



Doing the right deals

**Why capabilities are more important
than ever for M&A**



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Introduction

How do leaders make deals that work? How do they ensure that the resources they invest—often at a premium to market value—produce worthwhile returns?

We know from our body of research that one of the factors that differentiates successful deals is the same powerful quality that differentiates successful companies: a strategy rooted in capabilities.

What are capabilities?

We define capabilities as the specific combination of processes, tools, technologies, skills and behaviours that allows companies to deliver unique value to their customers. Think about Apple's design capability, Amazon's retail interface design or Frito-Lay's rapid flavor innovation.

As we've [highlighted for some time](#), capabilities-driven companies—those that owe their success to having a powerful set of capabilities that allows them to create unique value for customers—on average outperform their peers. In an age of rapid disruption, as the COVID-19 pandemic and rising ESG (environmental, social and governance) expectations quickly reshape the context in which all businesses operate, putting capabilities at the heart of your strategy plays an even more important role.

Over the past year, PwC examined 800 deals through a capabilities lens, including the 50 largest acquisitions in 16 different sectors completed in the past decade. Our examination was based on research conducted by Bayes Business School (formerly Cass Business School) of City, University of London.¹ We classified deals by whether they leveraged the buyer's capabilities to generate more value from the target (leverage deals), used the target's capabilities to enhance the buyer's (enhancement deals), or largely ignored capabilities (limited-fit deals). We found that both enhancement and leverage deals generate a substantial premium in terms of total annual shareholder return (TSR)—2.5 and 3.9 percentage points above local market index performance, respectively—compared with an underperformance of 10.9 percentage points for limited-fit deals against the local market index (see Figure 1).

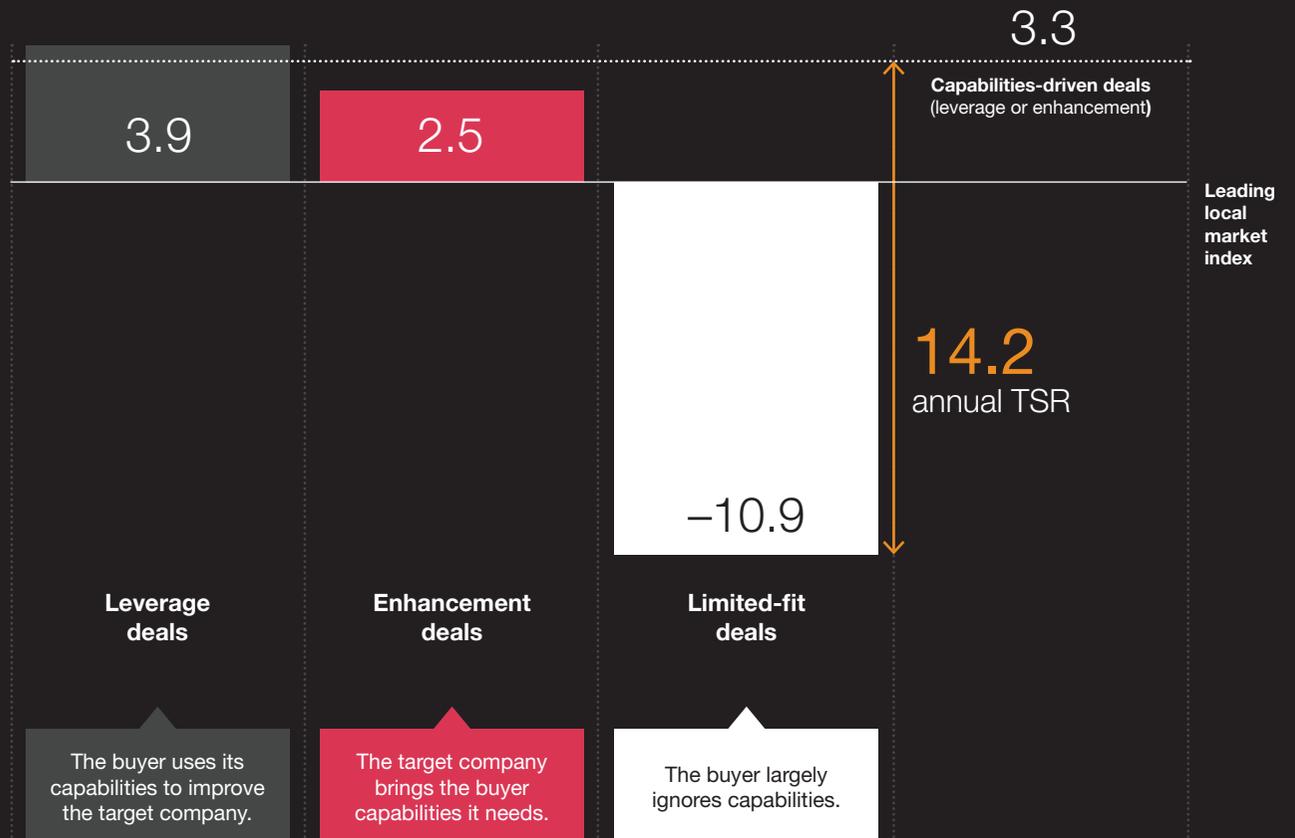
¹ Research by Bayes Business School included the identification of acquisitions and the calculation of deal performance.

These results tell us what happened in the past. But the same lessons apply to the rising number of deals struck in 2021—and beyond. The short-lived, pandemic-induced slowdown in mid-2020 has given way to a surge of deals worldwide, with megadeals such as the AT&T–Discovery merger making global headlines for generating an estimated US\$130bn in combined enterprise value. With **deals running at record levels**, in a market powered by rising share prices, low interest rates and the need for companies to adapt to a world of disruption, the stage is set for a sustained boom in M&A.

In a radically changed post-pandemic world, characterised by geopolitical instability, shifting consumer preferences, accelerated digitisation and new ESG mandates, there is a heightened need for speed and agility. Given the importance of adapting quickly to a transformed environment, organic change is often simply too slow. As a result, the traditional options of ‘build, buy or borrow’ have tipped sharply towards ‘buy,’ which is fuelling M&A activity, and ‘borrow,’ in which companies seek to share capabilities within ecosystems. Companies now need to understand and pursue the steps that will ensure a successful deal.

Figure 1
 Capabilities-driven deals significantly outperform limited-fit deals in total annual shareholder return (TSR)

Average annual TSR above or below local market index performance, in percentage points



Source: Strategy&

Understanding strategic fit and capabilities fit



Deals don't always produce value. PwC research has shown that 53% of all acquisitions underperformed their industry peers in terms of TSR. And as PwC's 2019 report *[Creating value beyond the deal](#)* shows, the deals that deliver value don't happen by accident. Success often includes a strong strategic fit, coupled with a clear plan for how value will be realised.



Armed with that knowledge, we set out to better understand the relationship between strategic fit and deal success. Taking the 50 largest acquisitions completed in 16 different sectors over the past decade, we first analysed the deals' stated strategic intent, as defined in corporate announcements and regulatory filings. Where several intents were present, we used the dominant intent. Then we classified each of the deals as one of the following:

- **Capability access deals**, for which the explicitly stated goal is to acquire some capability that the target has and the acquirer wants
- **Product or category adjacency deals**, in which a company buys a business with a product, service or brand that is related, but not identical, to its existing business categories
- **Geographic adjacency deals**, in which the acquirer uses M&A to expand into a new location
- **Consolidation deals**, which intend to realise synergies and economies of scale, usually between two companies with similar businesses
- **Diversification deals**, which allow companies to enter a new or unrelated sector, typically with the rationale of insulating results against the business cycle.

We then assessed the capabilities fit between buyer and target for each of the 800 deals. We classified each deal as one of the following:

- **Leverage deals**, in which the acquirer buys a company that it knows or believes will be a good fit for its current capabilities system
- **Enhancement deals**, which are designed to bring the acquirer capabilities that it doesn't yet have and that will allow it to expand its own capabilities system
- **Limited-fit deals**, which occur when the acquirer largely ignores capabilities; the transaction doesn't improve upon or apply the acquiring company's capabilities system in any major way.

To measure deal success, we determined the buyer's annualised TSR over a period ranging from just before the deal's announcement to one year post-closing and compared it with the performance of the leading local market index over the same period. We were then ready to determine the correlation between strategic fit—either stated strategic intent or capabilities fit—and deal success.

Quantifying the capabilities premium



The top-line results show that deal success depended significantly on the capabilities fit between the buyer and the target (shown on the right side of Figure 2), and our analysis confirms that both leverage and enhancement deals generated a substantial TSR premium over limited-fit deals.

Indeed, the capabilities premium for both leverage and enhancement deals was a powerful expression of value creation, equal to 14.2 percentage points above limited-fit deals, on average (Figure 1). Leverage deals, in which the buyer uses its capabilities to strengthen the target, performed slightly better on average than enhancement deals, in which onboarding new capabilities often comes with greater complexity. Limited-fit deals had a negative annual TSR compared with the local market indices (-10.9 percentage points), meaning they typically destroyed value compared with the market.

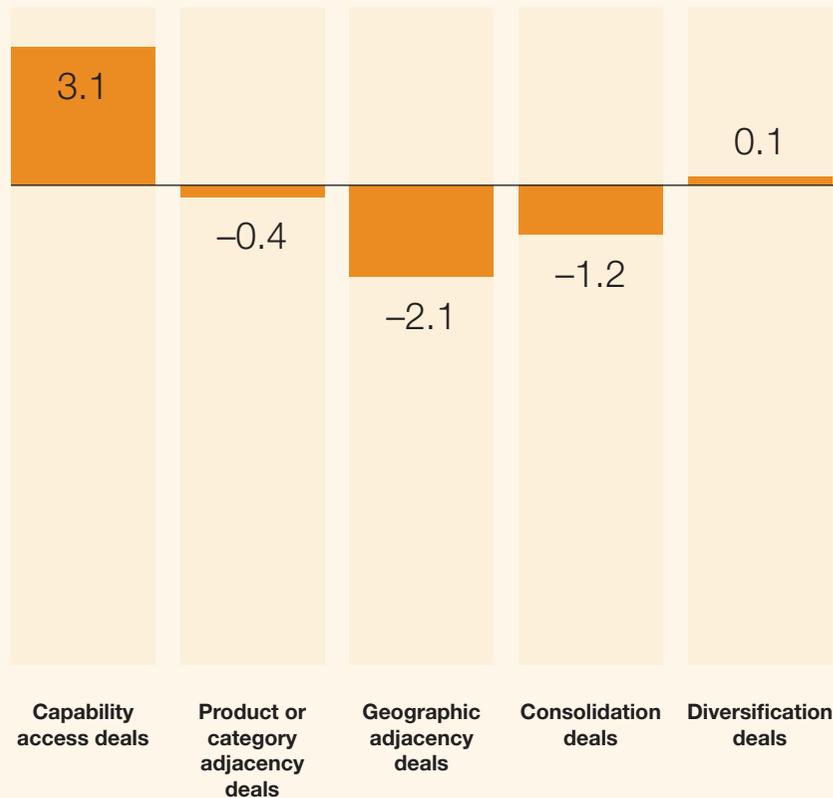
When we analysed deal success versus stated strategic intent, we found that the stated strategic intent (shown on the left side of Figure 2) had little or no impact on value creation, with the logical exception of capability access deals. Whether a deal succeeds depends less on its aim – whether it’s consolidation, diversification or entering new markets. What matters is whether there is a capabilities fit between the buyer and the target.

Figure 2

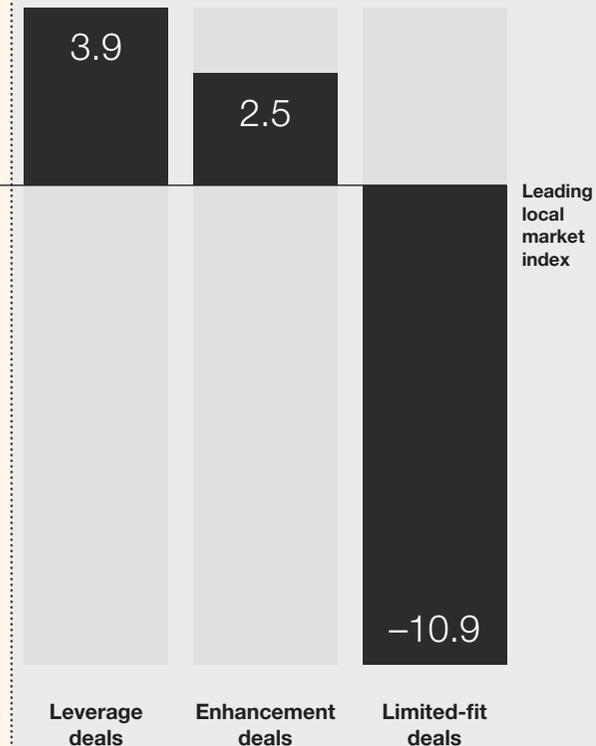
The capabilities fit of a deal is a better indicator of deal success than the stated strategic intent

Average annual TSR above or below local market index performance, in percentage points

Deal performance vs. stated strategic intent



Deal performance vs. capabilities fit



Source: Strategy&

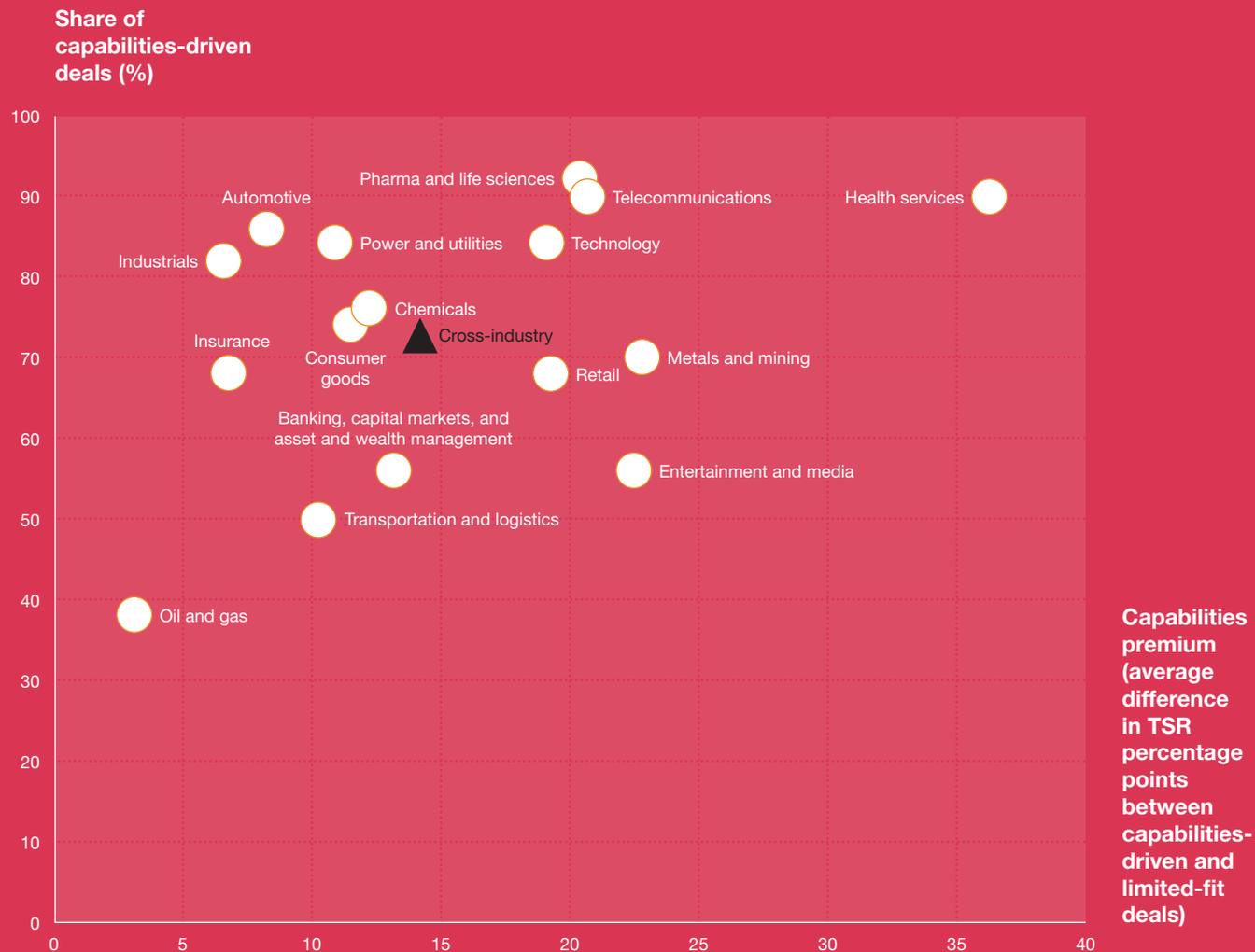
There was little variance among the remaining four types of deal, which on average performed either neutrally or negatively from a value-generation perspective compared with the market. Geographic adjacency deals stood out as performing less well than others, largely because many of them (34%) were limited-fit deals. This seems to indicate that buyers had underestimated what it would take to succeed outside of their existing geographic footprint and overestimated how far their capabilities could travel.

At an industry level, there is a high degree of variability in the frequency of capabilities-driven deals and the size of the capabilities premium (Figure 3). Even so, a positive capabilities premium was evident in each of the 16 industries we analysed, even in those such as oil and gas (in which only 38% of deals were capabilities-driven), wherein asset acquisition can play a significant role in addition to capabilities fit. The share of capabilities-driven deals was highest in the pharma and life sciences industry (92%), in which deals often combine one company’s innovation capabilities with another’s strengths in distribution.

When we examined the prevalence of deals by both stated strategic intent and capabilities fit, the most notable finding was that a full 27% of large deals were limited-fit deals (depicted on the right side of Figure 4). This suggests that for every dollar spent on M&A, roughly 25 cents was spent on such limited-fit deals. Accounting for the 800 deals we considered, this added up to more than US\$900bn in transaction value spent on deals that didn’t fit.

Figure 3

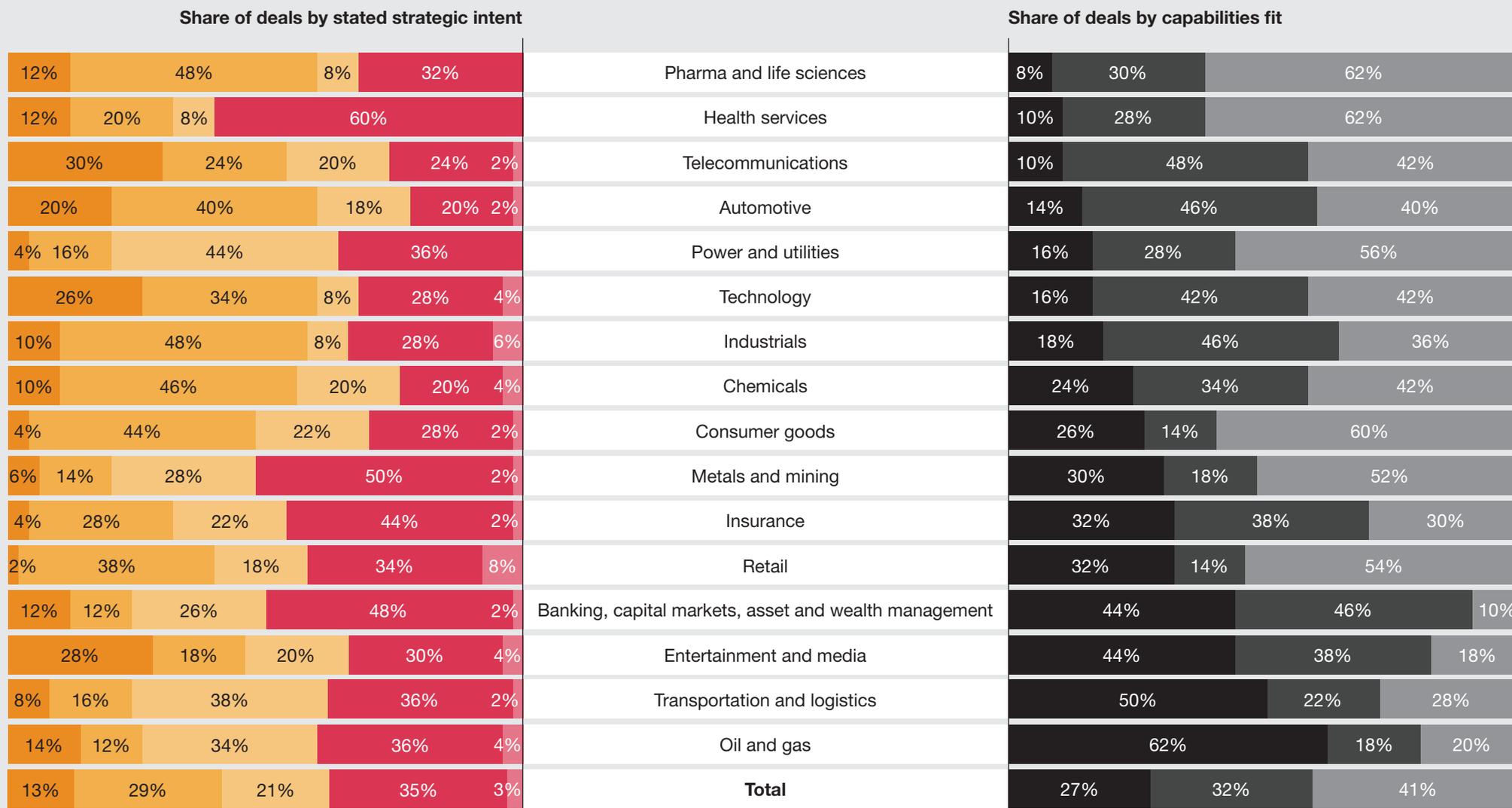
A positive capabilities premium was evident in each of the 16 industries we analysed—but many deals still seem to ignore an important capabilities lens



Source: Strategy&

Figure 4

The prevalence of capability-driven deals varies by industry. In total, more than one-quarter of our sample was limited-fit deals.



■ Capability access
 ■ Product/category adjacency
 ■ Geographic adjacency
 ■ Consolidation
 ■ Diversification

■ Limited fit
 ■ Enhancement
 ■ Leverage

Note: Sums may not total 100 due to rounding.

Source: Strategy&

How do different types of deals create value?



Capabilities leverage deals

In capabilities leverage deals, the buyer leverages its own capabilities to improve what the target company does. Though these tend to be a lower risk than capabilities enhancement deals, they still require the buyer to adjust or adapt its own capabilities to ensure that these work for the target. The proportion of deals falling into this category varies across our 16 industry sectors—ranging from a low of 10% in banking, capital markets, and asset and wealth management to a high of 62% in health services and pharma and life sciences.

Celgene Corporation's acquisition of Abraxis BioScience in 2010 is a good example of a leverage deal in the pharma and life sciences industry. The US\$2.9bn transaction enabled Celgene, a developer of therapies for cancer and inflammatory diseases, to leverage its clinical, regulatory and commercial capabilities to bring to market an innovative breast-cancer treatment developed by the target. There are many examples of smaller pharma deals that fall under the radar of this study that follow the same logic.

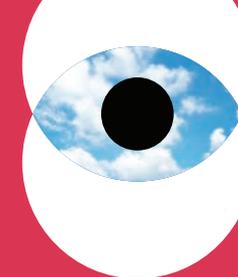
SS&C Technologies' 2018 acquisition of DST Systems offers another perspective on doing a leverage deal. The US\$5bn deal enabled SS&C to both expand its footprint into the US retirement and wealth management industry and leverage its software platform to increase the efficiency and digital capabilities of asset managers.

Capabilities enhancement deals

Capabilities enhancement deals tend to be most prevalent in industries that undergo significant disruption. In such industries, it's vital for companies to acquire new capabilities in order to thrive as a new environment takes shape. In fact, we believe that our study—which looked at only the largest deals—may understate the importance of capabilities enhancement deals, both in terms of their volume and performance. Many of these deals are smaller and fall under the radar of this study. In some instances, M&A integration (and therefore value creation) may take longer to realise than in leverage deals, meaning that our one-year post-close TSR consideration period may not capture the full benefit of deals in the enhancement category.

Looking across the 16 industries in our study, the proportion of M&A transactions categorised as capabilities enhancement deals was highest in telecommunications (48%), followed by automotive; industrials; and the banking, capital markets, and asset and wealth management sectors (all 46%).

Elsewhere, in the technology sector, consider Amazon's US\$13.6bn acquisition of Whole Foods in 2017. The deal gave Amazon the capability to sell in physical outposts, which it used to drive the expansion of its Amazon Fresh stores. Moreover, it provided the retail giant with a new knowledge base in the grocery industry, setting the stage for Amazon to disrupt the category by moving it online. In another high-profile example, Facebook looked to enhance its capabilities when it acquired WhatsApp for US\$19bn in 2014, as it sought to realise a mobile-first strategy by strengthening its messaging capabilities.



Leverage deals at a glance

Number of leverage deals in study:

329

(41% of all deals tracked)

Proportion that earned a premium versus local market index:

56%

Enhancement deals at a glance

Number of enhancement deals in study:

255

(32% of all deals tracked)

Proportion that earned a premium versus local market index:

57%

Limited-fit deals at a glance

Number of limited-fit deals in study:

218

(27% of all deals tracked)

Proportion that earned a premium versus local market index:

28%



Limited-fit deals

Limited-fit deals, which made up 27% of the deals we analysed, had the worst average performance of all categories. Looking across the 16 industry sectors, oil and gas stands out as having the highest limited-fit share, at 62% of all deals in the sector, while pharma and life sciences had the lowest proportion, at just 8%.

Oil and gas—industry acquisitions by overseas buyers—most notably from Europe—in US shale and tight oil provide a cautionary example of the importance of capabilities deals. In these instances, the acquirers had no specific capabilities to enhance the acquired assets, nor did the capabilities of the US asset they bought help them improve the remainder of their operations. It's no coincidence that the vast majority of these deals have not performed well in terms of enterprise value creation.

The banking, capital markets, and asset and wealth management sector had a relatively low level of capabilities-driven deals globally, at 56% of the total. The reality is that many of the acquisitions seen among regional US banks, for example, were more about becoming bigger than becoming better. The power and utilities industry in North America is another sector characterised by a high proportion of limited-fit deals. Many transactions over the past decade have been financial investments betting on the importance of gas versus oil, rather than capabilities-based deals.



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What do our findings mean for the current wave of deals?



Amid the current market turbulence, competitors are racing to capitalise on the window of opportunity presented by the rebound. Companies must be very clear about which capabilities they can leverage to succeed and which gaps in their capabilities they need to fill.

But while the importance of focusing on capabilities intensifies, the need to move quickly also increases the pressure to do M&A at pace—and thereby heightens the risk of failing to evaluate capabilities fit with sufficient care. We think this is a pitfall that acquirers should actively seek to avoid.

The first step is to understand how the M&A playing field has changed. COVID-19 has triggered five main shifts in the global business environment (see ‘Five global changes in the wake of the pandemic’). As companies look to navigate these changes, they should assess their own maturity against each of the five shifts and consider which capabilities they’ll need to address them.

Both the intensified need for agility in business models and the hastened transformation of the workforce point to the need for a new and adaptive mindset and culture. Examples of desirable overarching capabilities in these areas might include the ability to forecast accurately, anticipate change, execute at high pace and future-proof the operating model to be resilient to future shocks.

However, companies tend to build these capabilities organically rather than through M&A.

Conversely, the need to accelerate digitisation points to a host of capabilities that companies may want to acquire. These include customer experience design, digital marketing, e-commerce, the internet of things, app development, data analytics and more. Sustainability similarly maps broadly onto a range of capabilities that companies might seek to gain through deals. Think about recycled packaging production, plant-based ‘meat alternative’ product development, natural ingredients production, battery technology development, etc. Organisations were making progress on sustainability before the pandemic, as they were with digitisation. They must now go further and faster. To do this, they need to better understand the gap between where they are now and what capabilities they need to acquire on their ESG journey—in areas such as decarbonisation, reporting, and meeting new expectations about their governance and role in society.

Of the five changes, the one that represents the clearest break with the past is the stronger focus on supply chain resilience. The pandemic-induced breakdown of global supply chains has shifted the trade-off between efficiency and resilience. This rebalancing is also shaping acquisition strategies (companies may look to diversify their geographical footprint) and merger integration (buyers may choose to keep an acquired business a separate entity rather than integrating it completely).

Five global changes in the wake of the pandemic

COVID-19 has:

-  Accelerated the already rapid pace of digitisation
-  Increased the importance of sustainability
-  Intensified growth opportunities and the need for agility in business models
-  Heightened focus on having resilient, adaptable supply chains
-  Hastened the ongoing transformation of the workforce, including a shift to more remote working

Five steps to maximise the value from deals



Overall, our analysis of these 800 large deals shows the premium that arises for companies that apply a capabilities lens in their M&A activities. How can your company emulate these companies' success? Where do you start if capabilities fit has not been a key driver of your deal-making? We recommend taking five steps:



Determine the capabilities you have and the ones you need. Given your strategy and the way in which you aim to add value for your customers, which capabilities do you need to excel at to succeed now and in the future? Where do you have gaps to fill? To help answer these questions, consider using the [Capabilities Assessment Tool](#), which is designed to enable an organisation to identify the capabilities it has and understand which ones it will need to thrive. Then, you will want to assess what is the best way to fill your capabilities gap—should you build those capabilities organically, or should you acquire or partner with a company that has what you need?



Conduct ongoing portfolio optimisation reviews. Revisit and re-examine your portfolio through a capabilities lens. Are your businesses coherent, i.e., do they leverage a common set of differentiating capabilities? Are there businesses that you should divest because you don't have the capabilities that give you a right to win? Which businesses should you seek to acquire because your strengths would boost them into a whole new league?



Become a prepared, always-ready acquirer. Combine and build on the insights from the first two steps to turn M&A effectiveness into a differentiating capability in its own right for the firm. Have you assessed the universe of potential acquisitions from a capabilities perspective? Do you know which assets in your industry may be a better fit with your capabilities system than with their current owner, or are you overly reliant on advice from investment bankers to identify targets?



Build distinctive M&A integration (MAI) insight and capability. As underlined by PwC's 2020 M&A Integration Survey, *Evolving with agility*, MAI is absolutely critical in delivering value from any deal, but needs to be tailored specifically to each deal's unique attributes and characteristics. Are you integrating a target that will help you enhance capabilities? Or are you integrating a target to leverage your capabilities? In the first case, you need to scrutinise the building blocks of the capability you're acquiring to carefully connect it with your own strengths. In the latter case, you have the opportunity to be more aggressive and to use your capabilities to improve the target. In each instance, a thorough understanding of integration strategy and tactical execution is essential to achieving your deal's true potential.



Be decisive and act now. If an acquisition or division doesn't fit from a capabilities perspective, protect value and management bandwidth by exiting it quickly rather than trying to turn it around. Likewise, if there is a gap in capabilities, you need to act now to fill it, or you will be left behind in the race to win.

Taking these five steps can help ensure a strategic fit that's aligned with your capabilities, dramatically increasing your chances of creating value. And the time to embark on these steps? Today. Because doing the wrong M&A deal is simply not an option.

Research methodology

In our global study, we examined the 50 biggest acquisitions by transaction value completed between 1 January 2010 and 31 December 2018 in each of 16 industries: automotive; banking, capital markets, and asset and wealth management; chemicals; consumer goods; entertainment and media; health services; industrials; insurance; metals and mining; oil and gas; pharma and life sciences; power and utilities; retail; technology; telecommunications; and transportation and logistics. In selecting deals for analysis, we excluded those made by buyers that were not listed on a public stock exchange throughout the one-year post-deal performance measurement period (described in more detail below). We also excluded transactions in which the buyer was involved in another major deal during the performance measurement period, as this might have blurred the impact of the initial deal. The biggest transaction captured by our filter was Anheuser-Busch Inbev's US\$101.5bn purchase of SABMiller in 2016; the smallest was a US\$95m acquisition in the automotive sector in 2017.

To measure the performance of the 800 deals in our research sample, we calculated the acquirer's annualised total shareholder return (TSR)—stock price plus dividends—in the period running from one month before the announcement of the acquisition to 12 months after it closed. This is the time window referred to as the *performance measurement period* in the paragraph above. We limited it to one year because the longer the time frame is, the more 'noise' there will be, and the less attributable share price differences become to the deal itself. We then compared each deal's

performance with the compound annual TSR growth rate of the large-cap index in the acquiring company's home country over the same time frame. The indices we used as benchmarks included the CAC 40 in France, the DAX in Germany, the FTSE 100 in the UK, the S&P 500 in the US and the KOSPI Index in Asia. If the company did not pay any dividends during the period, the TSR was equivalent to the rise or fall in the company's share price.

There was one aspect of the research that required a degree of judgment: the classification of the intent of each deal, and especially the fit from a capabilities perspective. To help us reach a robust view of intent, we drew on corporate announcements, external press coverage and SEC filings. In classifying the deals in terms of capabilities fit, we ultimately relied on our judgment, our analysis and our experience with the companies involved, which enabled us to determine whether each deal fundamentally enhanced, leveraged or largely ignored the acquirer's capabilities.

Inevitably, we found that some deals appeared to have multiple goals—such as aiming both to leverage and to enhance capabilities. In these cases, we allocated the deal to the single category where we believed it had the best fit.

Authors



Alastair Rimmer

Partner, PwC UK

Alastair leads PwC's Deal Strategy practice globally at Strategy&. He has more than 30 years of strategy and transactions experience, and during his consulting career, he has worked extensively across the US, Europe, the Middle East and Asia.



Hein Marais

Partner, PwC UK

Hein is PwC's Global Value Creation leader and Head of UK Transaction Services. His career in the deals market spans more than 25 years. Hein focuses on transactions that involve complex global divestitures and integrations.



Gregg Nahass

Partner, PwC US

Gregg has completed more than 300 transactions in his 30 year career and is a leader in M&A integration services globally for PwC. He is an adjunct professor at the University of Southern California in the Marshall School of Business.

Contributors

We would like to thank the many colleagues who contributed valuable industry insights to our analysis and validated our research. In addition, we would like to acknowledge the particular contribution of our editorial group members for their assistance in producing this report:

PwC

Malcolm Lloyd

Global, EMEA and Spain Deals Leader
Partner, PwC Spain

John D. Potter

US Deals Clients Leader
Partner, PwC US

Will Jackson-Moore

Global Private Equity, Real Assets and
Sovereign Funds Leader
Partner, PwC UK

Strategy&

Peter Gassmann

Global Strategy& Leader
Partner, PwC Germany

Nadia Kubis

Director, PwC Switzerland

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