Creating value beyond the deal: industrial products and services

Being more strategic and locking in revenue streams

#BeyondTheDeal

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Contents

About this report:
To help understand the factors influencing performance, we interviewed 100 senior executives in industrial products and services (including automotive manufacturers and makers of other large durable products like airplanes and construction equipment) from a range of geographies about their experiences in creating value through M&A. All participants in this survey had made at least one significant acquisition and one significant divestment in the past 36 months. The survey included a combination of qualitative and quantitative questions and all interviews were conducted by telephone. All responses, where not attributed to our clients, are anonymised and presented in aggregate. This report draws on the insights gleaned from the study and the interviews, and on our own experience helping clients navigate the deals landscape. It offers a roadmap for how leaders should approach value creation within their organisations to deliver the full return potential on the transaction.

Executive summary

The industrial products and services (IPS) industry has a track record of which it can be proud when it comes to measuring value creation from mergers and acquisitions, in particular when looked at from the perspective of the acquirer's share price performance.

In the 24 months post-acquisition, IPS company share prices tend to significantly outperform those of other industries. Such companies generated on average a 35% return in terms of total shareholder return (TSR) in excess of the industry norm – or industry peers. Many of these companies are doing deals at scale and are successfully driving significant synergies, which is using acquisitions to increase their customer footprints geographically.

This compares with 14% across all industries in our main report *Creating value beyond the deal* (see Exhibit 1). Looking at the findings broken down by geography, Chinese acquirers generated by far the most value, with almost 79% of deals reporting a TSR in excess of their geographic and sector peers. That compares with 14% for European and 18% for North American acquirers.

Industrial products divestments generally pay off at a rate above the average (8% compared with an all other sectors average of 5%, see Exhibit 2).

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Industrial products companies do well on shareholder return

Exhibit 1

Average total shareholder return in excess of industry peers (acquirers)

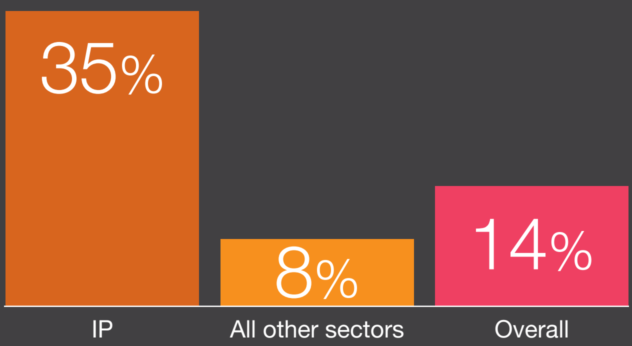


Exhibit 2

Average total shareholder return in excess of industry peers (divestitures)

Source: 2018 Total Shareholder Return data (Cass Business School sample of acquisition and divestment transactions announced between 1st of January 2008 and 31st of December 2016) and interviews with 100 senior IPS executives

The outsized performance of IPS companies to a large degree reflects the fact that these businesses are dealing with particularly thorny challenges, including significant cost pressure and managing a capital-intensive business with a global footprint. They are in most cases turning to M&A as a strategic tool to overcome them.

And given that M&A is so pivotal to their strategy and operations, IPS companies tend to make decisions about which deals to pursue with particular focus and care. This tends to show up in short-and long-term results.

A second key finding is that more than two-thirds (67%) of respondents believed that their deals created moderate or significant value for the underlying business, relative to the purchase price. That compares with 61% of respondents believing that their deals created value in our main cross-industry survey.

Cost synergies (74%) and capital efficiency (64%) were the top two facilitators of value in deals.

A third key finding is that product diversification is the driver for more than a third (39%) of deals, well above the average (17%) in our broader survey of all sectors. This report follows a larger PwC report, *Creating value beyond the deal,* which examined shareholder returns for thousands of transactions, eliciting responses from 600 global corporate executives in six large industries. The core finding: prioritising value creation up-front results in outperformance of industry benchmarks by 14 percentage points.

> IPS companies tend to make decisions about which deals to pursue with particular focus and care. This tends to show up in short-and long-term results.

That report found that for all industries, including industrial products, companies can get more value out of M&A by focusing on three elements:

1. **Stay true to strategic intent.** The organisation needs to approach deals as part of a clear strategic vision and long-term objectives for the business. Opportunistic dealmaking can create value, but not as often as strategic deals do.

2. **Be clear on all the elements of a comprehensive value creation plan.** Ensure a thorough and effective process for having a comprehensive value creation plan at an early, pre-deal stage. This should be informed by the necessary diligence and rigour around commercial and strategic considerations, as well as financials, advanced analytics, operations, technology, tax, legal and people matters.

3. **Put culture at the heart of the deal.** Keeping people and cultural aspects upfront in planning is fundamental. Wide engagement and communication of your value creation plan will help retain and build buy-in from key personnel. Failing to plan for cultural change will undermine the value created.

Finally, all IPS sectors are being affected by the 2019–20 COVID-19 (coronavirus) outbreak; although the overall scale and impact are yet to be determined, they already are significant.

Acquiring to extend customer base and market reach

According to interviews conducted with executives as part of the survey, the two most common rationales for industrial products companies to buy other businesses were product diversification (39%) and market expansion (30%) (see Exhibit 3).

The percentage for product diversification is well above the average of 17% that we found in the broader cross-industry survey. Respondents cited a need and desire to add products and capabilities, including expansion into new segments.

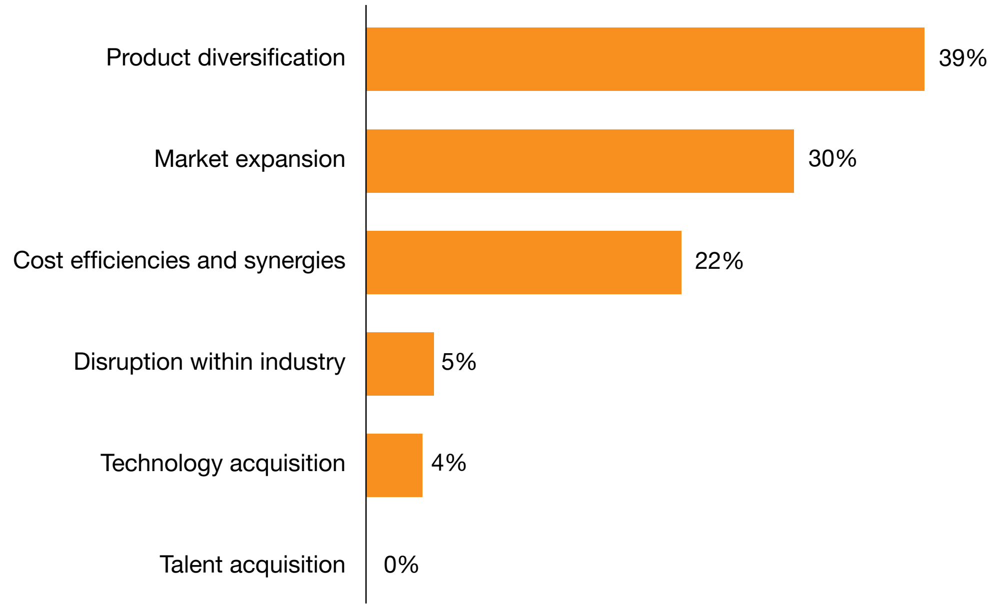
Somewhat surprisingly, considering the role that digitization is playing in new product development these days, technology acquisition was at the bottom of the list of reasons for acquisitions.

Rather than looking to revolutionise product design, industrial products companies are more concerned about acquiring companies that can help increase their presence around the globe with sales and distribution channels in growing and emerging markets. In addition, manufacturers are using acquisitions to create efficiencies on factory floors and in their supply chains.

"The percentage for product diversification is well above the average of 17% that we found in the broader cross-industry survey.

Exhibit 3
Key strategic drivers for deals

What was the main strategic driver of the deal? (please select one)



Source: Creating value beyond the deal: industrial products and services
Base: 2018 survey of 100 IPS executives on their most significant acquisitions and divestments, conducted in the preceding 36 months.

While IPS companies are aware that they must focus on developing and adopting new technologies and can't afford to be left behind in a period of industrial disruption, they naturally expect that their M&A strategies will deliver revenue and cost synergies. Asked to identify the types of value creation that their most recent deals facilitated, nearly three quarters of survey respondents pointed to cost synergies and 64% said capital efficiency (see Exhibit 4).

Often overlooked in discussions about M&A in the industrial products sector is that by acquiring the right technology start-ups, more established companies could accelerate a move towards providing "as-a-service" features to customers. These offerings, which potentially generate more predictable (and often higher margin) revenue streams, are essentially subscription or retainer services that deliver everything from predictive maintenance for industrial equipment to customised connectivity and infotainment features in vehicles.

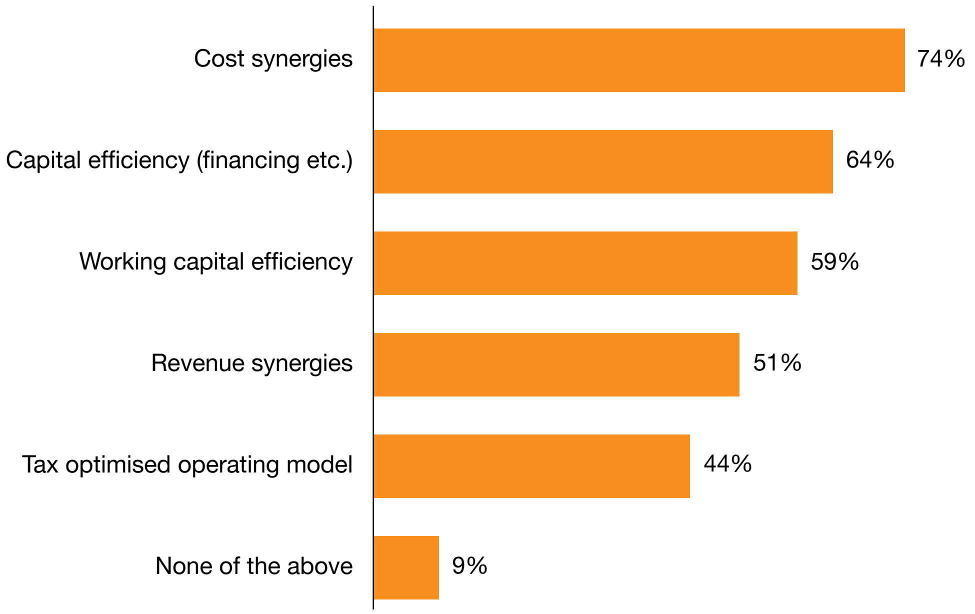
Supporting these services are advanced technologies, like sensors, database analytics, the Internet of Things and cloud storage – many of which are best embraced by industrial products companies through acquisition of technologically-oriented start-ups. By acquiring more capabilities like these, manufacturers address a broader set of its customers' desire for higher-quality, digitally enabled products at a lower cost that are adapted to their specific needs, as PwC highlighted in a recent report called *"Defining the new DNA of industrial digital organisations"*.

This creates not only more revenue, but also greater stickiness or loyalty in the relationship and contributes to the overall value of the deal.

Exhibit 4

Cost synergies and capital efficiency lead value drivers

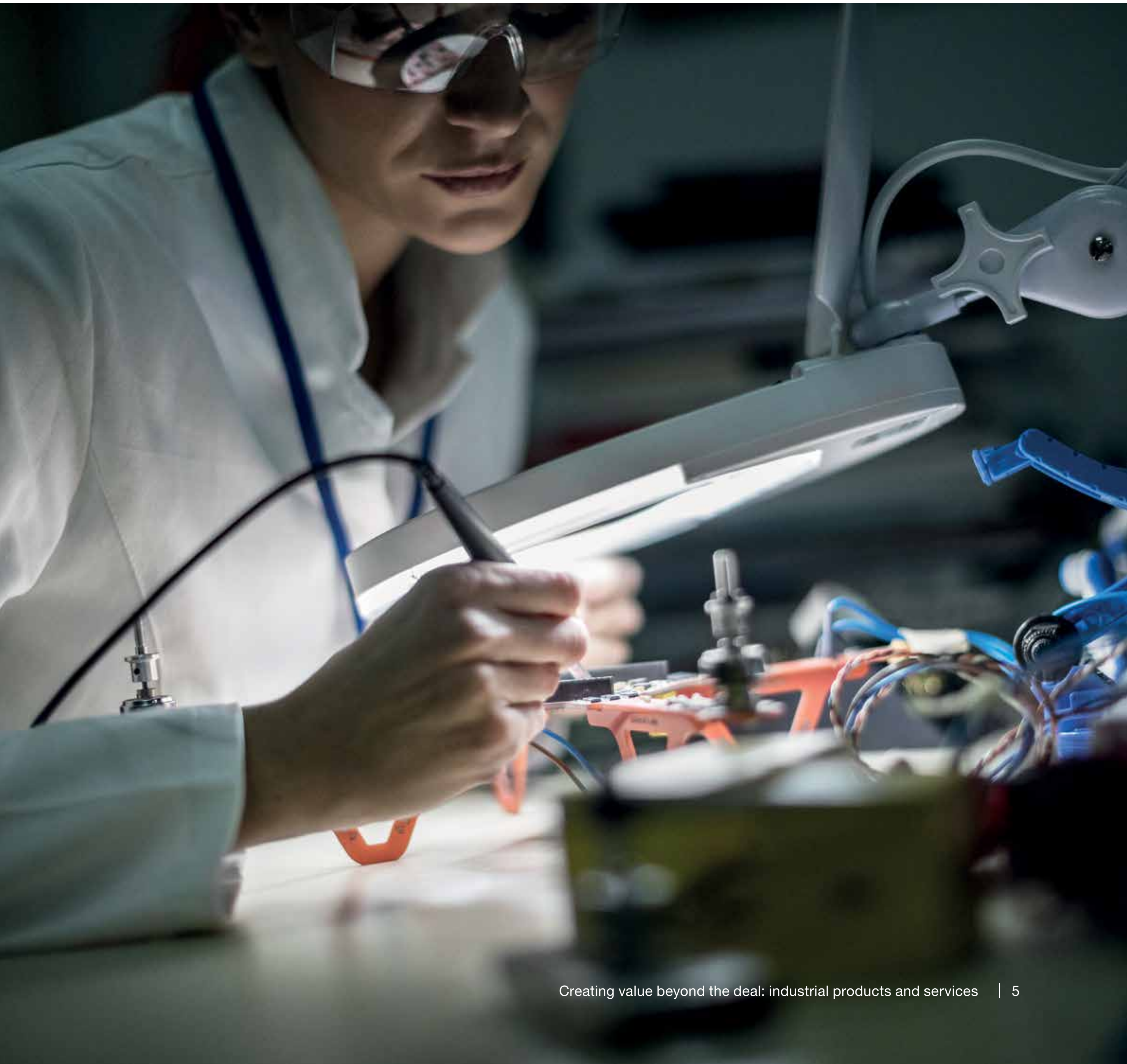
Which of the following types of value creation did this deal facilitate? (Select all that apply)



Source: Creating value beyond the deal: industrial products and services
Base: 2018 survey of 100 IPS executives on their most significant acquisitions and divestments, conducted in the preceding 36 months.

> We need to run at the same pace as our peers in other industrial sectors. Our most recent acquisition gave us access to digital asset management software and technology that will help us deliver the best physical asset management services to our clients.

Director of M&A at a Canadian industrials group.



Room for improvement

One issue we have identified is that – as we see in other industries – too many industrial products companies are opportunistic rather than strategic when looking at potential targets, jumping at what appears to be a good deal while neglecting to determine with careful analysis whether the acquisition aligns with their strategic direction for new products and market expansion.

Amplifying this point, one third of industrial products companies surveyed said that their last acquisition taught them that they need to do more to put value creation at the heart of future deals.

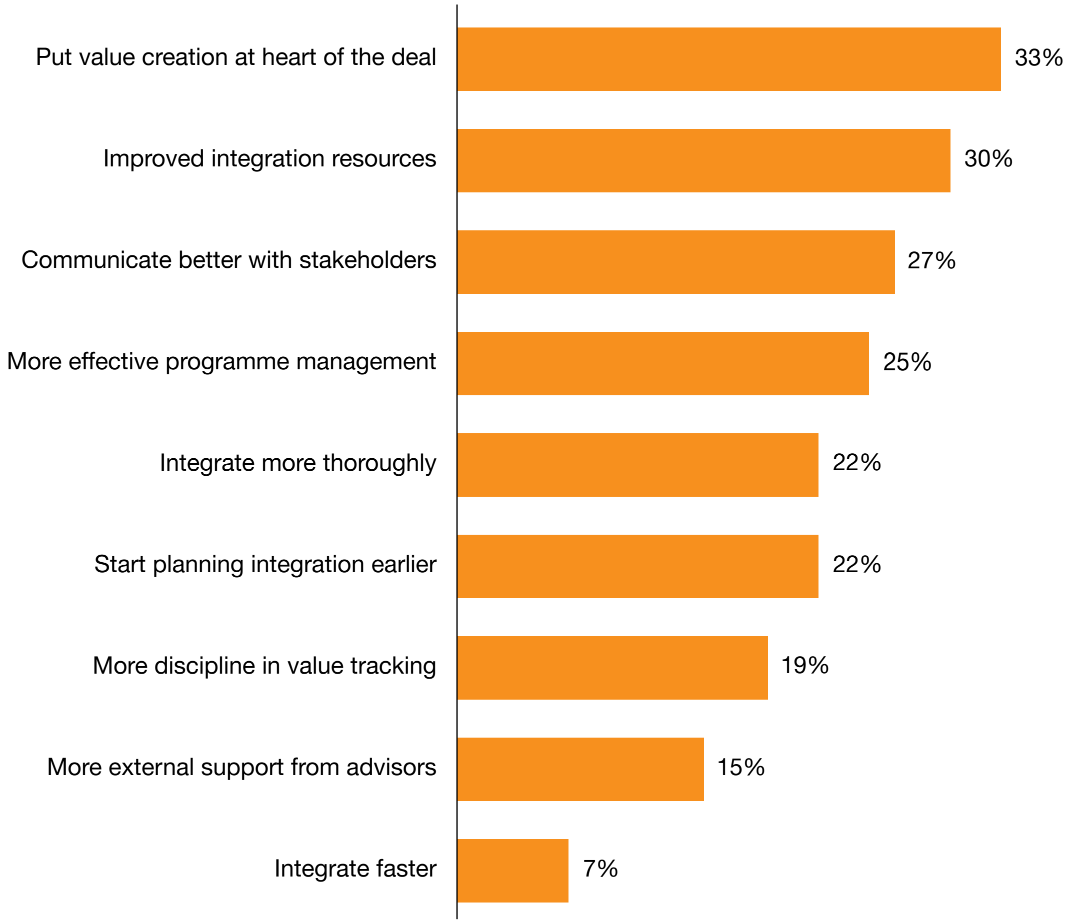
To do this, 30% of respondents said they need to allocate more resources to integration and 27% believe that they need to communicate better with key stakeholders (see Exhibit 5).

For many companies, achieving better M&A results will depend on starting the planning process earlier with a strategic driven decision-making process to determine which target companies are suitable. Care should be taken to analyse concerns before a deal, such as cultural issues, and to question whether they are deal breakers. It's also essential to have a detailed integration plan prepared by the time the deal closes, which among other crucial facets identifies who is responsible for its execution. All of this will also help create greater discipline in meeting value benchmarks, including the key performance indicators defined before the deal.

Exhibit 5

One third of companies recognise more needed to put value creation at the heart of future deals

What lessons would you take from this deal for future integrations? (Select top two)



Source: Creating value beyond the deal: industrial products and services
Base: 2018 survey of 100 IPS executives on their most significant acquisitions and divestments, conducted in the preceding 36 months.

> Not every deal goes as planned and there are always nooks and corners that get left. It tends to be the time constraints that catch us out.
>
> **Head of Strategy and M&A at a Swiss industrials group.**

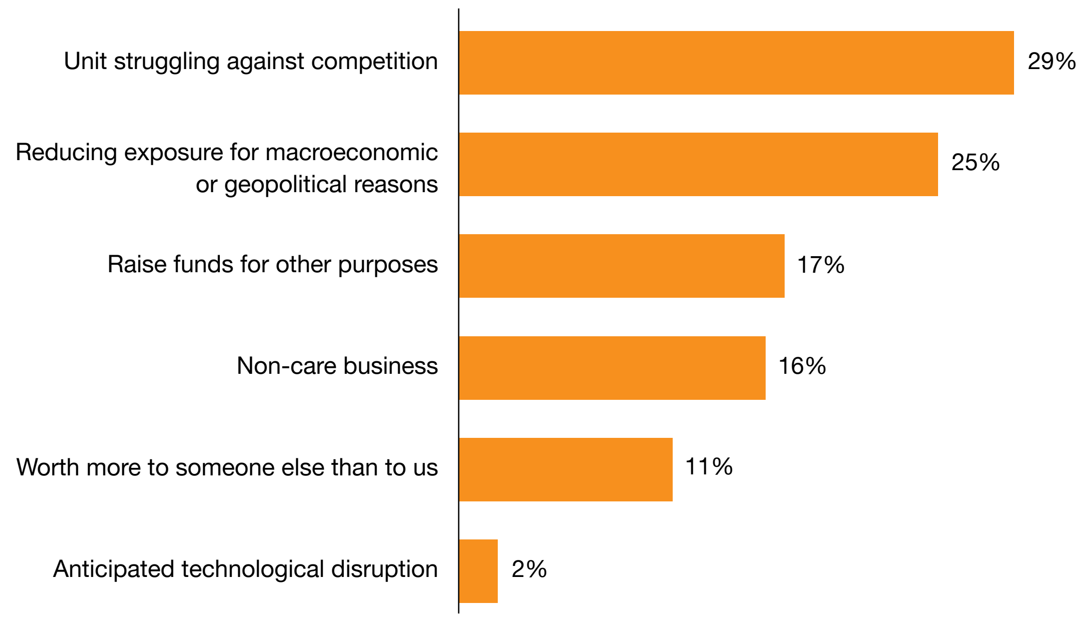
Divesting to clean up the portfolio

It is just as critical to be strategic and disciplined about divestments as with acquisitions. Unexpected opportunities may generate value, but most divestments are better made as part of an ongoing programme of asset review. The upshot is that the two most prevalent reasons for divestiture in the industrial products sector are that the business unit is struggling against the competition and to reduce macroeconomic and geopolitical exposure (see Exhibit 6).

Still, even with the best intentions, many divestments fall flat because they lack proper upfront preparation. The correlation between having a formal methodology and value creation is high. In deals where significant or moderate value was lost, there tended to be an absence of a formal value creation plan. Indeed, according to the survey of the deals that had significant or moderate value lost, 70% did not have a formal methodology (see Exhibit 7). Nonetheless that compared relatively favourably with other sectors, where we saw a 90% level in this context.

Exhibit 6
Competitive pressure top reason for doing a deal

What was the main strategic driver of the deal? (please select one)



Source: Creating value beyond the deal: industrial products and services
Base: 2018 survey of 100 IPS executives on their most significant acquisitions and divestments, conducted in the preceding 36 months.

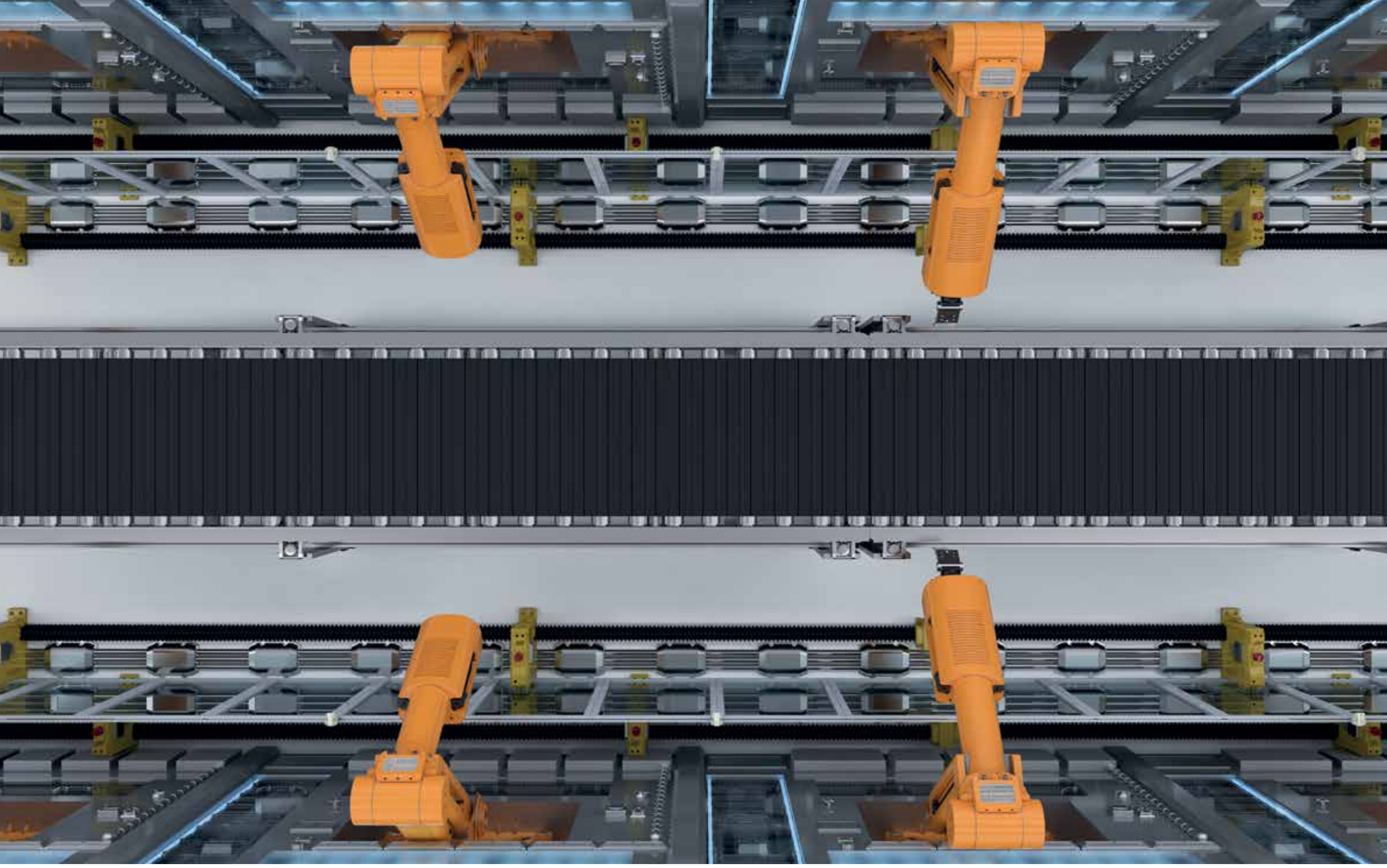
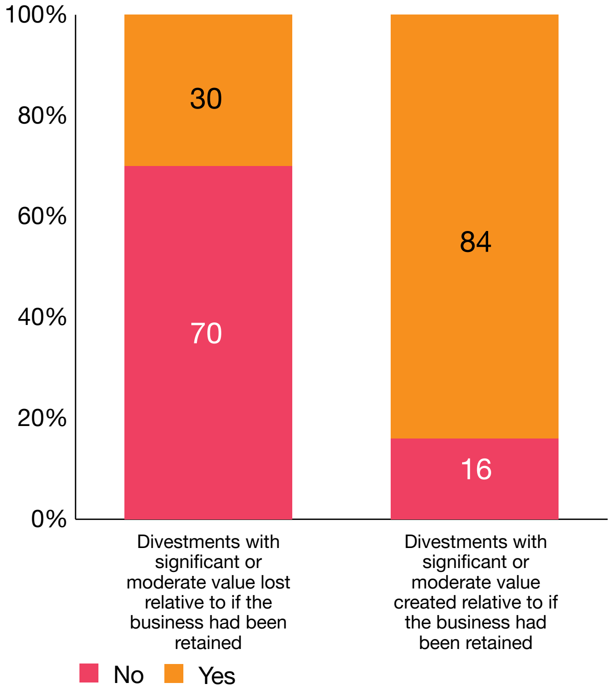


Exhibit 7

Divestments: having a formal methodology helps generate value

Do you have a formalised methodology and/or blueprint for creating value through divestments?



Source: Creating value beyond the deal: industrial products and services
Base: 2018 survey of 100 IPS executives on their most significant acquisitions and divestments, conducted in the preceding 36 months.

"According to the survey of the deals that had significant or moderate value lost, 70% did not have a formal methodology.

Indeed, 47% of respondents said they believed their divestment management could have been more effective and 43% intended to allocate additional resources to future divestments.

A successful divestment plan starts with robust and continuous communication about the possible deal. Companies that fail to adequately explain the thinking behind a divestment to everyone involved in the deal, will risk losing significant value on the deal because key managers in the company being divested may look for more secure employment elsewhere. And in the process buyers may flee, worrying that the depletion of talent will affect performance and customers may in turn move on.

Our survey results show a correlation between employee retention and value creation for an acquiring company. Of the companies that reported significant or moderate value created after an acquisition, a majority retained 95% of the employees they were hoping would stay. By contrast, of those whose total shareholder return fell significantly or even moderately, a majority lost more than 10% of the staff they had planned to keep with the combined companies (see Exhibit 8).

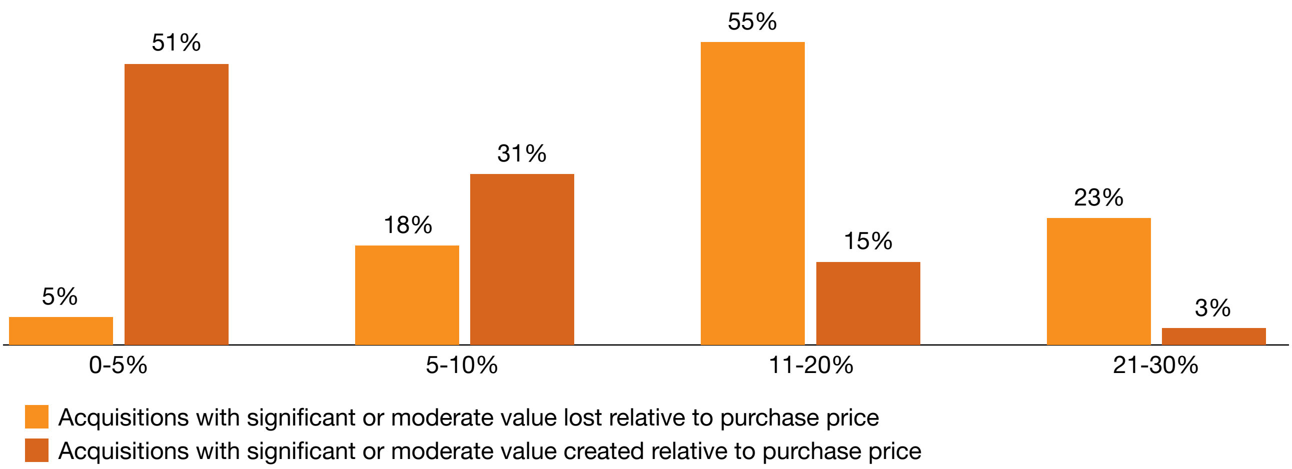
Sellers should therefore be prepared to address the most awkward questions a potential buyer may ask. Some companies, particularly those sellers who gather valuable insights from experienced third party advisors to help plot out the plan for divestments and answer critical issues about the divestment that may arise. They may also be able to help buyers understand the opportunity, smooth over relations with investors who may be sceptical about the deal, and build confidence in the value that can be generated by the sale.

“47% of respondents said they believed their divestment management could have been more effective and 43% intended to allocate additional resources to future divestments.

Exhibit 8

Retaining talent helps value creation for acquirers

What percentage of target employees left that you had hoped to retain?



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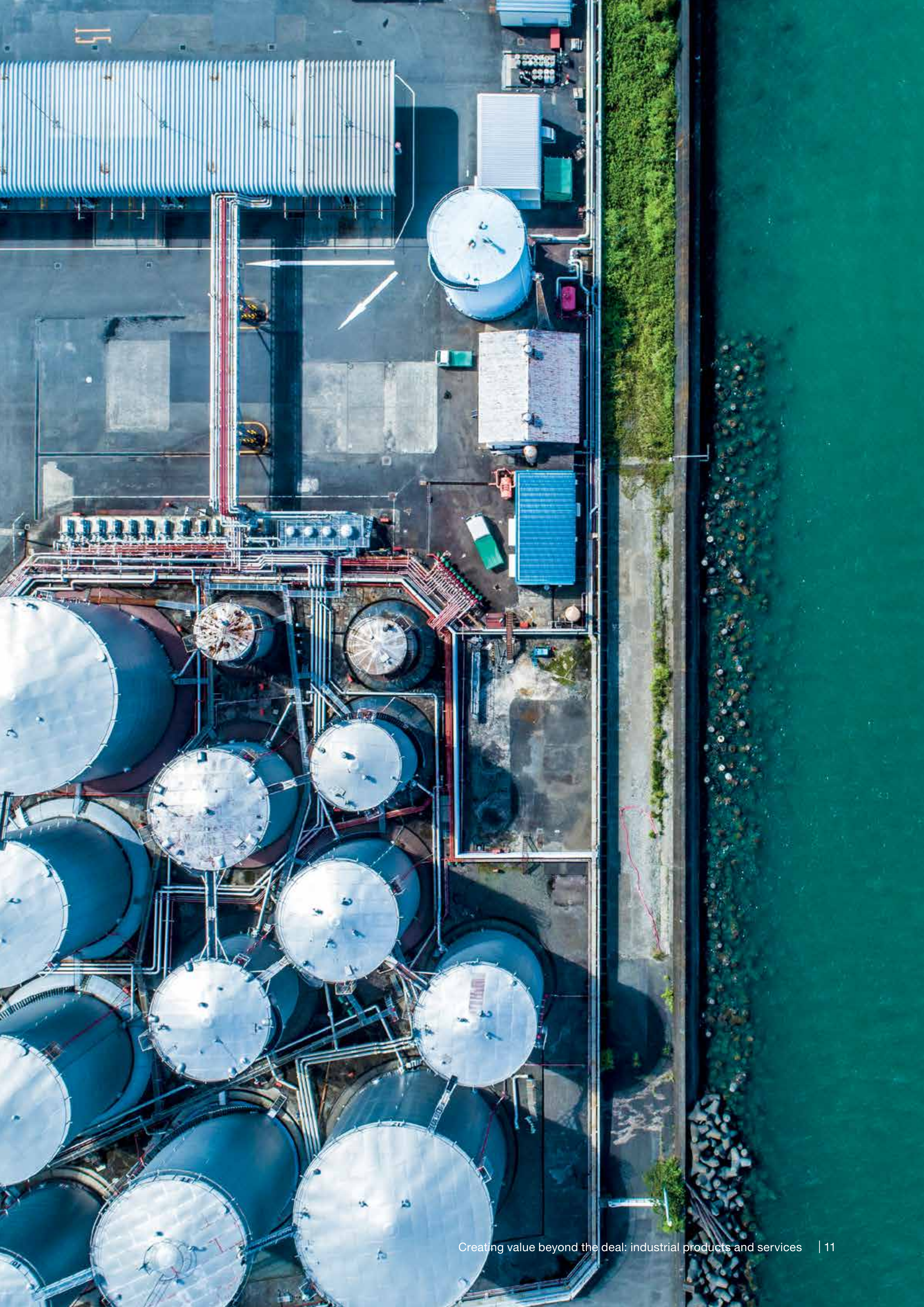


Industrial products companies can manage divestments more effectively through the development of and adherence to a 'divestment playbook', even when dealing with one-off transactions or the sudden introduction of a deal.

This 'seller's guide' to value creation should include the following:

1. **Develop a 'divestment playbook.'** Sellers need to develop consistent, value-focused messages based on thorough preparation and portfolio review with potential buyers in mind. This demands a solid methodology and a divestment playbook that includes a plan for handling the most awkward questions a potential buyer could ask.

2. **Don't leave due diligence to the buyers.** Despite its potential to create value many divestors we surveyed said they carry out no vendor due diligence at all. Successful divestors are heading off difficulties at an early stage, with their vendor due diligence efforts reflecting a more disciplined approach overall to divestments.

3. **Explore the art of the possible.** Divestment plans should involve more than just the allocation of existing capital. They should consider and map out the art of the possible. What could the asset being sold achieve with unconstrained capital, bringing in much-needed new skills and bolt-on acquisitions? This kind of approach will not only attract a wider pool of potential buyers, it will also hold on to value through the deal.

4. **There is no substitute for experience.** As shown in Exhibit 9, the more divestments are done, the more value this tends to create. Divestors – especially those with minimal experience in this area – should take advantage of an array of third-party advisers to help them maximise this. The goal should be to use these advisors as early as possible in the process, to help investors understand the opportunity, in a measured way, and to build their confidence over time.

5. **Make the most of your people.** Again, the success or failure of any M&A deal, be it on the buy-or the sell-side, hinges on keeping key members of the team. These employees, especially within the divesting companies, typically start to worry about their career safety long before a deal closes. Their exit decreases the success of the deal and may even jeapordise a potential sale. The importance of engaging them early in the process and providing an incentive linked to the deal's success were two key findings of the survey.

   Give the acquirer quality time with the key players to build confidence. Beyond consistent and upbeat messaging, sellers must be prepared to answer the awkward questions and be fluent in the facts. Obviously, failure to prepare limits the number of interested buyers, who must have all the information they need to analyse the business. If there are major holes in the data, some bidders may walk away, while others may discount values that are not sufficiently backed up or explained.

6. **Address legal complexity.** On the divestment side, much of the legal complexity stems from separating out the entity being sold and making sure it is done early enough so it's ready to go when it comes to market. Further, transition service and supply agreements are key legal levers for generating value from the divestment, because it helps align the interests of the two parties, specifying performance objectives and outlining responsibilities. An example of this would be a supply agreement being provided by the seller to the buyer, rather than negotiating a high price upfront.

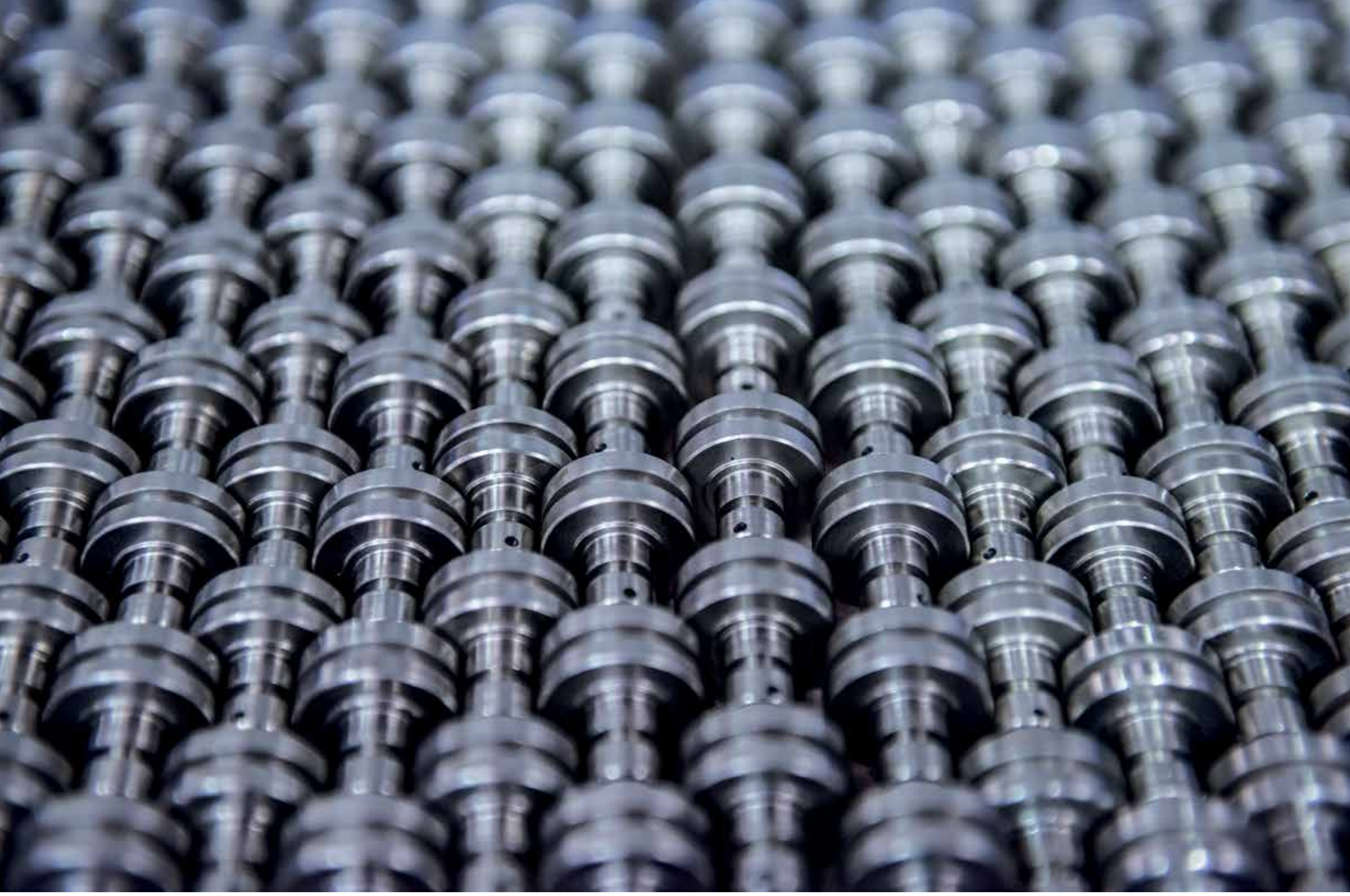
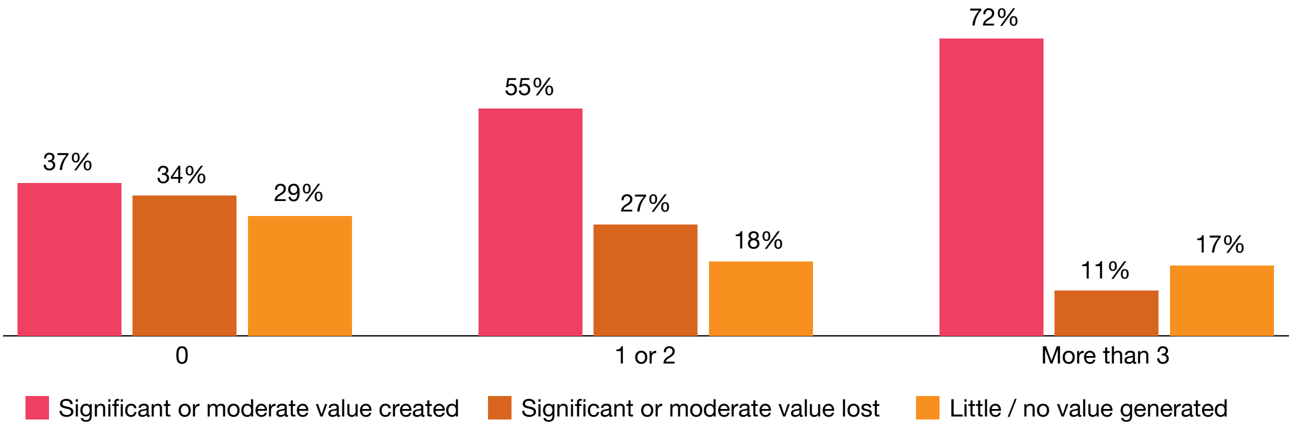


Exhibit 9

The more divestments that are done, the more value tends to be created

How many divestments do you typically make? How much value did this deal generate relative to the underlying business if it had been retained?



Source: Creating value beyond the deal: industrial products and services
Base: 2018 survey of 100 IPS executives on their most significant acquisitions and divestments, conducted in the preceding 36 months.

Strategies for success

We have come up with four key steps for success in dealmaking:

1 **Plan early and track progress rigorously.** It is crucial to have a comprehensive value creation blueprint. Interestingly, only 34% of corporations in the broad survey of all sectors said that value creation was a priority on Day One, and on reflection a total of 66% stated they should have put value creation at the heart of the deal. For many, that lack of priorities turned out to be a mistake. The plan should include:

- A target operating model to ensure that the organisation is configured to deliver the value creation strategy
- A personnel assessment, which should set out clearly the leadership and capability requirements for both existing (and potentially new) talent
- Consideration of the tax, working capital and pensions implications of the strategic options, and how you can capitalise on additional value upside during and post-deal

The earlier the plan is developed the better: 70% of deals that did not have a value creation plan in place ahead of completion lost moderate to significant value. By contrast, 84% of deals with a plan in place before completion created moderate or significant returns.

2 **Approach the deal smartly.** The goal in any acquisition is to preserve intellectual property, human capital, and the drive to innovate. Achieving this often depends on successful integration of newly acquired companies. Integration must be embraced as a business process – a series of disciplined steps that flow from a plan that begins long before the deal is signed. The plan should be flexible enough to adjust for the unexpected, aggressive enough to win highly competitive business terms, and broad enough to envision the challenges that will confront you from the moment the deal is signed.

Integration processes and programmes at industrial products companies that we have observed cover a wide gamut. Some companies create a single team to oversee both due diligence and integration. Members of this multi-disciplined core group help identify the target, conduct due diligence, negotiate the deal, and then manage integration. They may call on specialists within the company to handle certain tasks such as integrating system platforms, but the core group stays in place throughout the integration. The benefit from this approach is consistency. Team members have detailed knowledge of the deal and are thus sensitive to nuances that might be missed by those who step in at the last minute.

Other industrial products companies choose to go with two specialised teams – one group handling the due diligence through the deal closing then handing off the target company to a group of integration specialists. The benefit here is deep experience in the integration process. A final approach, usually employed by decentralised manufacturers, involves each business unit assuming a leadership role in making acquisitions while corporate development professionals provide support as needed. Here, the benefit is that the business unit is clearly committed to the deal and develops its own experience in dealmaking.

3 **Move quickly.** Business case studies are rife with post-mortems on deals that fail to deliver the value intended. Typically, melding divergent operating philosophies, management practices, culture, and operations are post-deal hurdles. However, industrial products companies that quickly tackle these challenges have reported better financial performance, morale, productivity, and new product time-to-market, along with fewer systems and management integration problems. Reconcile differences in operating philosophies as soon as possible. Successful acquisitions quickly go beyond the "my practices are better than your practices" impediment.

Frequent and open communications about the rationales for the deal and the expectations for the acquired company as well as its anticipated impact on the acquiring firm are also a stabiliser. It keeps people focused, energised, and committed, rather than distracted and perplexed. We encourage companies to communicate to all key stakeholders – employees, customers, suppliers, regulators, and investors – about deals. Early communications with employees drastically reduces uncertainty, allowing them to refocus on creating value. Major differences in operating philosophies and division, if not resolved early, will quickly drain deal value. A protracted integration of key platforms will delay capturing deal value as well.

“Companies can use social media and similar platforms to examine the attitudes that current and former employees have about the company and whether there are any underlying cultural issues that might make the acquisition less than ideal.

4 **Don't underestimate the importance of culture and talent.** Failure to focus on culture and retaining the best people in a target company came through as one of the big but often overlooked value destroyers in our survey. Successful dealmakers identify the leaders and innovators they need to ensure that the company they are acquiring is prepared to outpace the competition in their primary markets. Social media has an intriguing role to play here, too.

Companies can use social media and similar sites to examine the attitudes that current and former employees have about the company and whether there are any underlying cultural issues that might make the acquisition less than ideal. For example, a scan of social media may uncover signals about how a target company's employees are feeling about their compensation. And that, in turn, may provide a window into future payroll costs and compensation issues. Long working hours may also emerge as an issue, and that may translate into a need to look at staff turnover levels.

Methodology

To help understand the factors influencing performance, we interviewed 100 senior executives in industrial products and services (including automotive manufacturers and makers of other large durable products like airplanes and construction equipment) about their experiences in creating value through M&A. The report includes transactions between January 1, 2008, and December 31, 2016. All participants in this survey had made at least one significant acquisition and one significant divestment in the past 36 months.

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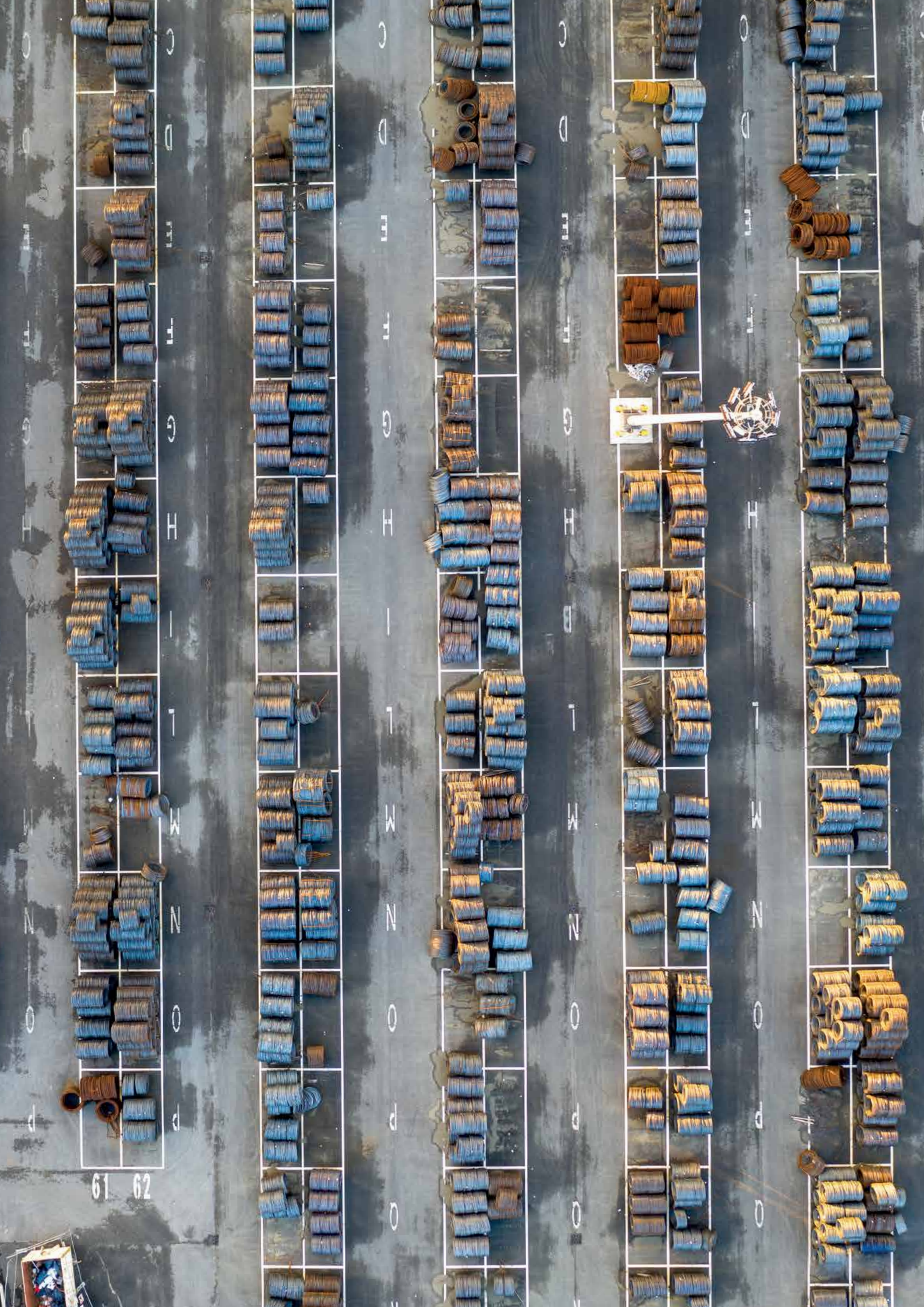
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