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Writing a Credible Investment Thesis

Only a third of acquiring executives actually write down the reasons for doing a deal.

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Every deal your company proposes to do—big or small, strategic or tactical—should start with a clear statement how that particular deal would create value for your company. We call this the investment thesis. The investment thesis is no more or less than a definitive statement, based on a clear understanding of how money is made in your business, that outlines how adding this particular business to your portfolio will make your company more valuable. Many of the best acquirers write out their investment theses in black and white. Joe Trustey, managing partner of private equity and venture capital firm Summit Partners, describes the tool in one short sentence: "It tells me why I would want to own this business."

Perhaps you're rolling your eyes and saying to yourself, "Well, of course our company uses an investment thesis!" But unless you're in the private equity business—which in our experience is more disciplined in crafting investment theses than are corporate buyers—the odds aren't with you. For example, our survey of 250 senior executives across all industries revealed that only 29% of acquiring executives started out with an investment thesis (defined in that survey as a "sound reason for buying a company") that stood the test of time. More than 40% had no investment thesis whatsoever (!). Of those who did, fully half discovered within three years of closing the deal that their thesis was wrong.

Studies conducted by other firms support the conclusion that most companies are terrifyingly unclear about why they spend their shareholders' capital on acquisitions. A 2002 Accenture study, for example, found that 83% of executives surveyed admitted they were unable to distinguish between the value levers of M&A deals. In Booz Allen Hamilton's 1999 review of thirty-four frequent acquirers, which focused chiefly on integration, unsuccessful acquirers admitted that they fished in uncharted waters. They ranked "learning about new (and potentially related) business areas" as a top reason for making an acquisition. (Surely companies should know whether a business area is related to their core before they decide to buy into it!) Successful acquirers, by contrast, were more likely to cite "leading or responding to industry restructuring" as a reason for making an acquisition, suggesting that these companies had at least thought through the strategic implications of their moves.

Not that tipping one's hat to strategy is a cure-all. In our work with companies that are thinking about doing a deal, we often hear that the acquisition is intended for "strategic" reasons. That's simply not good enough. A credible investment thesis should describe a concrete benefit, rather than a vaguely stated strategic value.

A credible investment thesis should describe a concrete benefit, rather than a vaguely stated strategic value. This point needs underscoring. Justifying a deal as being "strategic" ex post facto is, in most cases, an invitation to inferior returns. Given how frequently we have heard weak "strategic" justifications after a deal has closed, it's worth passing along a warning from Craig Tall, vice chair of corporate development and strategic planning at Washington Mutual. In recent years, Tall's bank has made acquisitions a key part of a stunningly successful growth record. "When I see an expensive deal," Tall told us, "and they say it was a 'strategic' deal, it's a code for me that somebody paid too much."

And although sometimes the best offense is a good defense, this axiom does not really stand in for a valid investment thesis. On more than a few occasions, we have been witness to deals that were initiated because an investment banker uttered the Eight Magic Words: If you don't buy it, your competitors will.

Well, so be it. If a potential acquisition is not compelling to you on its own merits, let it go. Let your competitors put their good money down, and prove that their investment theses are strong.

Let's look at a case in point: [Clear Channel Communications' leaders Lowry, Mark and Randall] Mayses' decision to move from radios into outdoor advertising (billboards, to most of us). Based on our conversations with Randall Mays, we summarize their investment thesis for buying into the billboard business as follows:

Clear Channel's expansion into outdoor advertising leverages the company's core competencies in two ways: First, the local market sales force that is already in place to sell radio ads can now sell outdoor ads to many of the same buyers, and Clear Channel is uniquely positioned to sell both local and national advertisements. Second, similar to the radio industry twenty years ago, the outdoor advertising industry is fragmented and undercapitalized. Clear Channel has the capital needed to "roll up" a significant fraction of this industry, as well as the cash flow and management systems needed to reduce operating expenses across a consolidated business.

Note that in Clear Channel's investment thesis (at least as we've stated it), the benefits would be derived from three sources:

- Leveraging an existing sales force more extensively
- Using the balance sheet to roll up and fund an undercapitalized business
- Applying operating skills learned in the radio trade

Note also the emphasis on tangible and quantifiable results, which can be easily communicated and tested. All stakeholders, including investors, employees, debtors and vendors, should understand why a deal will make their company stronger. Does the investment thesis make sense only to those who know the company best? If so, that's probably a bad sign. Is senior management arguing that a deal's inherent genius is too complex to be understood by all stakeholders, or simply asserting that the deal is "strategic"? These, too, are probably bad signs.

Most of the best acquirers we've studied try to get the thesis down on paper as soon as possible. Getting it down in black and white—wrapping specific words around the ideas—allows them to circulate the thesis internally and to generate reactions early and often.

The perils of the "transformational" deal. Some readers may be wondering whether there isn't a less tangible, but equally credible, rationale for an investment thesis: the transformational deal. Such transactions, which became popular in the exuberant '90s, aim to turn companies (and sometimes even whole industries) on their head and "transform" them. In effect, they change a company's basis of competition through a dramatic redeployment of assets.

The roster of companies that have favored transformational deals includes Vivendi Universal, AOL Time Warner (which changed its name back to Time Warner in October 2003), Enron, Williams, and others. Perhaps that list alone is enough to turn our readers off the concept of the transformational deal. (We admit it: We keep wanting to put that word transformational in quotes.) But let's dig a little deeper.

Sometimes what looks like a successful transformational deal is really a case of mistaken identity. In search of effective transformations, people sometimes cite the examples of DuPont—which after World War I used M&A to transform itself from a maker of explosives into a broad-based leader in the chemicals industry—and General Motors, which, through the consolidation of several car companies, transformed the auto industry. But when you actually dissect the moves of such industry winners, you find that they worked their way down the same learning curve as the best-practice companies in our global study. GM never attempted the transformational deal; instead, it rolled up smaller car companies until it had the scale to take on a Ford—and win. DuPont was similarly patient; it broadened its product scope into a range of chemistry-based industries, acquisition by acquisition.

In a more recent example, Rexam PLC has transformed itself from a broad-based conglomerate into a global leader in packaging by actively managing its portfolio and growing its core business. Beginning in the late '90s, Rexam shed diverse businesses in cyclical industries and grew scale in cans. First it acquired Europe's largest beverage—can manufacturer, Sweden's PLM, in 1999. Then it bought U.S.-based packager American National Can in 2000, making itself the largest beverage-can maker in the world. In other words, Rexam acquired with a clear investment thesis in mind: to grow scale in can making or broaden geographic scope. The collective impact of these many small steps was transformation.[14]

But what of the literal transformational deal? You saw the preceding list of companies. Our advice is unequivocal: Stay out of this high-stakes game. Recent efforts to transform companies via the megadeal have failed or faltered. The glamour is blinding, which only makes the route more treacherous and the destination less clear. If you go this route, you are very likely to destroy value for your shareholders.

By definition, the transformational deal can't have a clear investment thesis, and evidence from the movement of stock prices immediately following deal announcements suggests that the market prefers deals that have a clear investment thesis. In "Deals That Create Value," for example, McKinsey scrutinized stock price movements before and after 231 corporate transactions over a five-year period. The study concluded that the market prefers "expansionist" deals, in which a company "seeks to boost its market share by consolidating, by moving into new geographic regions, or by adding new distribution channels for existing products and services."

On average, McKinsey reported, deals of the "expansionist" variety earned a stock market premium in the days following their announcement. By contrast, "transformative" deals—whereby companies threw themselves bodily into a new line of business—destroyed an average of 5.3% of market value immediately after the deal's announcement. Translating these findings into our own terminology:

- Expansionist deals are more likely to have a clear investment thesis, while "transformative" deals often have no credible rationale.
- The market is likely to reward the former and punish the latter.
- The dilution/accretion debate. One more side discussion that comes to bear on the investment thesis: Deal making is often driven by what we'll call the dilution/accretion debate. We will argue that this debate must be taken into account as you develop your investment thesis, but your thesis making should not be driven by this debate.

Sometimes what looks like a successful transformational deal is really a case of mistaken identity. Simply put, a deal is dilutive if it causes the acquiring company to have lower earnings per share (EPS) than it had before the transaction. As they teach in Finance 101, this happens when the asset return on the purchased business is less than the cost of the debt or equity (e.g., through the issuance of new shares) needed to pay for the deal. Dilution can also occur when an asset is sold, because the earnings power of the business being sold is greater than the return on the alternative use of the proceeds (e.g., paying down debt, redeeming shares or buying something else). An accretive deal, of course, has the opposite outcomes.

But that's only the first of two shoes that may drop. The second shoe is, How will Wall Street respond? Will investors punish the company (or reward it) for its dilutive ways?

Aware of this two-shoes-dropping phenomenon, many CEOs and CFOs use the litmus test of earnings accretion/dilution as the first hurdle that should be put in front of every proposed deal. One of these skilled acquirers is Citigroup's [former] CFO Todd Thomson, who told us:

It's an incredibly powerful discipline to put in place a rule of thumb that deals have to be accretive within some [specific] period of time. At Citigroup, my rule of thumb is it has to be accretive within the first twelve months, in terms of EPS, and it has to reach our capital rate of return, which is over 20% return within three to four years. And it has to make sense both financially and strategically, which means it has to have at least as fast a growth rate as we expect from our businesses in general, which is 10 to 15% a year.

Now, not all of our deals meet that hurdle. But if I set that up to begin with, then if [a deal is] not going to meet that hurdle, people know they better make a heck of a compelling argument about why it doesn't have to be accretive in year one, or why it may take year four or five or six to be able to hit that return level.

Unfortunately, dilution is a problem that has to be wrestled with on a regular basis. As Mike Bertasso, the head of H. J. Heinz's Asia-Pacific businesses, told us, "If a business is accretive, it is probably low-growth and cheap for a reason. If it is dilutive, it's probably high-growth and attractive, and we can't afford it." Even if you can't afford them, steering clear of dilutive deals seems sensible enough, on the face of it. Why would a company's leaders ever knowingly take steps that would decrease their EPS?

The answer, of course, is to invest for the future. As part of the research leading up to this book, Bain looked at a hundred deals that involved EPS accretion and dilution. All the deals were large enough and public enough to have had an effect on the buyer's stock price. The result was surprising: First-year accretion and dilution did not matter to shareholders. In other words, there was no statistical correlation between future stock performance and whether the company did an accretive or dilutive deal. If anything, the dilutive deals slightly outperformed. Why? Because dilutive deals are almost always involved in buying higher-growth assets, and therefore by their nature pass Thomson's test of a "heck of a compelling argument."

As a rule, investors like to see their companies investing in growth. We believe that investors in the stock market do, in fact, look past reported EPS numbers in an effort to understand how the investment thesis will improve the business they already own. If the investment thesis holds up to this kind of scrutiny, then some short-term dilution is probably acceptable.

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Footnotes:

10. Joe Trustey, telephone interview by David Harding, Bain & Company. Boston: 13 May 2003. Subsequent comments by Trustey are also from this interview.

11. Accenture, "Accenture Survey Shows Executives Are Cautiously Optimistic Regarding Future Mergers and Acquisitions," Accenture Press Release, 30 May 2002.

12. John R. Harbison, Albert J. Viscio, and Amy T. Asin, "Making Acquisitions Work: Capturing Value After the Deal," Booz Allen & Hamilton Series of View-points on Alliances, 1999.

13. Craig Tall, telephone interview by Catherine Lemire, Bain & Company. Toronto: 1 October 2002.

14. Rolf Börjesson, interview by Tom Shannon, Bain & Company. London: 2001.

15. Hans Bieshaar, Jeremy Knight, and Alexander van Wassenaer, "Deals That Create Value," McKinsey Quarterly 1 (2001).

16. Todd Thomson, speaking on "Strategic M&A in an Opportunistic Environment." (Presentation at Bain & Company's Getting Back to Offense conference, New York City, 20 June 2002.)

17. Mike Bertasso, correspondence with David Harding, 15 December 2003.