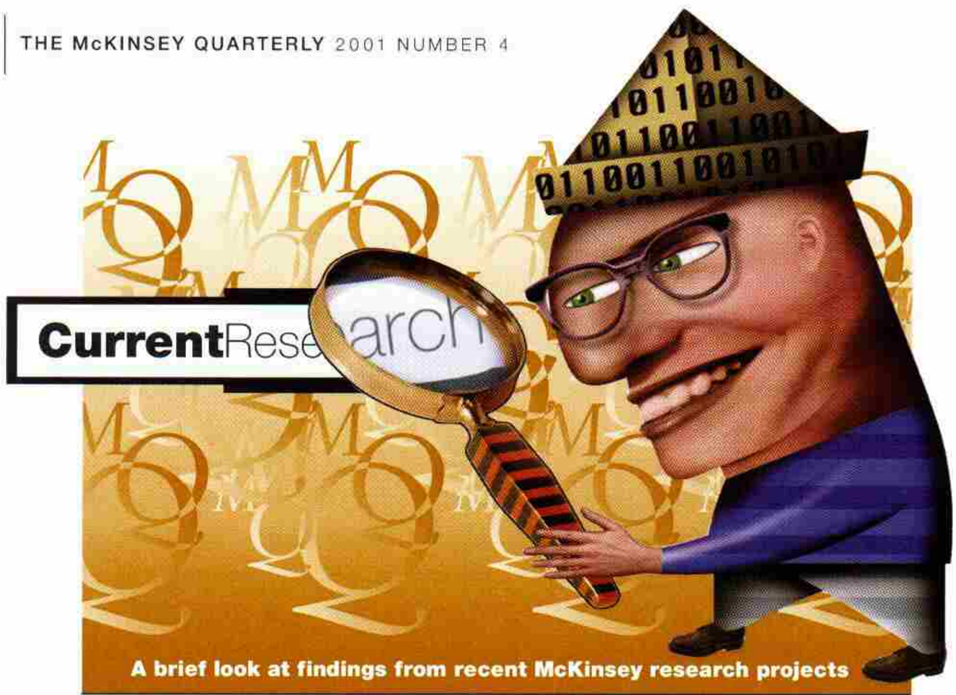

A brief look at findings from recent McKinsey research projects

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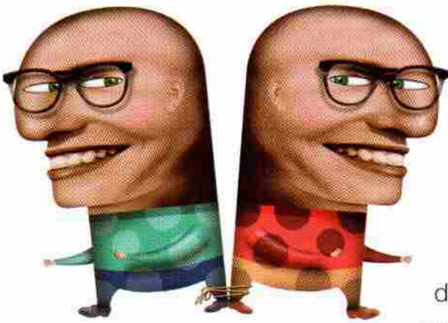


Why **mergers** fail

Revenue deserves more attention in mergers; indeed, a failure to focus on this important factor may explain why so many mergers don't pay off. Too many companies lose their revenue momentum as they concentrate on cost synergies or fail to focus on postmerger growth in a systematic manner. Yet in the end, halted growth hurts the market performance of a company far more than does a failure to nail costs. Some balance may have to be restored.

The belief that mergers drive revenue growth could be a myth. A Southern Methodist University (SMU) study of 193 mergers, worth $100 million or more, from 1990 to 1997 found that revenue growth was fairly elusive. Measured against industry peers, only 36 percent of the targets main-

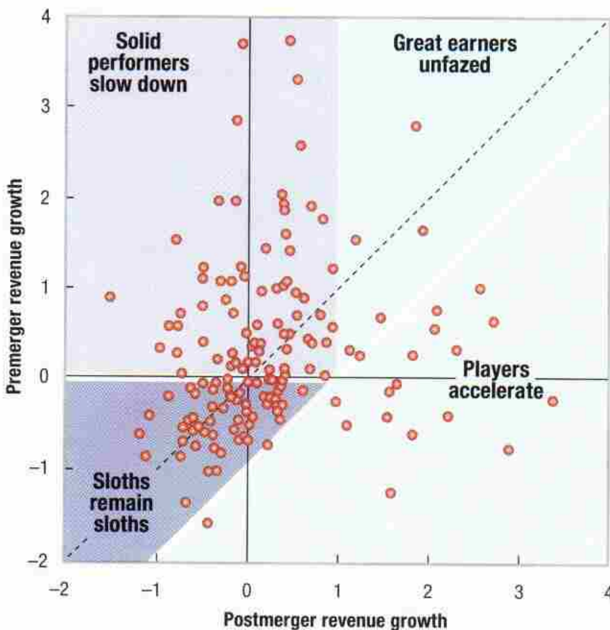
tained their revenue growth in the first quarter after the merger announcement. By the third quarter, only 11 percent had avoided a slowdown; the median lag was 12 percent. When McKinsey joined the SMU researchers to take a closer look, it turned out that the targets' continuing underperformance explained only half of the slowdown; unsettled customers and distracted staff explained the rest.

Moreover, these revenue shortfalls don't represent the beginnings of a J-curve. Further McKinsey research sampled more than 160 acquisitions by 157 publicly listed companies across 11 industry sectors in 1995 and 1996 (Exhibit 1). Only 12 percent of these companies managed to accelerate their growth significantly over the next three years. In fact, most sloths remained sloths, while most solid performers slowed down. Overall, the acquirers managed organic growth rates that were four percentage points lower than those of their industry peers; 42 percent of the acquirers lost ground. Exhibit 2, on the next page, shows how one company with apparently solid growth rates actually fell well short of the revenue it could have expected had it and its targets stayed apart and maintained industry-average growth rates.

EXHIBIT **1**

Revenue growth through M&A is not easy

Standard deviation of pre- and postmerger revenue growth from industry mean,[1] for mergers in 1995 and 1996

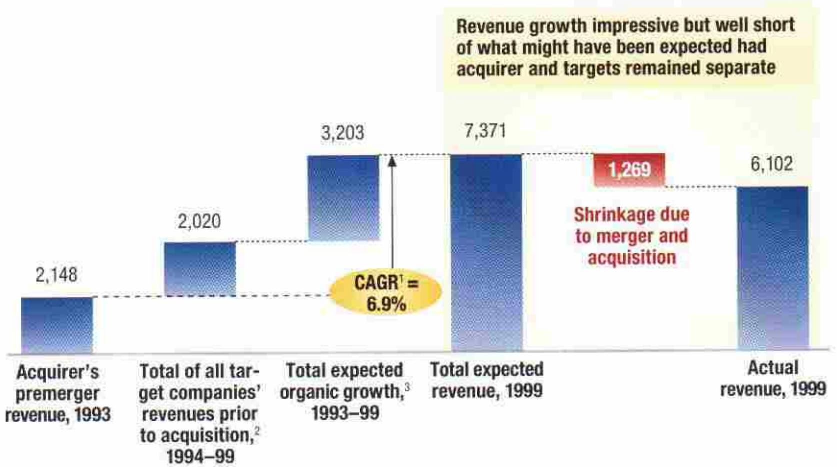


[1]Sample of >160 acquisitions by 157 publicly listed companies across 11 industry sectors; revenue growth calculated for combined entity 2–3 years before and after merger in question.

EXHIBIT 2

The illusion of growth

Computer company example, $ million



[1]Compound annual growth rate.
[2]Last full reporting year prior to acquisition; revenues of 5 acquired companies by year include $368 million, 1994; $502 million, 1995; $94 million, 1996; $88 million, 1999; $968 million, 1999.
[3]Total revenue growth expected had acquirer and each target continued to grow at average growth rates for industry.

These results held across the board. Mergers in high-tech and other so-called growth sectors were as susceptible to the burden of mergers as any. Nor, oddly enough, did size matter—small companies risking a large acquisition were no less successful than larger companies swallowing a start-up or two. On average, experienced acquirers didn't have better success rates than novices.

Why worry so much about revenue growth in mergers? Because, ultimately, it is revenue that determines the outcome of a merger, not costs; whatever the merger's objectives, revenue actually hits the bottom line harder. As Exhibit 3 shows, fluctuations in revenue can quickly outweigh fluctuations in planned cost savings. Given a 1 percent shortfall in revenue growth, a merger can stay on track to create value only if a company achieves cost savings that are 25 percent higher than those it had anticipated. Beating target revenue-growth rates by 2 to 3 percent can offset a 50 percent failure on costs.

Furthermore, cost savings are hardly as sure as they appear: up to 40 percent of mergers fail to capture the identified cost synergies.[1] The market

[1]Haarmann Hemmelrath Management Consultants, *Stahl und Reisen*, Volume 119, Number 8, p. 131.

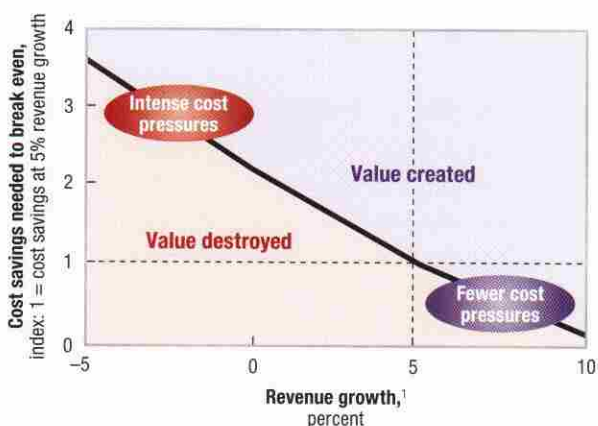
penalizes this slippage hard: failing to meet an earnings target by only 5 percent can result in a 15 percent decline in share prices. The temptation is then to make either excessively deep cuts or cuts in inappropriate places, thus depressing future earnings by taking out muscle, not just fat.

Finally, companies that actively pursue growth in their mergers generate a positive dynamic that makes merger objectives, including cost cutting, easier to achieve. An emphasis on growth is far better for motivating talented employees—on either side of a merger—than cost cutting could ever be.

Given the impact of revenue, it is surprising that so few merger-ready companies treat it as rigorously as costs. Even fewer are successful. Of the 160 acquirers studied, only 12 percent achieved organic growth rates (from 1992 to 1999) that were significantly ahead of the organic growth rates of their peers, and only seven of those companies had total returns to shareholders that were better than the industry average. Before capturing the benefits of integration, such merger masters look after their existing customers and revenue. They also target and retain their revenue-generating talent—especially the people who handle relations with customers.

EXHIBIT 3

Exceeding revenue targets eases pressure on costs



[1]Assumes 5% growth built into merger plan.

What is more, the merger masters institutionalize three complementary strengths for repeated success in acquisitions. First, cost disciplines are "hardwired" at every level, an approach that allows senior management to focus on revenue. Second, successful acquirers recognize that successful mergers lead to a virtuous cycle of better deals and better results, so these companies forge a meticulous merger discipline that improves with experience. Third, to instill a performance culture geared for growth, they use every means they have—notably, entrepreneurial, well-mentored teams with ambitious targets and incentives.

Success is determined above all by the ability to protect revenue and to generate growth just after a merger. Those acquirers that get the balance wrong—plunging headlong into cost savings—may soon see their peers outstrip them in growth.

—Matthias M. Bekier, Anna J. Bogardus, and Tim Oldham

Chicago thinks **small**

Chicago was justifiably proud when Boeing decided, this spring, to move its headquarters there from Seattle. The third-largest city in the United States, Chicago is home to more Fortune 500 companies than any other metropolitan region except New York. This concentration helped the Windy City post the highest growth in personal income and the second-highest rate of growth in employment among the five largest US cities during the past decade.

Even so, will Chicago be able to attract the important companies of the future? Today, more than 90 percent of all employees in the Chicago metropolitan area work for businesses in traditional sectors such as financial services, manufacturing, real estate, and retailing—industries that are expected to experience relatively low job growth nationally over the next few years. If Chicago is to go on growing, it must win its share of companies in newer, mushrooming sectors such as biotechnology and software.

A study delivered to the mayor in March 2001 concluded that the city should think small and build a business environment attractive to start-ups as well as to giant Boeing. New businesses and "gazelles" (companies that grow by more than 20 percent annually over a four-year period) accounted for 80 percent of US net employment growth from 1992 to 1996. Large cities such as New York (which since 1993 has been home to 10 percent of the nation's start-ups) and new-economy cities such as Austin, Texas, rode this wave by attracting and nurturing small companies (Exhibit 1). New York, for instance, invested public money in New York–centric venture funds, leased affordable space to new firms through a public-private partnership, and streamlined or eliminated 1,300 regula-