The Big Idea: The New M&A Playbook

by Clayton M. Christensen, Richard Alton, Curtis Rising, and Andrew Waldeck

Listen to an interview with Andrew Waldeck.

When a CEO wants to boost corporate performance or jump-start long-term growth, the thought can be extraordinarily seductive. Indeed, companies spend more than $2 trillion on acquisitions each year, and a recent study puts the failure rate of mergers and acquisitions somewhere between 70% and 90%. Attempting to explain those abysmal statistics, usually by analyzing the attributes of deals that worked and those that didn’t, is a robust theory that identifies the causes of those successes and failures.

Here we propose such a theory. In a nutshell, it is this: So many acquisitions fall short of expectations because firms incorrectly match candidates to the strategic purpose of the deal, failing to distinguish between those that reinforce operations and those that could dramatically transform the company’s growth prospects. As a result, firms pay too much for the acquisition, integrate the acquisition in the wrong way, and pay too much for the acquisition, and don’t get the returns they were anticipating.

To state that theory less formally, there are two reasons to acquire a company, which executives often confuse with each other. One is to boost your company’s current performance—to help you hold on to a position in the market. The other is to cut costs, and on the other. An acquisition that delivers those benefits almost never changes the game plan because investors anticipate and therefore discount the performance improvements. Firms also become unrealistic about how much of a boost to expect, pay too much for the acquisition, and don’t integrate the acquisition in the wrong way.

The second, less familiar reason to acquire a company is to reinvent your business model and your company. Almost nobody understands how to identify the best targets to achieve that goal and how or whether to integrate them. Yet they are the ones most likely to confound investors.

In this article, we explore the implications of our theory in order to better guide executives in acquisitions and thus dramatically increase their success rate. The first step is to understand means for one company to buy another.

What Are We Acquiring?
The success or failure of an acquisition lies in the nuts and bolts of integration. To foresee how must be able to describe exactly what we are buying.

The best way to do that, we've found, is to think of the target in terms of its business model. A business model consists of four interdependent elements that create and deliver value. The first is the customer element, which helps customers do an important job more effectively, conveniently, or affordably than they do now. The second element is the profit formula, made up of a revenue model and a cost structure that specify how the customer value is created and how much of it will be collected. The third element is the resources—such as employees, products, facilities, and cash—that companies use to deliver the customer value proposition. The fourth element is the manufacturing, R&D, budgeting, and sales. (For more on this business model construct, see Christensen and Henning Kagermann, “Reinventing Your Business Model,” HBR December 1994.)

Under the right circumstances, one of those elements—resources—can be extracted from a company and integrated into the parent’s business model. That’s because resources exist apart from the company (though not necessarily apart from the management team). We call such deals “leverage my business model” (LBM) acquisitions. A company can’t, however, routinely plug other elements of an acquisition’s business model into its own. Formulas and processes don’t exist apart from the organization, and they rarely survive its integration into another firm’s business model, operate it separately, and use it as a platform for transforming my business model” (RBM) acquisition. As we shall see, there is far more growth potential in business models than in purchasing their resources.

Executives often believe they can achieve extraordinary returns by acquiring another firm’s resources. Alternatively, they walk away from potentially transformative deals in the mistaken belief that they destroy the value of a high-growth business model by trying to integrate it into their own. Mistakes are so common and how to avoid them, let’s explore in more detail how acquisition decisions are made:

• improving current performance
• reinventing a business model.

Boosting Current Performance

A general manager’s first task is to deliver the short-term results investors expect through the business. Investors rarely reward managers for those results, but they punish stock values relatively more than they reward them. So companies turn to LBM acquisitions to improve the output of their profit formulas.

A successful LBM acquisition enables the parent either to command higher prices or to reduce costs enough, but the conditions under which an acquisition’s resources can help a company acco...
Acquiring resources to command premium prices.

The surest way to command a price premium is to improve a product or service that’s still de whose customers are willing to pay for better functionality. Companies routinely do this by pu that are compatible with their own products. If such components are not available, then acqu talent—usually in the form of intellectual property and the scientists and engineers who are c product improvement than internal development.

Apple’s $278 million purchase of chip designer P.A. Semi in 2008 is an example of just su had procured its microprocessors from independent suppliers. But as competition with other the competitive importance of battery life, it became difficult to optimize power consumption designed specifically for Apple’s products. This meant that to sustain its price premium, Appl technology and talent to develop an in-house chip design capability—a move that made perf

A Word About Conglomeration

Cisco has relied on acquisitions for similar reasons. Because its proprietary product architect edge of performance, the company has acquired small high-tech firms and plugged their tec product development process. (See the sidebar “Can This Acquisition Help You Command I

Can This Acquisition Help You Command Premium Prices?

Acquiring resources to lower costs.

When announcing an acquisition, executives nearly always promise that it will lower costs. It accomplishes that in only a few scenarios—generally, when the acquiring company has high up profitably.

Whether they are called “roll ups,” “consolidation of shrinking industries,” or “natural resource succeed in the same way: The parent plugs certain resources from the acquisition into its exi the acquired model and shutting down, laying off, or selling redundant resources. The perfor target’s resources in such a way that scale economics can drive down costs.

Here’s a simple example: Many New England homes are heated with oil in the winter. Oil ret deliveries. If one retailer buys a competitor that operates in the same neighborhoods, the par competitor’s customers and can eliminate the duplicate fixed costs of two trucks that serve n critical acquired resource is not the trucks or drivers, which the company does not need to se customers themselves, and they are plug-compatible with the parent’s resources, processes deal will lower the acquirer’s costs.

But if the heating oil company purchased a similar firm in a different city, the acquisition woul position in a new geographic area, not reduce it in either one. There might be some overhead
lowered far less than in the previous example because the oil retailer would need the acquire new customers.

One sees scale-enhancing resource acquisitions like the same-neighborhood oil company does company acquires another so that it can carry the acquired products through its high-fixed-cost. ArcelorMittal buys competing steel companies, transfers production to utilize excess capacity then shuts down redundant mills. Oil and natural gas company Anadarko's 2006 acquisition same pattern. What made Kerr-McGee attractive was the adjacency of its oil fields to Anadarko operate those fields with the same network of pipelines, support ships, and other fixed opera fields been in the North Atlantic and Anadarko's in the Gulf of Mexico, Anadarko would have cost networks to support both operations. This would have resulted only in overhead efficiency managerial complexity.

To work out whether a potential resource acquisition will help lower your costs, you must determine whether resources are compatible with your own and with your processes (see the sidebar “Can This Costs?”) and then determine whether scale increases will actually have the desired effect.

Can This Acquisition Help You Lower Costs?

For companies in industries where fixed costs represent a large percentage of total costs, increases in substantial cost savings, in the same way that the oil company could lower its costs in industries where cost-competitiveness can be reached at relatively low levels of market share that does not reduce its cost position but replicates it, as would a heating oil company that produces in a market city. (See the exhibit “When Will Increased Scale Lower Costs?”) In the polyester fabric industry, companies whose cost structures are dominated by variable costs, resource acquisitions typically improve efficiency and cost reductions to the profit formula.

Similarly, the benefits of scale are most substantial in operating categories that have a high fixed costs in manufacturing, distribution, and sales. Acquisitions that are justified by economies of scale in purchasing, human resources, or legal services often have disappointing effects on the profit. Timesacquired the Boston Globe, for example, there were few operating synergies (reporter separate). The administrative overlaps in areas like HR and finance were not enough to mak
As a general rule, the impact of an LBM acquisition on the acquirer’s share price will be apparent only if the market understands the full potential of both businesses before the acquisition and has had enough time to judge the outcome of the integration and any synergies that may arise. Investors are often much less optimistic about the outcomes of LBM deals, and history generally proves them right: The best-case result is a jump in share price that quickly fades, and hope that LBM acquisitions can unlock unexpected growth, but as we will see, they frequently disappoint.

**The temptation of one-stop shopping.**

A word of warning is in order for companies seeking to boost current performance through LBM customers: All the successful examples we’ve identified involve selling “acquired” customers products to current customers. Acquisitions made for the purpose of cross-selling products succeed only occasionally.

Why? Let’s say Clayton Christensen is a typical shopper, who buys both consumer electronics and hardware. If Walmart, which carries both product categories, has a better chance of winning his business than Best Buy, which sells only consumer electronics, or Home Depot, which sells only hardware? In a word, no. That’s because the two jobs-to-be-done arise at different times: Clayton needs to buy consumer electronics just before birthdays and holidays, whereas he needs to buy hardware on Saturday mornings to fix something at home. Because these two jobs-to-be-done arise at different times, the fact that Walmart sells both products does not give it an advantage over the specialists. Typical shopper Clay does, however, the same time—when he’s on a road trip. Hence, we have seen a convergence of convenience with retail.
other words, an acquisition whose rationale is to sell a variety of products to new customers’ need to buy those products at the same time and in the same place.

More than once, ambitious executives, such as Sanford Weill of Citigroup fame, have asserted thinking that customers’ needs for credit cards, checking accounts, wealth management, and brokerage could be furnished most efficiently and effectively by the same company. Those expectations are again. Each function fulfills a different job that arises at a different point in a customer’s life, so there holds no advantage. Cross-selling in circumstances like these will complicate and confuse, a

Reinventing Your Business Model

The second fundamental task of a general manager is to lay the groundwork for long-term growth. Doing business, since the value of existing business models fades as competition and technology advance. RBM acquisitions help managers tackle that task.

Investors’ expectations give executives a strong incentive to embrace the work of reinventing business models. Mauboussin point out in their book *Expectations Investing* (Harvard Business Review Press) that it is not earnings growth per se that determines growth in their company’s share price—individual investors expect. A firm’s share price represents myriad pieces of information about its predicted cash flows, single number and discounted into its present value. If managers grow cash flows at the rate of 10%, their share price will grow only at its cost of capital, because those expectations have already been built into the price. To persistently create shareholder value at a greater rate, managers must do something—taken into account—and they must do it again and again.

Acquiring a disruptive business model.

The most reliable sources of unexpected growth in revenues and margins are disruptive processes. Disruptive companies are those whose initial products are simpler and more affordable than those products. They secure their foothold in the low end of the market and then move to higher-performance tier by market tier. Although investment analysts can see a company’s potential in the market positioned, they fail to foresee how a disruptor will move upmarket as its offerings improve. So the growth potential of disruptive companies.
To understand how that works, consider Nucor, an operator of steel minimills, which back in simpler and less costly way to make steel than the big integrated steel-makers of the day. In reinforcing bar (rebar), the simplest and lowest-margin of all steel products. Analysts valued rebar market and the profits Nucor could earn in it. But the pursuit of profit drove Nucor to deinvaded subsequent product tiers, commanding higher and higher margins from its low-cost kept having to revisit their estimates of the company’s addressable market—and hence its gr

As a result, Nucor’s share price fairly exploded, as the exhibit “Why Disruptive Businesses A From 1983 to 1994, Nucor’s stock appreciated at a 27% compounded annual rate, as analys had underestimated the markets the company could address. By 1994, Nucor was in the top up with its growth potential. Even though sales continued to increase handsomely, that accruing “discountability,” caused Nucor’s share price to level off. If executives had wanted the comp appreciating at rates in excess of analysts’ expectations, they would have had to continue to businesses.

A company that acquires a disruptive business model can achieve spectacular results. Take, technology giant EMC’s acquisition of VMware, whose software enabled IT departments to π
single machine, replacing server vendors’ pricey hardware solution with a lower-cost softwar
disruptive to server vendors, it was complementary to EMC, giving the storage hardware ven
customers’ data rooms. When EMC acquired VMware, for $635 million in cash, VMware’s re:
With a disruptive wind at its back, VMware’s growth exploded: Annual revenues reached $2.1
stake in VMware is worth more than $28 billion, a stunning 44-fold increase of its initial inves

Johnson & Johnson’s Medical Devices & Diagnostics division provides another example of h
through acquisition can boost growth from average to exceptional. From 1992 through 2001,
performed adequately, growing revenues at an annual rate of 3%. But during the same perio
but disruptive business models that ignited outsize growth. Together these RBM acquisitions
period, fundamentally changing the division’s growth trajectory. (See the sidebar “ Can This ,
Company’s Growth Trajectory?”)

Can This Acquisition Change Your Company’s Growth Trajectory?

Acquiring to decommoditize.

One of the most effective ways to use RBM acquisitions is as a defense against commoditiz:
previous in this magazine, the dynamics of commoditization tend to follow a predictable pal
Michael Raynor, and Matt Verlinden, “Skate to Where the Money Will Be,” HBR November
profitable point in the value chain shifts as proprietary, integrated offerings metamorphose in:
The innovative companies supplying the components start to capture the most attractive mar

If a firm finds itself being commoditized in this way, acquisitions won’t improve the output of i
will. Firms in this situation should instead migrate to “where the profits will be”—the point in tl
best margins in the future. Right now, the business models of major pharmaceutical compan
reasons, including their inability to fill new-product pipelines and the obsolescence of the dire
leaders like Pfizer, GSK, and Merck have tried to boost the output of their troubled business
the products and pipeline resources of competing drugmakers. But in the wake of such acqu
plummeted 40%. A far better strategy would be to focus on the place in the value chain that i
management of clinical trials, which are now an integral part of the drug research process an
pharmaceutical companies. Despite this, most drugmakers have been outsourcing their clinic
organizations such as Covance and Quintiles, better positioning those companies in the valu
organizations, or a disruptive drugmaker like Dr. Reddy’s Laboratories, would help reinvent t
model.

Paying the Right Price

Given our assertion that RBM acquisitions most effectively raise the rate of value creation for
acquirers typically underpay for those acquisitions and overpay for LBM ones.
The stacks of M&A literature are littered with warnings about paying too much, and for good reason: deal fever has caught up in deal fever and paid more for an LBM deal than could be justified by cost savings. It is crucial to determine the target’s worth by calculating the impact on profits from the acquisition. That said, the stock price will increase, but only to a slightly higher plateau, with a gentle upward trend weighted-average cost of capital, which for most firms is about 8%. In contrast, consider the “Disruptors,” which charts the average earnings multiple of 37 companies we’ve determined to be overvalued after they went public. Annual P/E ratios for this group are far higher than historical levels, leading investors to believe that shares were overpriced. Yet investors who purchased at the time of the IPO and held the stock for six months saw astounding 46% annual return, indicating that the shares were persistently underpriced, even after accounting for growth.

Analysts charged with determining the right price for a company’s shares work hard to find a fair price. However, such comparables make disruptive companies seem overpriced, deterring companies from acquisitions they need for reinvention. In reality, the right comparables for disruptive companies are different from those of traditional companies, regardless of industry.

Ultimately, the “right” price for an acquisition is not something that can be set by the seller, looking to sell to the highest bidder. The right price can be determined only by the buyer, since the buyer will serve.

Avoiding Integration Mistakes

Your approach to integration should be determined almost entirely by the type of acquisition. If you are looking for the purpose of improving your current business model’s effectiveness, you should consider how to make the most use of the acquired company as its resources are folded into your operations. That’s what Cisco does with the great acquisitions. (There are certainly exceptions: An acquired process, for instance, is sometime a substitute for or is added to the acquirer’s.) But if you buy a company for its business model intact, most commonly by operating it separately. That’s what Best Buy did with Geek Squad. Best Buy focused business model as a separate business alongside its low-margin, low-touch retail operations. The focused business model was distinct enough from EMC’s storage model that EMC chose not to integrate it into its own business model, allowing EMC’s original business model to continue to grow at an exceptional rate.
Failing to understand where the value resides in what’s been bought, and therefore integrating it, is one of the biggest disasters in acquisitions history. Daimler’s 1998 acquisition of Chrysler for $36 billion is a prime example. Although the purchase of one car company by another looks like a classic resource acquisition, it is not. From about 1988 to 1998, Chrysler had aggressively modularized its products, outsourcing many of the components. This so simplified its design processes that it could design a car at half the time compared with Daimler required. As a result, during this period Chrysler introduced a series of very popular new models, which translated into market share every year.

When Daimler’s acquisition of Chrysler was announced, analysts began the “synergies” drumbeat. They predicted that integrating the companies would strip out $8 billion in “redundant” costs. But when Daimler began (brands, dealers, factories, and technology) into its operations, the real value of the acquisition (innovative business models and a lean profit formula) disappeared, and with it the basis for Chrysler’s success. Daimler was forced to preserve Chrysler’s business model as a separate entity.

Companies rightly turn to acquisitions to meet goals they can’t achieve internally. But there is a danger. Companies can make acquisitions that allow them to command higher prices, but that have raised prices all along—by improving products that are not yet good enough for the market. They can make acquisitions to cut costs by using excess capacity in their resources and processes, but again, only in the same way they could have by finding new customers on their own. And they can make acquisitions to serve as platforms for transformative growth—just as they could if they developed those business models themselves. At the end of the day, the decision to acquire is a question of whether it is faster and cheaper for you to make something that you could, given enough time and resources, make yourself.

Every day, the wrong companies are purchased for the wrong purpose, the wrong measures are taken, the wrong deals are made, and the wrong elements are integrated into the wrong business models. Sounds like a disaster? But it need not be. We hope that the next time an investment banker knocks on your door with the acquisition of a lifetime for you, you’ll be able to predict with greater accuracy whether the deal is a deal or a debacle.

**Clayton M. Christensen** (cchristensen@hbs.edu) is the Robert and Jane Cizik Professor at Harvard Business School. **Richard Alton** (ralton@hbs.edu) is a senior researcher at the Innovation at Harvard Business School. **Curtis Rising** (rising@harvard2.com) is the managing director of Square Partners, a consulting practice focused on inorganic growth and leadership assessment. **Andrew Waldeck** (awaldeck@innosight.com) is a partner at Innosight, a consulting firm in Watertown, Massachusetts.