Fortuna Advisors LLC

Buona Fortuna!
August 26, 2010

Buona Fortuna! is published by Fortuna Advisors LLC to share views on business strategy, corporate finance and valuation.

Want to be a Great Acquirer? Do More Deals

John R. Cryan and Jeffrey L. Routh

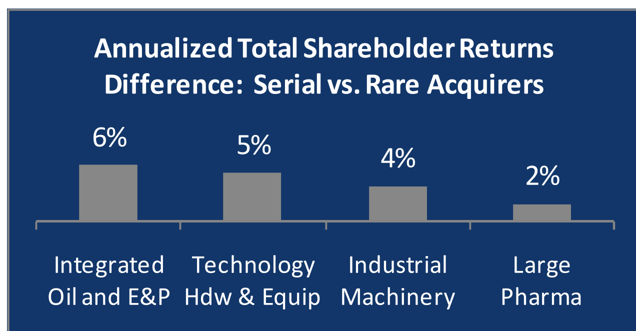
The market demands growth in revenue, cash flow and value, and the more that is delivered the higher the demands, creating a management conundrum. At a certain point most companies find that organic growth alone is insufficient to meet expectations and yet the prevailing wisdom is that most acquisitions 'fail to create value'. What's management to do?

The Problem with the 'Prevailing Wisdom'

Many research studies show declining share prices on most M&A announcements. It would seem that the expected synergies typically don't compensate the buyer's shareholders for the premiums paid. So while most acquisitions do create value in aggregate, that is the companies are worth more together than apart, often more than 100 percent of the value enhancement goes to the seller's shareholders.

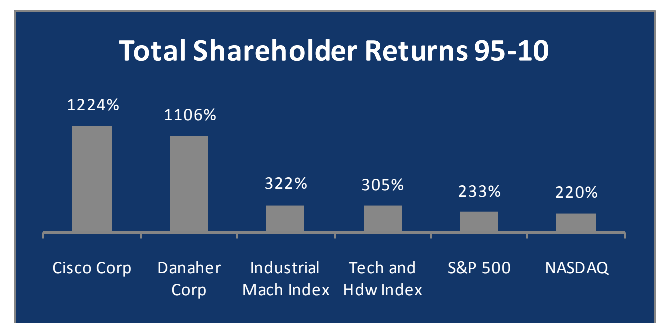
Despite the claim that acquisitions destroy value, some companies excel as acquirers and deliver outstanding value for shareholders. To evaluate this, we studied the relationship between long term total shareholder returns (TSR) and different acquisition strategies and a variety of deal characteristics.

The only trait that consistently has a strong positive relationship with long term TSR across each industry is acquisition frequency[1]. The companies that create value through acquisitions typically demonstrate a greater propensity to acquire. We call them Serial Acquirers and many generate outstanding results by better planning, executing and integrating acquisitions than their less acquisitive peers.



Transactions are core to the corporate strategy of these companies and are an explicit element of how they expect to grow and operate in the future. Their acquisition strategy is fully integrated with their capital allocation decisions, capital structure policies and investor communications. They have dedicated resources responsible for ensuring the success of each deal and they tout their ability to identify & exploit opportunities. The Serial Acquirer's track record speaks for itself. They often trade at a premium to peers as investor's *price-in* exceptional but disciplined growth.

To provide a practical demonstration of our findings we focused on two of the world's very best acquirers, Danaher Corporation (DHR) and Cisco Systems (CSCO), and their formerly public targets. Together they have completed more than 175 acquisitions since the mid '90s. Their industries, products, cultures and strategies are vastly different yet both achieve exceptional results by being better than the competition at planning, executing and integrating acquisitions[2].

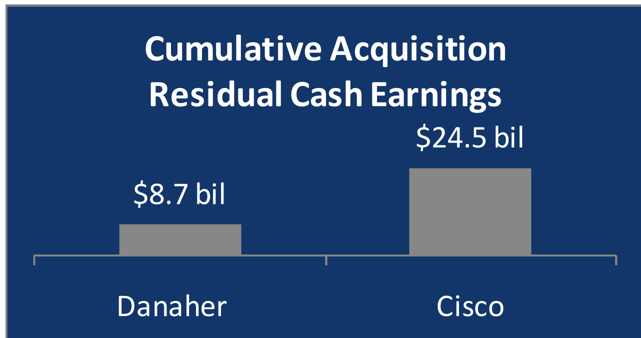


Despite their differences Cisco and Danaher have created substantial long term shareholder value beating their industry indices by 3-4x. We examined how they did it.

One Penn Plaza,36th Floor, New York, NY 10119 • info@fortuna-advisors.com • (212) 786-7365
© Copyright 2010 Fortuna Advisors LLC, all rights reserved.

Value Creation: Growth AND Return

Their TSRs are driven by a powerful combination of growth and return. Through our analytical lens, since the mid 90s, Cisco and Danaher have delivered over $33B of cumulative cash flow in excess of the required return on all capital including intangibles. We call this Acquisition Residual Cash Earnings (ARCE).



Danaher's M&A strategy emphasizes improving rates of return while Cisco focuses on growth but clearly it's the combination of growth and return that allows them to be successful year after year.

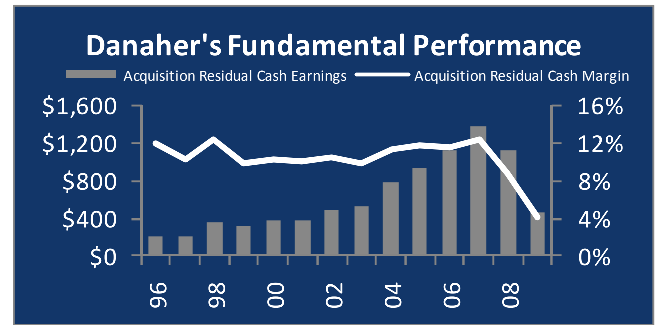
The Danaher Business System

Danaher's deal strategy relies on the ability to operate each target in a more efficient and therefore more valuable way. They apply the Danaher Business System (DBS), which is a culture where every employee from the CEO to the shop floor is responsible for improving the way work gets done.

Danaher has consistently earned a positive Acquisition Residual Cash Margin (ARCM), or cash flow in excess of the required return on all capital including intangibles, as a percent of revenue. ARCM averaged 10% of revenue from 1996-2009, and has been remarkably stable, despite buying lower return targets, demonstrating the company's ability to rapidly integrate acquisitions and improve performance.

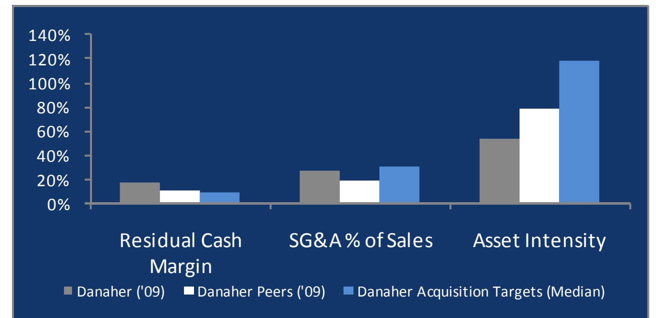
In 2007, the Company made its largest acquisition to date, buying Tektronix. When asked about the deal; Danaher's CEO Larry Culp responded "Tektronix was an acquisition we would've loved to have done 10 -years ago. We couldn't it was too much of a 'bet the farm', much more manageable now given our current size." Danaher's ARCE peaked in 2007 at $1.4B.

When a business is run this efficiently, growth is tremendously valuable. Danaher keeps acquisitively investing in growth and delivering desirable returns on those investments. Even during the downturn in 2008 and 2009, Danaher delivered cash flow in excess of the required return on all capital.



Danaher's integration approach fits with its acquisition strategy. DBS is not only a series of processes; it's a culture focused on efficiency. The implementation within an acquired company is uncompromising.

Like many acquirers, Danaher attacks the SG&A of its targets to improve efficiency. However, less obvious but more remarkable and important is the company's ability to improve asset utilization. Danaher's consolidated asset intensity is less than half that of their target companies, so for each dollar of revenue, Danaher only requires half the assets.



Freeing up capital via asset efficiency improvements creates value for Danaher's shareholders and generates additional cash flow to fund the next acquisition without further diluting existing owners.

Like an astute value investor, Danaher has demonstrated the ability to buy companies that are trading well below the level implied by their stand alone forward returns. Buying companies with bearish investor's expectations allows Danaher to pay a premium that in most cases values the target below long term

	Danaher
Percent of Targets at a Discount Pre-Announcement	91%
Median Target Premium/Discount Pre-Announcement	-40%
Median Target Premium/Discount Post-Announcement	-21%

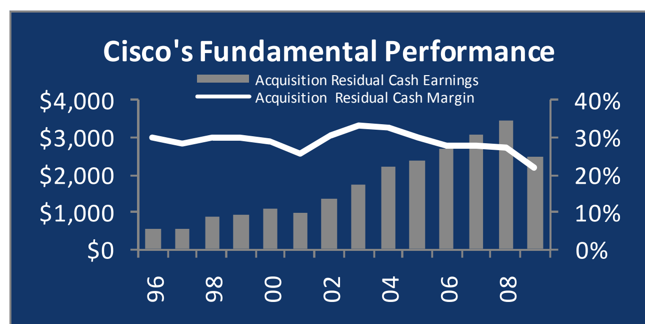
© Copyright 2010 Fortuna Advisors LLC, all rights reserved.

market norms. In the past Danaher's acquisition targets traded at a median discount to the market of 40% and even after paying a premium, the prices offered still valued the enterprise at a substantial 21% discount, providing further upside potential to Danaher's shareholders[2].

Cisco: New Platforms for Growth

Cisco's overall corporate strategy and corporate development approach is quite different from Danaher. The Company identifyies future growth and market opportunities rather than turnaround situations. Despite the differences, the benefit of a proactive M&A strategy is no less important. Their corporate development process requires the company to identify and capitalize on market disruptions through new technologies and business models. Over the past 14 years the company has average 26% revenue growth which compounds to 2500% cumulative growth!

Positioning the Company for future growth has required Cisco to sacrifice near term returns experiencing an 800 bps decline in Acquisition Residual Cash Margin. However, despite the declining ARCM, the larger Cisco generated peak ARCE dollars in 2008. It's a classic growth versus return tradeoff.



With an emphasis on growth, there is a bit more willingness and ability to pay closer to full stand alone value, but still 63% of its targets trading at a discount. The effective Cisco acquisition prices are likely lower than those in the table below if we recognize that some of these were stock deals at the peak of the tech bubble. Cisco astutely used its own richly valued shares as consideration in these transactions, and since the collapse of the internet bubble Cisco has made mostly cash based acquisitions.

Cisco's integration process is similarly well aligned with its acquisition strategy. During the integration phase Cisco continuously measures its ability to retain employees, sustain revenue and launch new products based on the acquired technology and capabilities.

	Cisco
Percent of Targets at a Discount Pre-Announcement	63%
Median Target Premium/Discount Pre-Announcement	-9%
Median Target Premium/Discount Post-Announcement	14%

Cisco's ability to embed existing products within the acquired company's technology, and vice versa, delivers more value to the customer and supports additional growth by leveraging its massive global footprint, product line breadth and organizational capabilities.

Successful M&A Processes

So what do these vastly different companies with very dissimilar strategies have in common? They excel in three key areas related to M&A that set them apart from their peers:

- M&A Planning
- Execution Excellence
- Meticulous Integration

M&A Planning

Creating a **robust** acquisition planning process and pipeline requires a long term strategy and vision for the corporation and for the corporate development function. Management teams must dedicate time and resources to evaluating opportunities that exist today and could exist in the future, both in terms of strategic fit and valuation.

Serial Acquirers excel in this area as they plan and analyze continuously. This allows them to act quicker because they've already done the groundwork and laid the strategic foundation.

Superior Execution

With a **continuous** corporate development process, Serial Acquirers are more likely to avoid the emotional connection to a transaction that draws so many less frequent acquirers into a value destructive M&A frenzy. Serial Acquirers continuously have a *finger on the pulse of the market* and incorporate both internal and external information into their deci-

© Copyright 2010 Fortuna Advisors LLC, all rights reserved.

sion making processes. Serial Acquirers are content to let a deal pass rather than become undisciplined in the execution.

Meticulous Integration

Our research clearly demonstrates that post-merger integration is where the shareholder value of the deal is won or lost. Planning and execution are indeed critical steps, but the integration of the target must be achieved or the overall process fails.

What is the plan for doing things differently and creating new value after you own the business? What are the investments needed? Where can efficiencies be realized? What milestones and performance targets can be expected (same as those used to justify the deal)? How can incentives be aligned with the integration plan so those making it happen have a stake in the success?

In many companies the integration process is assumed to be a "given". In others, they leave it to a business unit to manage the newly acquired business and there is no formal integration tracking. Do not make these mistakes. Serial Acquirers have fully dedicated acquisition teams managing the integration process in meticulous detail.

Conclusion

Both Danaher and Cisco are industry leaders that have demonstrated the ability to consistently earn high returns and redeploy capital to drive growth. Each has created significant value for shareholders relative to the broader market and peers. They're routinely on Fortune Magazine's 'Most Admired Companies' List and they should also be regarded as two of the best acquirers in the world.

They are bold and transparent in their desire to acquire. Their corporate culture, strategy, and management processes form the infrastructure needed to support their M&A competency, a competitive advantage allowing them to succeed where so many fail. Each commits significant resources to support its acquisitions and M&A process, and the results speak for themselves.

For those companies that have not experienced the acquisition success of Danaher or Cisco, now is the time to identify the formal and informal roadblocks that limit the ability to profitably grow through acquisitions. Begin by asking, what are the traits of successful acquirers in your industry? What types of deals tend to perform better? What can be done internally to become an elite acquirer?

John R. Cryan *(john.cryan@fortuna-advisors.com) is Partner and Co-Founder of Fortuna Advisors LLC*

Jeffrey L. Routh *(jeff.routh@fortuna-advisors.com) is an Associate in the firm's New York Office.*

Notes:

1. *For more on our acquisition research see "Who Says M&A Doesn't Create Value?" at http://www.fortuna-advisors.com/buona-fortuna.html*
2. *More detailed analysis of Danaher and Cisco through the Fortuna lens can be found at www.fortuna-advisors.com/casestudies*
3. *See www.fortuna-advisors.com for more on Internal Capitalism, Gross Business Returns (GBR), Residual Cash Margin (RCM) and other aspects of Fortuna-lytics.*

© Copyright 2010 Fortuna Advisors LLC, all rights reserved.

Want to be a Great Acquirer? Fortuna Advisors Can Help

Do you understand how much growth investment you need to meet and exceed investor expectations?

Have you clearly identified the business areas you are willing to consider for acquisitive growth?

Do you maintain an ongoing target list of opportunities and monitor performance, valuation and expectations?

We are experts in value based M&A planning and strategic deal analysis.

We evaluate internal M&A processes to help eliminate formal and informal roadblocks

We collaborate on corporate development, capital deployment, business portfolio review and valuation to assist management in developing and implementing strategic plans to drive the share price higher!

Contact Fortuna Advisors
(212) 786-7365
info@fortuna-advisors.com