually unrecognizable.

Bain's research into the evolution of the sectors determined that there is a $250 billion growth opportunity in wealth management by 2030 and that scale M&A will ultimately play a critical role as the largest players will outpace the market and be able to invest in the digital and analytical capabilities to offer differentiated services. Asset managers also will rely on scale deals for distribution/client coverage models and cost leadership, to build winning offerings, and to establish the ecosystems and platforms for a changing sector.

But even though scale deals will likely determine the shape of the wealth and asset management businesses in 2030, the year ahead will likely be one defined by smaller scope deals—a trend that began in mid-2022 as interest rates climbed, making deals valued at greater than $1 billion more expensive. Additionally, geopolitical and macroeconomic uncertainty on a global level will likely continue to hold back many large investments.

While 2021 set a 10-year record for global M&A activity in wealth and asset management, the cooldown that started in June 2022 is projected to lead to a 42% drop in deal value but an increase of 13% in deal volume by the end of 2022, reflecting a smaller average size of deals (*see Figure 1*).

Figure 1: Wealth and asset management deal value is projected to decrease by 42% from a 2021 peak of $77 billion



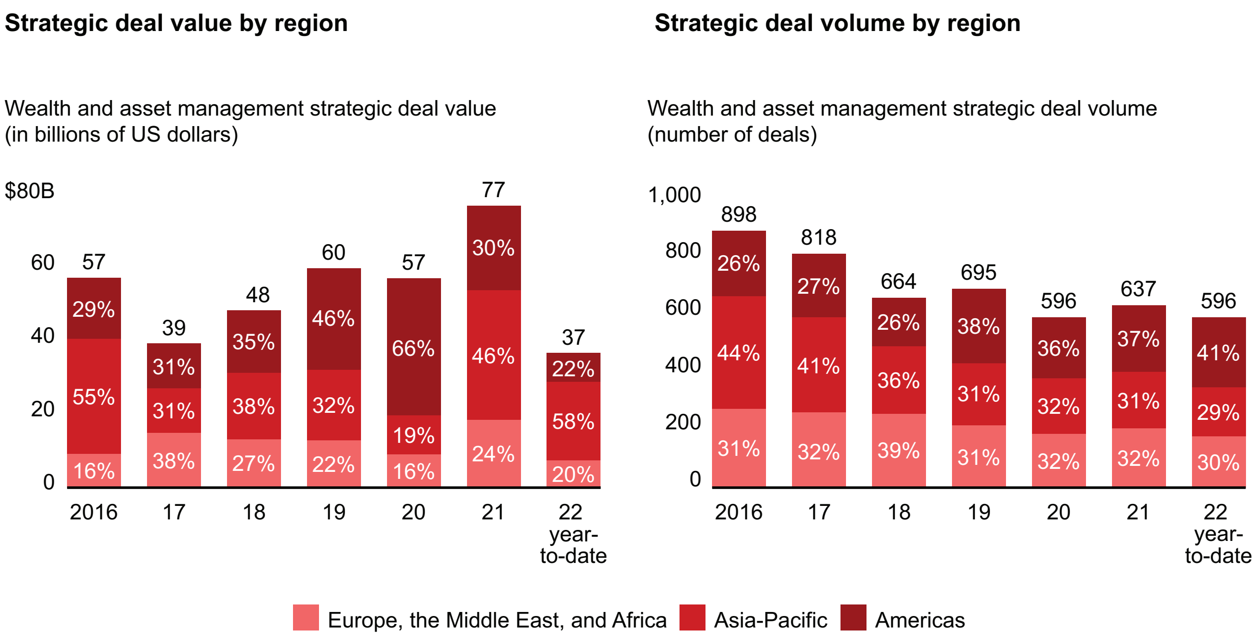
Note: Wealth and asset management is a subset of financial services covering wealth management firms
Source: Dealogic as of October 31, 2022

The share of strategic deal volume by region stayed relatively stable compared with the previous year, though a larger share (58% vs. 46%) of the strategic deal value has been coming from the Asia-Pacific region, where a large share of 2022's deals valued at greater than $1 billion took place (*see Figure 2*).

Many of the deals in Europe were aimed at entering and consolidating the UK market, including one of the few deals valued at greater than $1 billion in 2022, RBC's $2.1 billion acquisition of Brewin Dolphin. In the Americas, deals valued at greater than $1 billion saw players acquiring capabilities/scale in (digital) trading/brokerage to strengthen holistic, digitally enabled wealth and asset management offerings. That was the aim of Itaú Unibanco's acquisition of 50.1% of a fully digital and cloud-based brokerage in Brazil. In North America, 2022 also saw the continued rollup of the registered investment adviser and independent adviser market.

The downturn will further increase the gap between winners and losers.

Figure 2: Asia-Pacific's share of deal value has increased from 19% in 2020 to 58% in 2022 despite deal volume holding steady at around 30%



Note: Wealth and asset management is a subset of financial services covering wealth management firms
Source: Dealogic as of October 31, 2022

The years ahead

Looking into the short- to medium-term future, we expect M&A activity to persist, but it will likely look different given the market downturn. We anticipate fewer large deals for scale, both in wealth and asset management—that's what happened in the 2009 recession and what has already been observed during the second half of 2022. But there's an exception. We expect the strongest companies to capitalize on attractive scale investment opportunities as the downturn further increases the gap between winners and losers. In Bain's M&A Practitioners' 2023 Outlook Survey, more than 50% of surveyed practitioners across the financial services industry said that they expect more attractive assets to be available in 2023 compared with 2022.

The larger share of deals in 2023 are likely to be for scope. In wealth management, players will be looking for targets that can help them grow in different ways from scale acquisitions. For example, human-enriched, digitally enabled delivery models will prevail in wealth management, and it will be M&A that becomes the catalyst for ultimate success in those areas. Current valuation levels provide attractive opportunities for strategic buyers with a long-term investment mindset (fintech valuations dropped by about 50% between May 2021 and June 2022). Additionally, M&A for digital capabilities and digitally enabled advisory models will enhance adviser productivity. That, in turn, will be a key enabler to achieving scale over the medium term.

Similarly, we anticipate an uptick in offering-related and tech platform–related deals. For example, as client demand continues to increase for alternatives and private market investments, we expect wealth and asset management companies to pursue targets or strategic partners in this space. That was the objective of AllianceBernstein's 2022 acquisition of CarVal Investors, a global private alternative investment manager with about $15 billion in assets under management. When Finnish wealth and asset manager Evli merged with EAB, the Finnish asset management and investment services company, it was able to offer an even more extensive range of alternatives (as well as digital service solutions and personnel fund services).

Wealth management clients will increasingly ask for more holistic advice across an expanding range of issues such as estate planning, taxes, and accounting, so we'll likely see more interest from companies in acquiring these capabilities to round out their offerings (often with a tech angle, which will enable these capabilities to be deployed at scale).

In addition, we expect to see a growth route materialize with the convergence of wealth management and asset management—a deeper vertical integration of the value chain. Goldman Sachs moved in this direction in 2022 when it announced it would internally unify its asset and wealth management businesses back together under one roof. Other companies have been turning to M&A to enable such vertical integration. For example, Schroders invested in Benchmark Capital in 2016 and then bought remaining minority interest in 2021 as well as a series of independent financial advisers, such as Redbourne Wealth Management in early 2022 (which it purchased through Benchmark Capital).

The long-term view

Between now and 2030, there also will be scale activity for wealth management companies. As the largest wealth managers outpace the market, scale benefits will become even more apparent since players will have to make significant investments in tech and data/analytics to provide differentiated client experiences. When a company shifts from a traditional to a digitally enabled wealth management model, returns to scale can be up to 35% higher (because of lower variable costs in a digitally enabled model). To achieve that scale, companies will turn to M&A for consolidation. For smaller players, wealthtechs will serve as platforms to capture benefit from virtual scale, enabling them to compete, but not to differentiate, on technology.

For asset managers, we see two winning models for the future: scale leaders (e.g., BlackRock as a passive scale leader, Amundi as an active scale leader) and differentiated players (e.g., Partners Group, Wellington Management). M&A continues to be a key source of growth and critical scale for both models as there are high-value picks to be made. It will also enable the establishment of platforms centered around specific product offerings, client segments, geographies—or a multiboutique approach.

Wealth and asset management companies hoping to capture both the near- and long-term future opportunities need to proactively pursue an M&A pipeline, screening for both the scope deals that will help them differentiate their business and the scale deals that will help them become industry leaders.