McKinsey & Company

Strategy & Corporate Finance Practice

The power of through-cycle M&A

How companies can use deal making to accelerate strategic shifts during the COVID-19 crisis.

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April 2020

Meeting the humanitarian challenge of COVID-19 is the imperative of our time. While healthcare workers and first responders battle the virus, risking their lives to save others, business leaders have a different but related mandate: to protect the health and safety of employees and customers while preserving people's livelihoods.[1]

The companies that can quickly adjust their strategies to the economic and humanitarian shocks of the pandemic will be best positioned to emerge from the crisis healthy and profitable. Our experience and two decades of research show that a through-cycle mindset to M&A can enable and even accelerate these strategic shifts. History has shown that outperformers actively reserve cash and invest—organically and inorganically—through downturns. In this article, we examine how companies can use M&A to better weather the current economic storm and come back stronger in the "next normal."[2]

A fog of uncertainty surrounds this moment, but our research into resilient companies reveals a few truths that can help businesses prepare to move when the mist lifts: continue to invest through downturns, especially in M&A; pursue programmatic M&A through economic cycles; and adjust corporate and M&A strategies rapidly to adapt to a changing world.

Keep investing—even in downturns

The global scale of the crisis, the wide ranges of disease progression, the likelihood that the next normal will require new strategies—these and many other factors are behind the fog of ambiguity enveloping industries today. To cut through this ambiguity, business leaders will need to explore a range of scenarios and develop plans to navigate them.[3]

As we write this, few business leaders have the confidence to finance, approve, or execute transactions. Indeed, fewer than half as many transactions were completed in March 2020 than in March 2019, and many have been put on hold or pulled. The depth of this M&A pullback was highlighted the week of April 13, 2020—the first week since September 2004 that no deal larger than $1 billion was announced.[4]

M&A activity is likely to continue to be limited in the short term given the critical focus on employee safety, financing challenges, and volatile valuations. But we believe business leaders should heed lessons from M&A trends during the dot-com crash and the 2008 financial crisis (Exhibit 1).

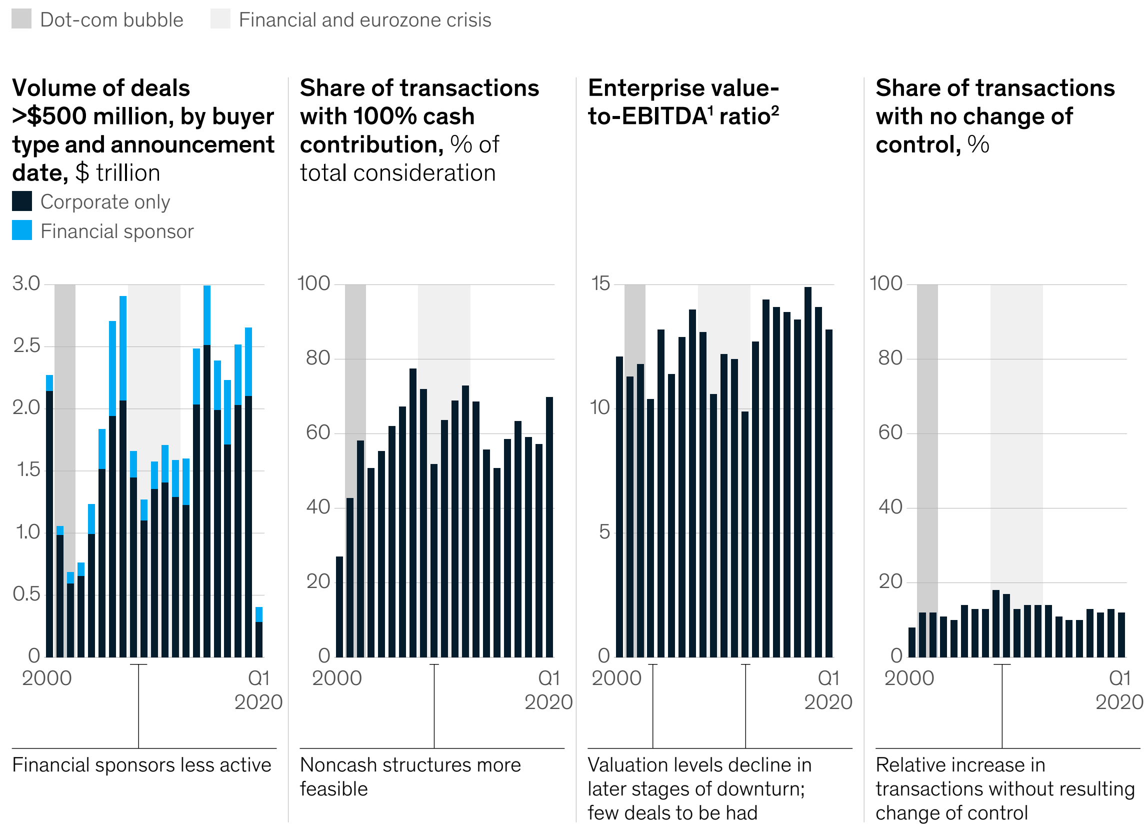
The total value of transactions declined by between 40 percent and 60 percent, especially in financial-sponsor activity. M&A practitioners with through-cycle mindsets kept making deals, however, benefiting from lower valuations in the later stages of the crises and then accelerating their activity from 2009 through 2012. They also pursued a broader range of transaction types, including minority investments and partnerships; used more noncash structures; and accepted higher-leverage ratios.

The COVID-19 crisis is unique, of course, and the current economic contraction will not evolve in exactly the same way previous downturns did. At some point, however, deal making will resume. The combination of unprecedented economic stimulus packages, low interest rates, and strong signaling from central banks may help cushion the blow and eventually jump start investment and consumer spending. Additionally, prices have fallen sharply for a range of commodities from oil and copper to lumber, which may help enable growth in many industries.

[1] Kevin Buehler, Arvind Govindarajan, Ezra Greenberg, Martin Hirt, Susan Lund, and Sven Smit, "Safeguarding our lives and our livelihoods: The imperative of our time," April 2020, McKinsey.com.
[2] Shubham Singhal and Kevin Sneader, "The future is not what it used to be: Thoughts on the shape of the next normal," April 2020, McKinsey.com.
[3] Yuval Atsmon, Chris Bradley, Martin Hirt, Mihir Mysore, Nicholas Northcote, Sven Smit, and Robert Uhlaner, "Getting ahead of the next stage of the coronavirus crisis," March 2020, McKinsey.com.
[4] Kane Wu, "Coronavirus takes toll on global M&A as $1 billion deals disappear," Reuters, April 20, 2020.

Exhibit 1

Lessons from past downturns can be instructive in the COVID-19 era.



[1] Earnings before interest, taxes, depreciation, and amortization. [2] NTM multiple, only available for selected public transactions (NTM = financial measure buyer considers for company valuation).
Source: S&P Capital IQ

Pursue programmatic M&A through cycles

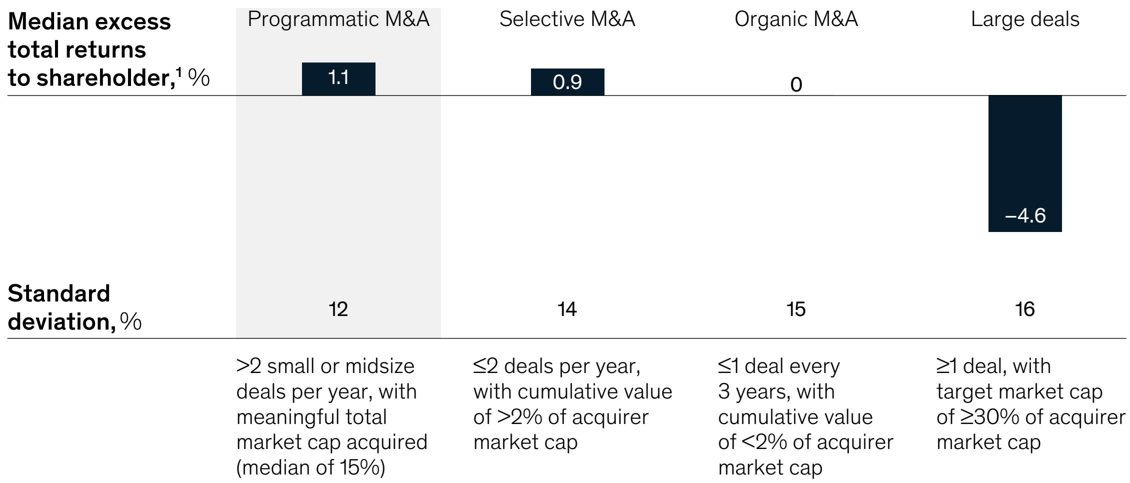
The overall cycle of M&A is volatile; deal making typically declines during an economic shock and picks up again as the recovery begins to take hold. No one knows when the current crisis will end, or exactly how it will reshape markets or human behaviors. However, we do know that during the last downturn the companies that used a programmatic approach to M&A delivered excess returns with less volatility than did companies that used other approaches to M&A (Exhibit 2). This is consistent with more than 20 years of McKinsey research on programmatic M&A (see the box "Understanding the value of programmatic M&A").

Understanding the value of programmatic M&A

Our more than two decades of research into the Global 2,000, the world's largest public companies by market capitalization, shows that through-cycle "programmatic M&A"—making many relatively small transactions as part of deliberate and systematic M&A programs—delivers far more total returns to shareholders on average than other approaches, including organic growth and "big bang" deals, with less volatility and risk. The findings suggest that most companies should continue their active portfolio management, and, on average, a programmatic approach performs best, even in an economic downturn.

Exhibit 2

Companies that pursued programmatic M&A during the last recession outperformed peers.



[1] Companies that were among the top 2,000 companies by market capitalization as of Dec 31, 2007 (>$3.7 billion) and were still trading as of Dec 31, 2017; excludes companies headquartered in Africa and Latin America.

Source: S&P Capital IQ; McKinsey analysis

The companies most likely to emerge strongly from the COVID-19 crisis will be those agile enough to adapt to their unique situations and pivot their M&A activities before the next normal arrives.

We have also found that, among companies practicing programmatic M&A, those who were more aggressive about reshaping their portfolios divested more in the last downturn.[5] While volatility is high, our review of recent data also suggests that, from January 2019 through March 2020, the programmatic approach to M&A outperformed all others.

Update corporate and M&A strategies—now

The companies most likely to emerge strongly from the COVID-19 crisis will be those agile enough to adapt to their unique situations and pivot their M&A activities toward the most relevant and attractive opportunities *before the next normal arrives*. This

[5] Jeff Rudnicki, Kate Siegel, and Andy West, "How lots of small M&A deals add up to big value," July 2019, McKinsey.com; and Martin Hirt, Kevin Laczkowski, and Mihir Mysore, "Bubbles pop, downturns stop," May 2019, McKinsey.com.

will require a reassessment of their position in three areas: competitive advantage, capacity, and conviction. These three C's are the foundation for maximizing the value of M&A (Exhibit 3) (see the box "A checklist for maximizing the value of M&A").

A checklist for maximizing the value of M&A

By focusing on three C's—competitive advantage, capabilities, and conviction—deal makers and executives can better manage their M&A program and use them as a means to weather the economic downturn resulting from COVID-19.

Competitive advantage

1. Determine the effect of COVID-19 shocks on overall strategy and business portfolio.

2. Reevaluate two or three priority M&A themes to support the updated strategy.

3. Redefine deal-screening criteria with updated M&A themes to refresh target lists.

Capabilities

4. Update "dry powder" analysis to account for changes that may limit the company's ability to pursue transactions.

5. Develop alternative deal structures to manage valuation volatility and liquidity challenges.

6. Retool integration approaches based on refreshed M&A themes and COVID-19-induced execution challenges.

Conviction

7. Secure executive and board commitment to M&A to accelerate decision making when markets thaw.

8. Build a through-cycle valuation perspective to enable transactions during the crisis.

9. Review the full landscape of potential targets before rushing to assess distressed assets.

10. Carefully choreograph outreach to targets and tailor the value proposition to acknowledge the crisis.

Rethinking competitive advantage

The COVID-19 crisis will test every corporate strategy because its depth and scope exceed anything we have seen previously. Like the Great Depression and the world wars, it will drive lasting change in people's and organizations' perceptions and behaviors.

In the business realm, leaders will need to determine what is fundamentally changing in terms of market performance and outlook: which market shocks are temporary, and which are permanent; which require immediate action to manage risk, and which create new long-term opportunity.

M&A is a fundamental enabler of corporate strategy, and in our experience, the most successful senior leaders can describe exactly how and why M&A contributes to the company's performance. They see the direct links between M&A strategy and corporate strategy, and they update and refine their M&A priorities to support specific corporate goals.

As they think about deal making during the pandemic, executives should understand the areas in which M&A is the most effective tool to meet the company's strategic goals and how the company's distinct capabilities could add more value to M&A targets. The most effective companies will develop very detailed approaches for executing in priority areas, including identifying specific deal-screening criteria to narrow the range of potential targets (Exhibit 4).[6]

Assessing capacity in a changing environment

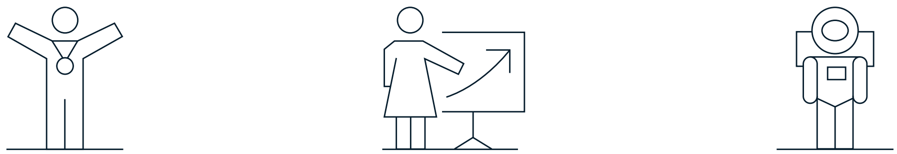
Every crisis demands tremendous organizational capacity—to ensure safety, stability, continuity, and clear communications. M&A, too, requires capacity. Acquisitions require financing, of course, but companies also need the talent, systems, and governance to deliver on the promise of each new asset. In a challenging and rapidly changing environment such as this one, acquirers must conduct a thorough assessment of their capacity to execute deals and integrate or separate from assets. They should consider the following criteria when assessing M&A capacity:

Update 'dry powder' analysis. Estimate how much capital can be reasonably deployed for M&A in the

[6] Sophie Clarke, Robert Uhlaner, and Liz Wol, "A blueprint for M&A success," April 2020, McKinsey.com.

Exhibit 3

Successful M&A programs in a downturn demonstrate three main characteristics.



Competitive advantage
Reassess competitive position given economic, industry, and strategic shocks

Capacity
Assess financial and operational capacity to finance, structure, execute, and integrate M&A transactions in a complex and changed environment

Conviction
Build up organizational commitment to M&A despite new or competing priorities; prepare for action

current environment, acknowledging that it has changed but that it should not be zero in most cases. An assessment of the current capital structure should include a look at leverage and equity ratios, debt covenants, rating requirements, and investor expectations. Financial capacity may change quickly, so this assessment should involve a range of scenarios and input from all members of the management team.

To expand M&A capacity, look toward various sources of financing—internal sources, as well as debt and equity financing. Internal financing in times of crisis might include explicitly prioritizing M&A over other previously approved capital investments or reducing capital allocations to shareholders, especially by slowing share buybacks. Investors are not likely to see dividend reductions as suitable M&A financing. Leaders raising debt or equity should carefully assess lenders' and capital markets' receptiveness and the achievable pricing, given expanding debt spreads and depressed equity valuations. Accelerated equity financing at lower levels can lead to higher dilution of current shareholders and therefore needs to be marketed to investors with a crystal-clear rationale and equity story.

Develop alternative deal structures. Given the current volatility in valuations and companies' liquidity challenges, acquirers may need to consider a broader range of deal structures (see the sidebar, "An overview of deal structures"). The optimal structure for a deal is one that helps both sides manage uncertainty and share risks and rewards. Some companies will forge new partnerships to access capital, particularly with asset-management and private-equity firms with dry powder and an appetite for deals. An important consideration with alternative deal structures is to make sure that terms do not undermine the acquirer's plans to integrate the target.

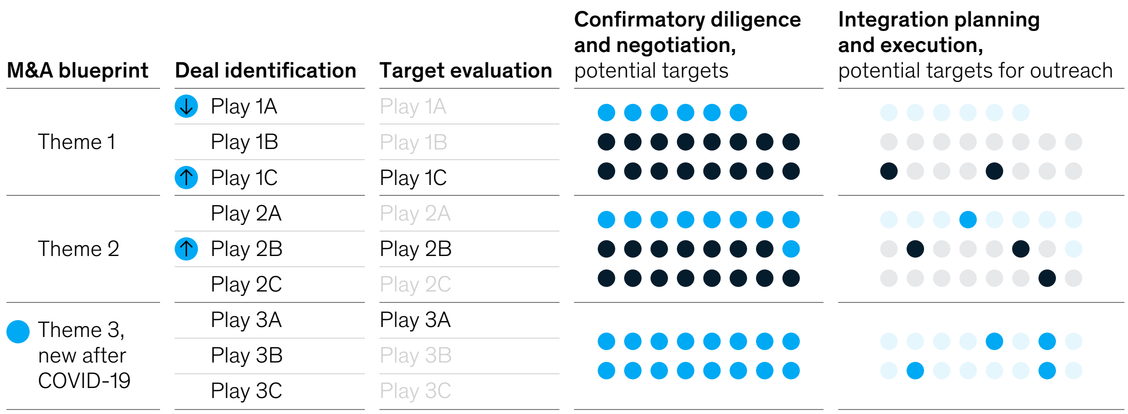
Revise integration approaches. To pursue new M&A themes and to manage crisis-induced execution challenges, many acquirers will need to update their integration tools and approaches. For instance, the business may need to refocus on value creation as leaders scramble to get back to precrisis operational levels. Deals may invite more regulatory scrutiny and take longer to approve. To that end, acquirers should consider readjusting their preclose-integration planning and timelines to stay flexible and manage potential delays. They will also need to actively manage the expectations of key stakeholders, including employees and capital markets. Financial and operational pressures could trigger the need for immediate restructuring of acquired targets.

And finally, bridging corporate cultures, which is challenging in the best of times, will be difficult when in-person interactions are limited or impossible. Personalized approaches, such as scheduling more one-on-one and small-group videoconferences, will likely be the most successful ones. Senior leadership can use

Exhibit 4

To account for COVID-19 effects, companies should update M&A themes, screens, and target lists.

Deal-sourcing, execution, and integration process



Theme Area in which the company needs M&A to deliver its strategy and has the ability to add value to targets

Play Detailed plan for how the company will execute on its M&A theme and create value

Target Specific company or asset to be pursued by acquirer

An overview of deal structures

Different types of deal structures can help balance risks and benefits between buyers and sellers. It is helpful to view potential structures along the following three dimensions:

Upside for sellers

— *Earn out structures.* The deal emphasizes elements of the purchase price that are based on financial success after the sale—for instance, sales or profitability growth achieved.

Upside for sellers and downside protection for buyers

— *Seller to retain stake.* The deal involves minority investments or "less than 100%" transactions that can be combined with strategic partnerships.

— *Vendor notes.* The seller provides a loan to the buyer to help finance parts of the purchase price; often combined with earn-out structure which determines final redemption.

— *Option structures.* Buyers and sellers are allowed to exercise various options in case financial metrics are over- or underdelivered after sale.

— *Relative contributions.* The transaction is based on cash flow and EBITDA contribution instead of a share-price exchange ratio or premium.

— *Swaps and in-kind structures.* In this noncash transaction, complete assets are traded or deals are centered on in-kind contributions (including shares).

Downside protection for buyers

— *Specific warranties.* The seller provides expanded guarantees—for example, regarding the nature of business, historical financials, or litigation and environmental risks.

— *Phased payments.* The purchase price is paid in multiple installments, potentially linked to buyers achieving key milestones after sale.

these channels to address critical integration questions while frontline leaders work virtually with their newly formed teams to get to know one another and manage day-to-day issues. Companies should plan for a second deliberate phase of cultural integration once the crisis wanes and employees begin to return to work as normal.

Finding and building conviction

Confidence and boldness are scarce in every crisis, but the ability to act quickly and decisively is the key to successful M&A. In our experience, the best acquirers commit to clear strategies, avoid deals that may look good financially but do not quite fit into those strategies, and prepare to execute before the fog lifts.

Secure commitments to accelerate decision making. Senior managers and the board will need to gain agreement on the importance of M&A in the crisis and postcrisis strategy, even as they are addressing other urgent priorities. They should jointly clarify how the crisis requires a shift in strategy and how M&A and its specific themes will enable the company's outperformance in the next normal.

To establish the capacity and focus needed for M&A, senior leaders should make the case for through-cycle M&A valuation and manage expectations by setting financial guardrails and defining boundary conditions. They should also identify who will lead the execution of M&A, from target identification and outreach to integration. To maintain alignment and flexibility, many leaders will conduct regular M&A working sessions with key decision makers in which they discuss potential targets and priorities.

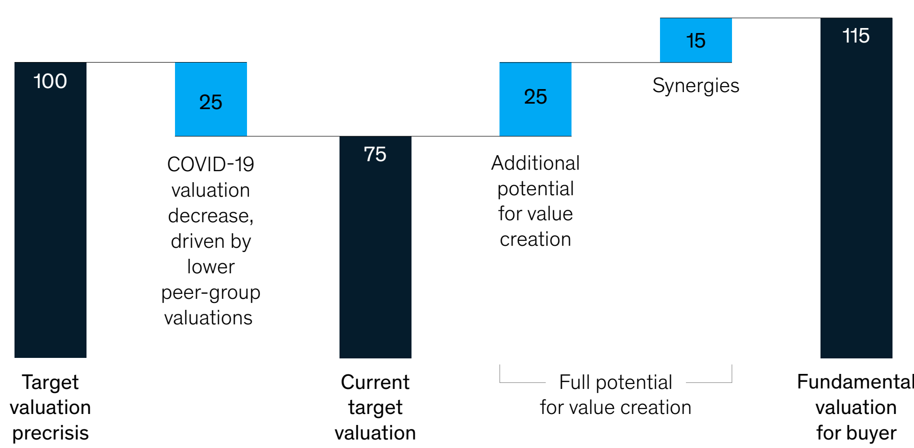
To remove decision-making roadblocks, some companies will streamline their governance and formal approval processes, set clear milestone deadlines, convene promptly when necessary rather than at a set cadence, and convey a sense of urgency based on early-mover advantages. Updates on M&A should be a recurring item on executives' and boards' agendas.

Build a through-cycle valuation perspective. A target's lower valuation may attract a buyer, assuming no fundamental changes to the underlying business, but the owners of the target may be fixated on precrisis valuation (Exhibit 5). To make the transaction possible, the buyer may need to convey the additional through-cycle value-creation potential from the deal and raise the premium and propose creative structuring for the deal.

Exhibit 5

Understanding the fundamental value of a target is key to a successful deal.

Valuation breakdown, illustrative, indexed to 100



Buying a distressed asset that is inconsistent with strategy will likely not create the value expected and could distract from other pursuits.

Develop comprehensive target lists for each M&A theme. The most successful acquirers look beyond obvious targets, including distressed assets, and carefully study the broader landscape to find the most suitable candidates in the context of their prioritized M&A themes.[7] They, of course, ensure that any acquisition is anchored in strategy. Buying a distressed asset that is inconsistent with strategy will likely not create the value expected and could distract from other, more strategic pursuits.

Reach out to priority targets with unique, tailored value propositions. Acquirers should be forthright about why a deal makes sense now. Examples of tangible advantages may include a strong balance sheet, reliable infrastructure, resilient supply chain, trusted brand, and effective sales force. In addition to appealing financials, a compelling pitch usually features an exciting vision tailored carefully to the target, including a clear business case built on common goals, values, and a commitment to invest in the business.

These conversations are the basis for proactive deal sourcing—going beyond discussions of assets and prices to cultivate relationships and present a compelling value proposition that spells out the deal's benefits to the target and its stakeholders. Internally, business leaders should identify and gain agreement on what is nonnegotiable before beginning conversations with targets. A single senior leader should manage executive interactions with each target, using intermediaries sparingly. In the end, most successful deals are built on trust and shared values, not price per share.

Uncertainty from COVID-19 and the human toll it is taking make this crisis much more worrisome than many previous global challenges. It's unclear how long the pandemic will last, when a treatment or vaccine will be discovered or widely available, or how much economic pain we will experience at the global, national, local, or personal level.

The situation will remain fluid, but we know some things for certain: the fog will lift, and when it does, the companies positioned to execute through-cycle M&A strategies quickly—those who have done the homework on their strategies and have strong balance sheets and a through-cycle mindset—will be able to deliver more value for shareholders, employees, customers, and the communities in which they do business, and can help speed the global recovery.

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The authors wish to thank Patrick McCurdy, Philipp Espel, Manny Fragata, Tobias Lundberg, Kate Siegel, Robert Uhlaner, and Liz Wol, for their contributions to this article.

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[7] An M&A theme is an area in which the company needs M&A to deliver its strategy and has the ability to add value to targets.