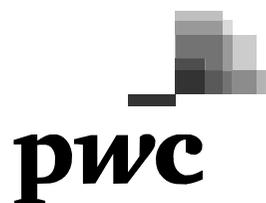


The Capabilities Premium in M&A



Deals That Win



Many executives struggle with developing and executing strategies successfully

More than half of senior executives don't think they have a winning strategy



4 out of 5 executives admit their overall strategy isn't well understood within their own company!

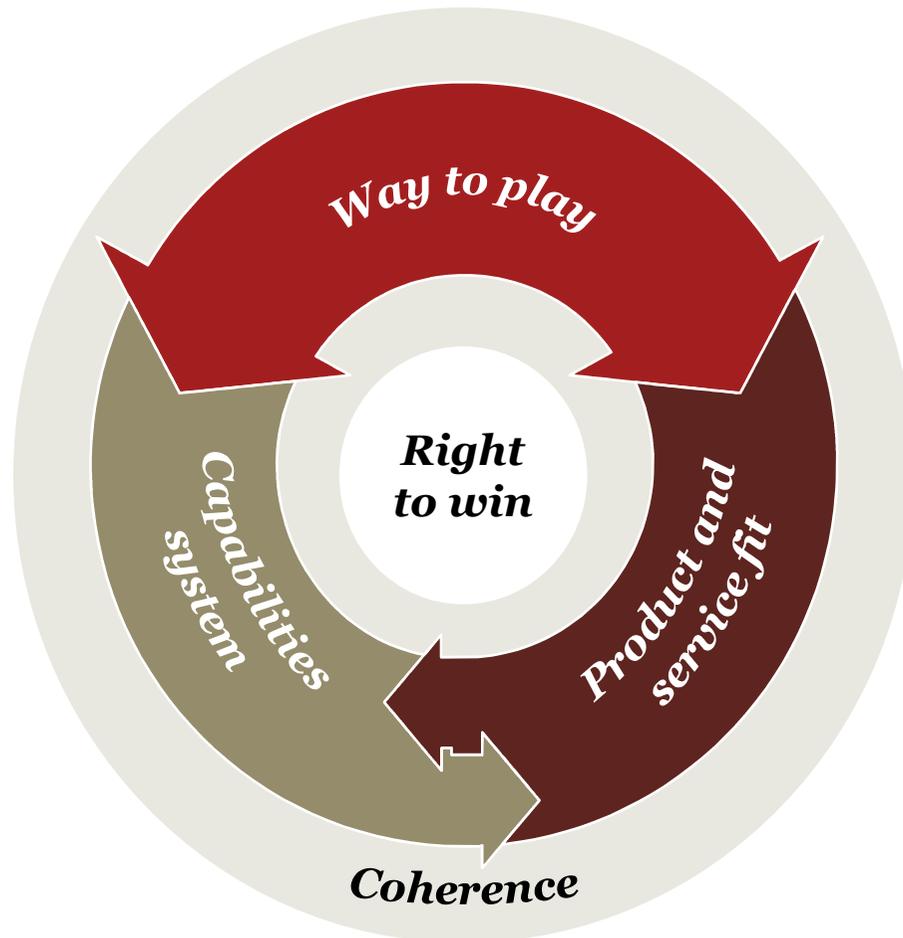


2 out of 3 admit they don't have the capabilities needed to create value

9 out of 10

Concede they are missing major opportunities in the market

Winning companies are coherent and align their strategic direction to the capabilities that make them unique



Way to Play

Successful companies have a clear understanding of the way they create value for customers

→ **How are you going to face the market?**

Capabilities System

The engine of value creation is the system of 3-6 differentiating capabilities that allow companies to deliver their value proposition

→ **What gives you competitive advantage?**

Product & Service Fit

Companies with products and services that leverage a similar capabilities system have superior returns

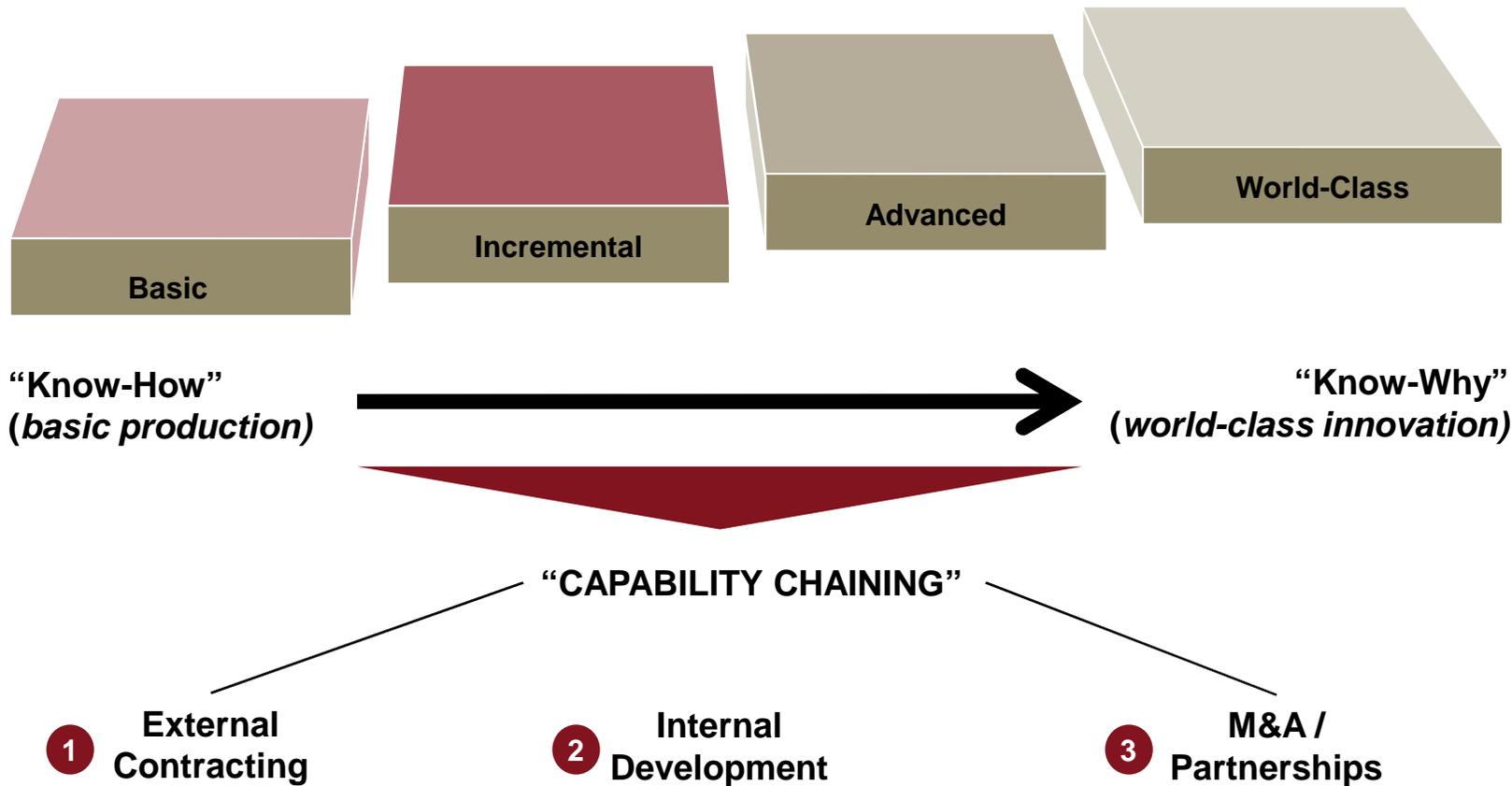
→ **What are you going to sell and to whom?**

While conceptually simple, this idea is quite different from the traditional “market-back” approach to strategy

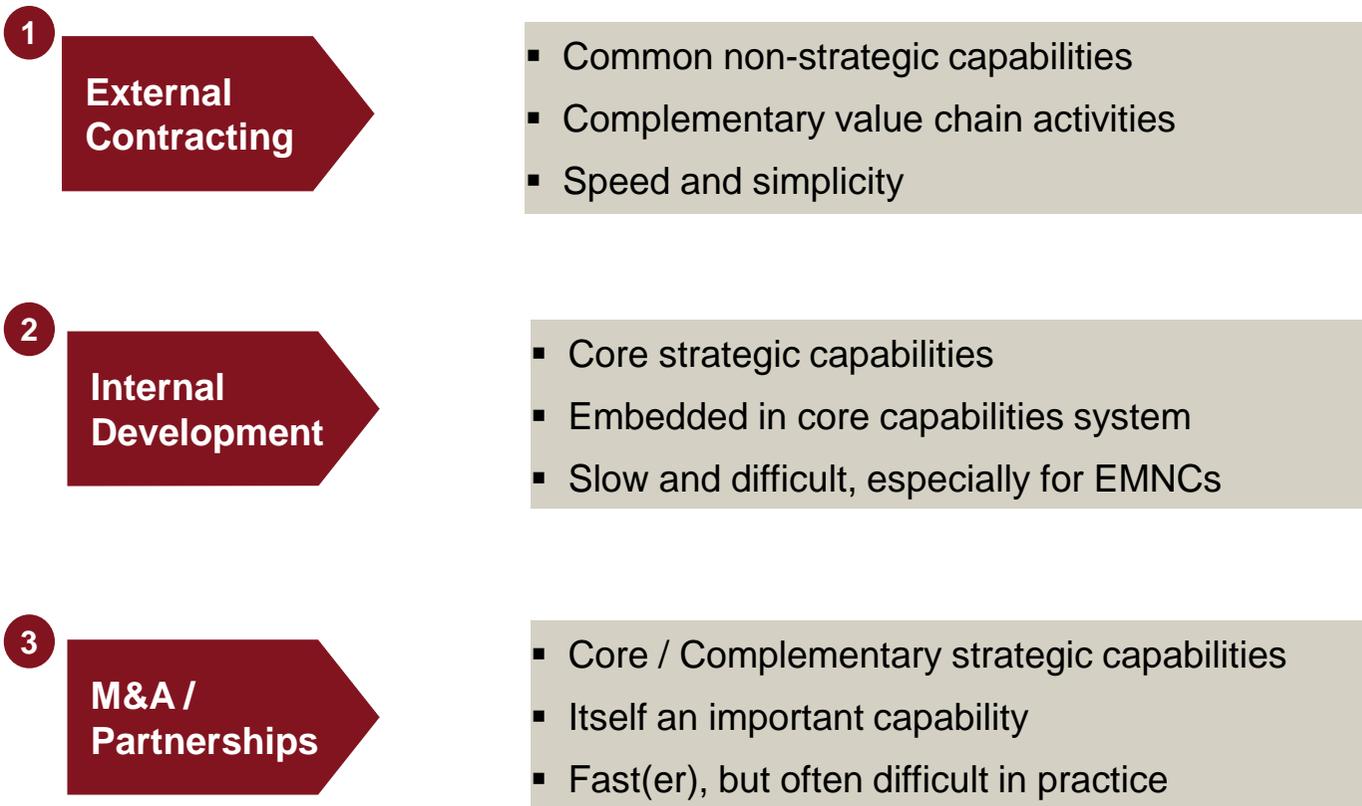
Capabilities-Driven Strategy – Conceptual Foundation

- The underlying premise is our belief that firms achieve different results in the market place because each possesses a unique bundle of capabilities as well as tangible / intangible assets, and human resources
- A capability’s potential for creating a sustainable advantage is a function of its **Relevance** (“Does the capability create value?”), **Uniqueness** (“Can the capability be copied by competitors?”) and **Immobility** (“Can the profits generated by the capability be retained by the firm?”)
- As many capabilities (and assets) cannot be acquired instantaneously, a firm’s choice of strategy is naturally constrained by its current capabilities (path dependency) and the speed with which it can develop new capabilities - otherwise, any firm could choose any strategy and profits would very quickly be driven down to zero
- As a result, capabilities are the very essence of strategy and a far greater driver of competitive advantage than industry attractiveness
- In addition, the greater the rate of change in its external environment, the more likely it is that a firm’s capabilities will provide a secure foundation for its long-term strategy

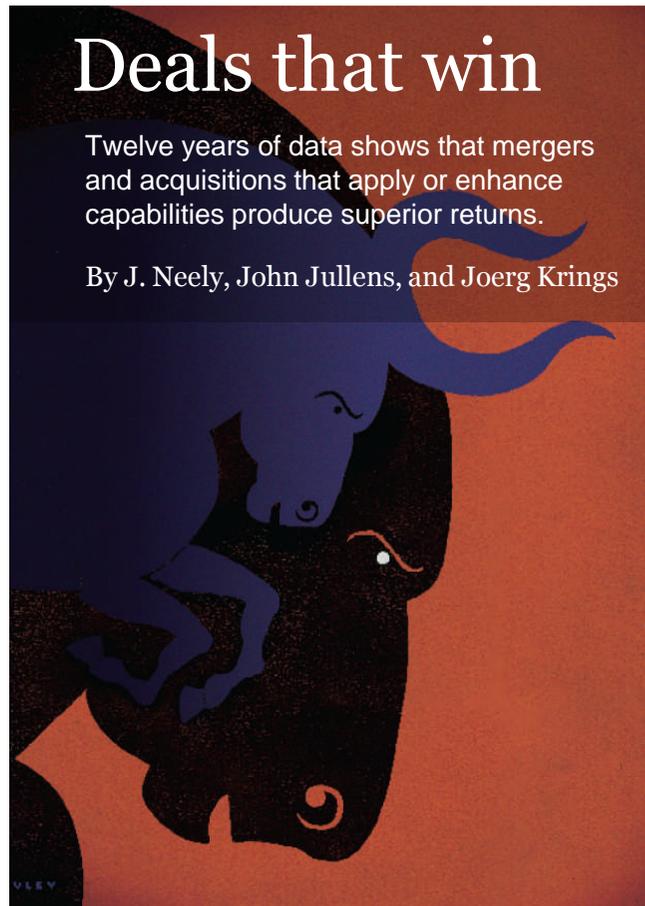
In practice, the journey from basic production to world-class innovative capabilities takes a long time



Firms must decide how to develop the required capabilities every each step along the way



In fact, Strategy&'s latest study shows that achieving a capabilities fit in deals matters more than ever



- M&A deals designed from the start to enhance or leverage companies' distinctive strengths **exceedingly outperform** other deals
- Our study shows that capabilities-driven deals outperform others **by 14% of annual shareholder return**
- Capabilities-driven deals led to higher returns in **8 out of 9 sectors surveyed**
- Our findings agree perfectly with our core belief about the **importance of capabilities for essential advantage**

Our study focused on a relatively small sample, but with distinctive insights from a closer look at each deal

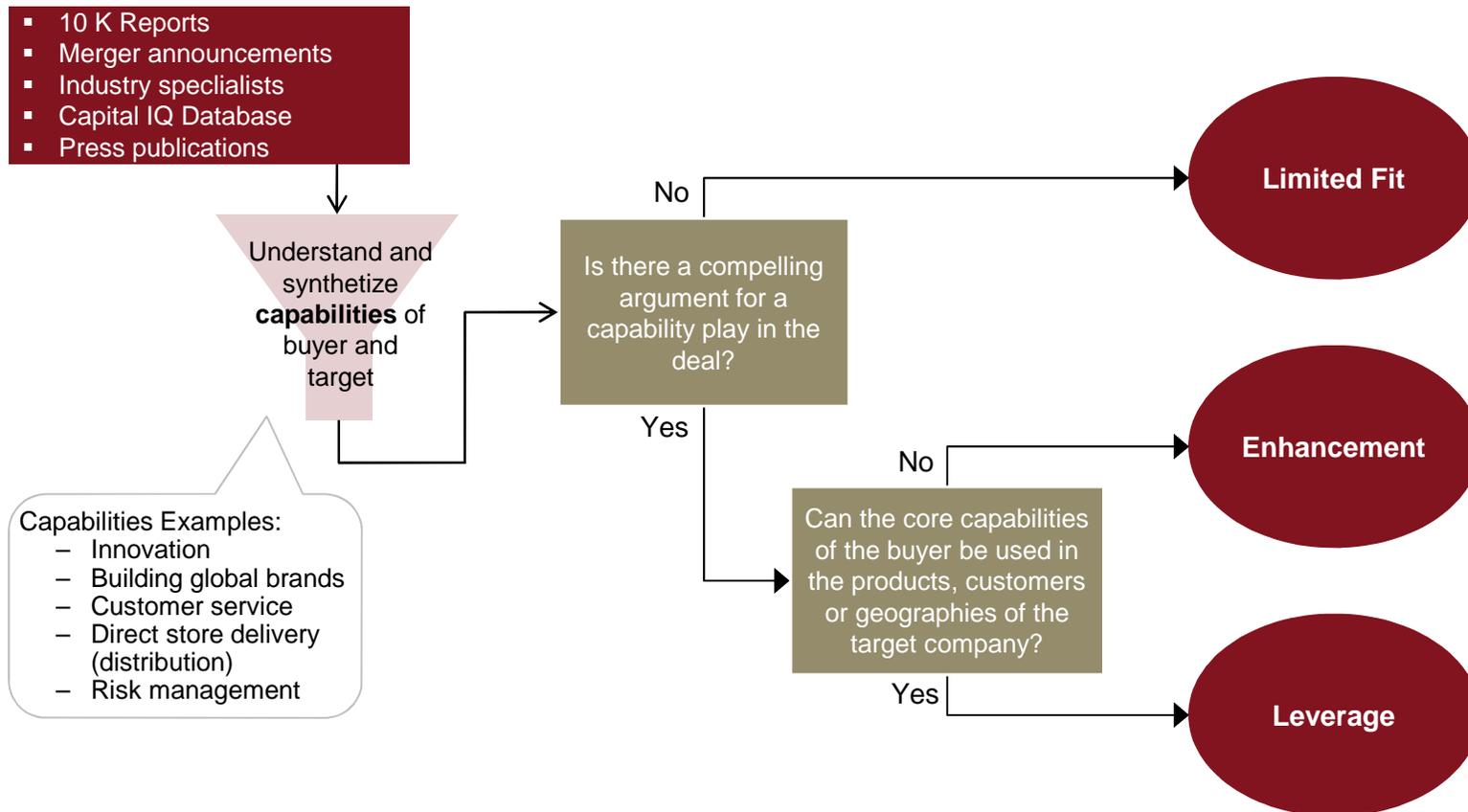
▪ **Scope and metrics**

- 540 largest global transactions, 60 in each sector, announced between 2001-2012
- Annualized total shareholder return 2 years post announcement, compared to relevant local market index
- Capabilities-fit evaluation, based on:
 - Public announcements & press coverage
 - SEC filings
 - Financial data (Bloomberg, Capital IQ)
 - In-depth industry specialist interviews

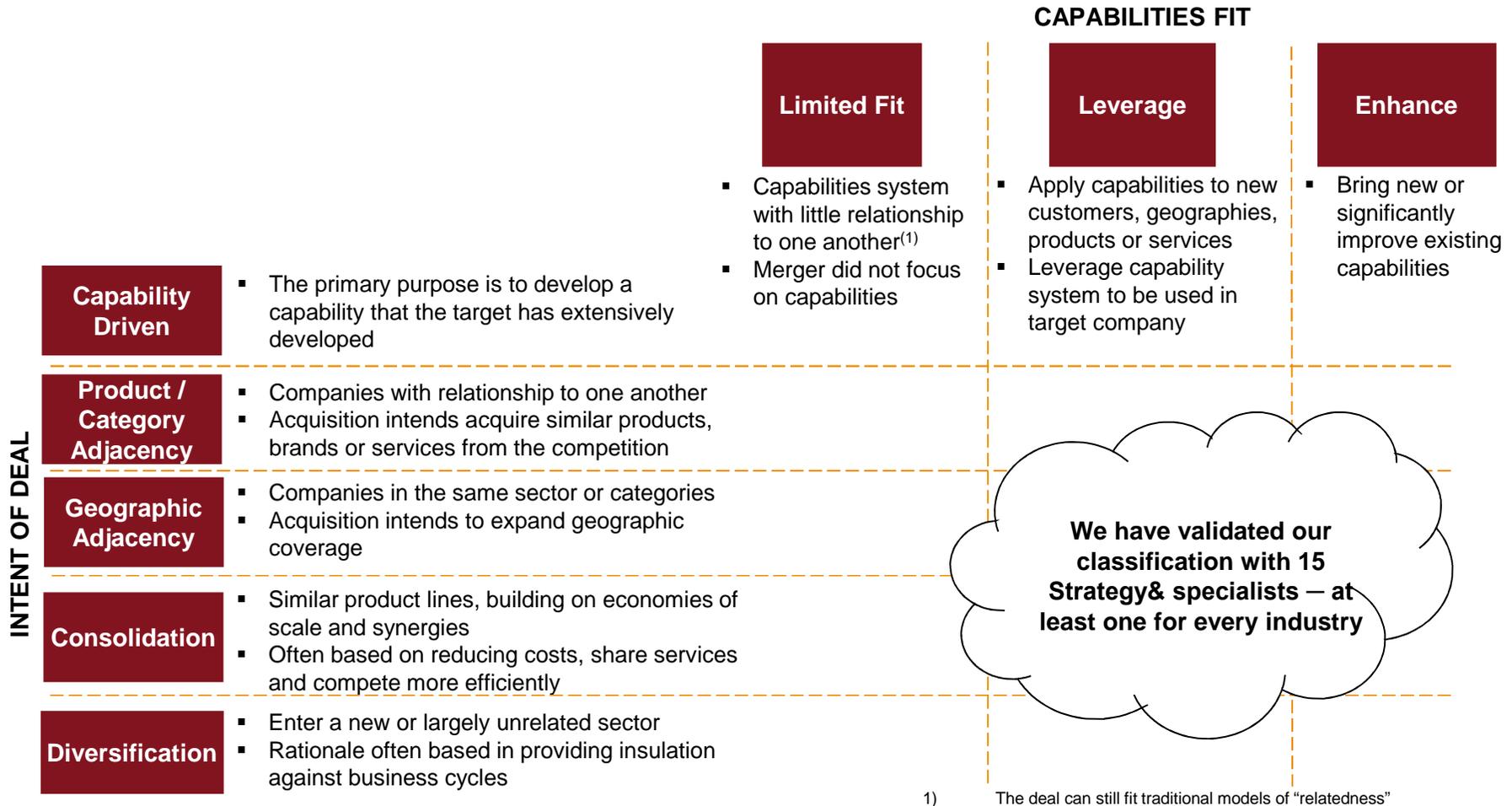
▪ **Sectors**

- Chemicals
- Consumer staples
- Electric and gas utilities
- Financial services
- Healthcare
- Industrial
- Technology
- Media
- Retail

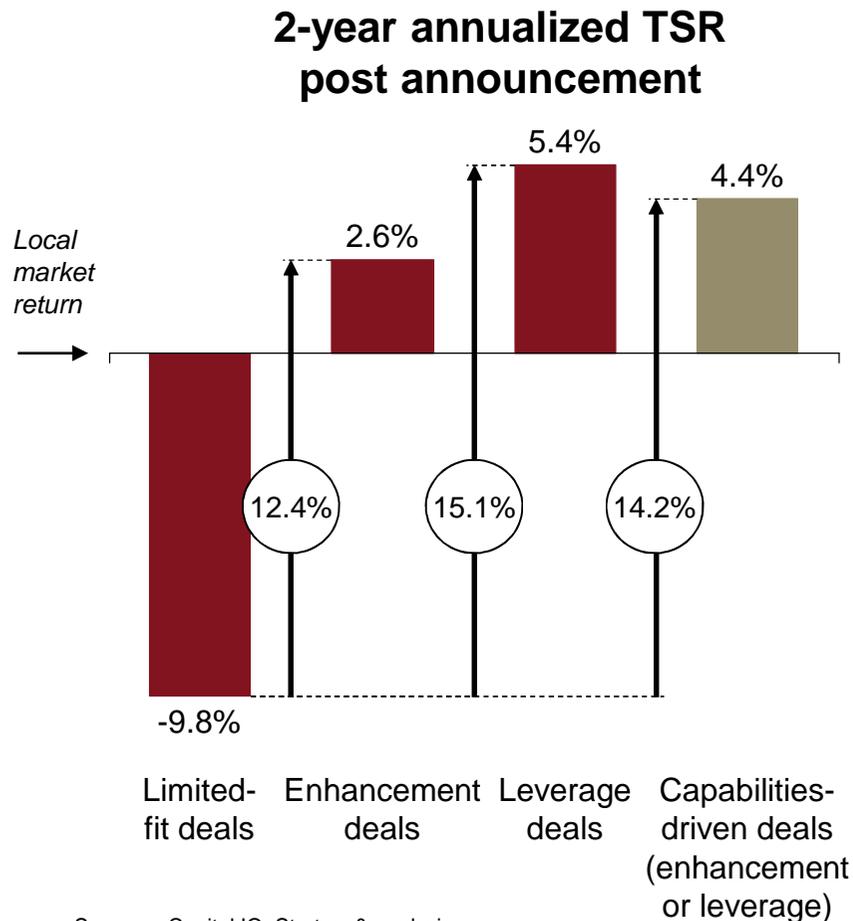
Screening for Capabilities Fit leveraged publically available information and specialist input



The classification included expressed deal intent and assessment of capabilities fit



Capabilities-driven deals outperformed limited-fit deals by 14% points in annualized 2-year TSR

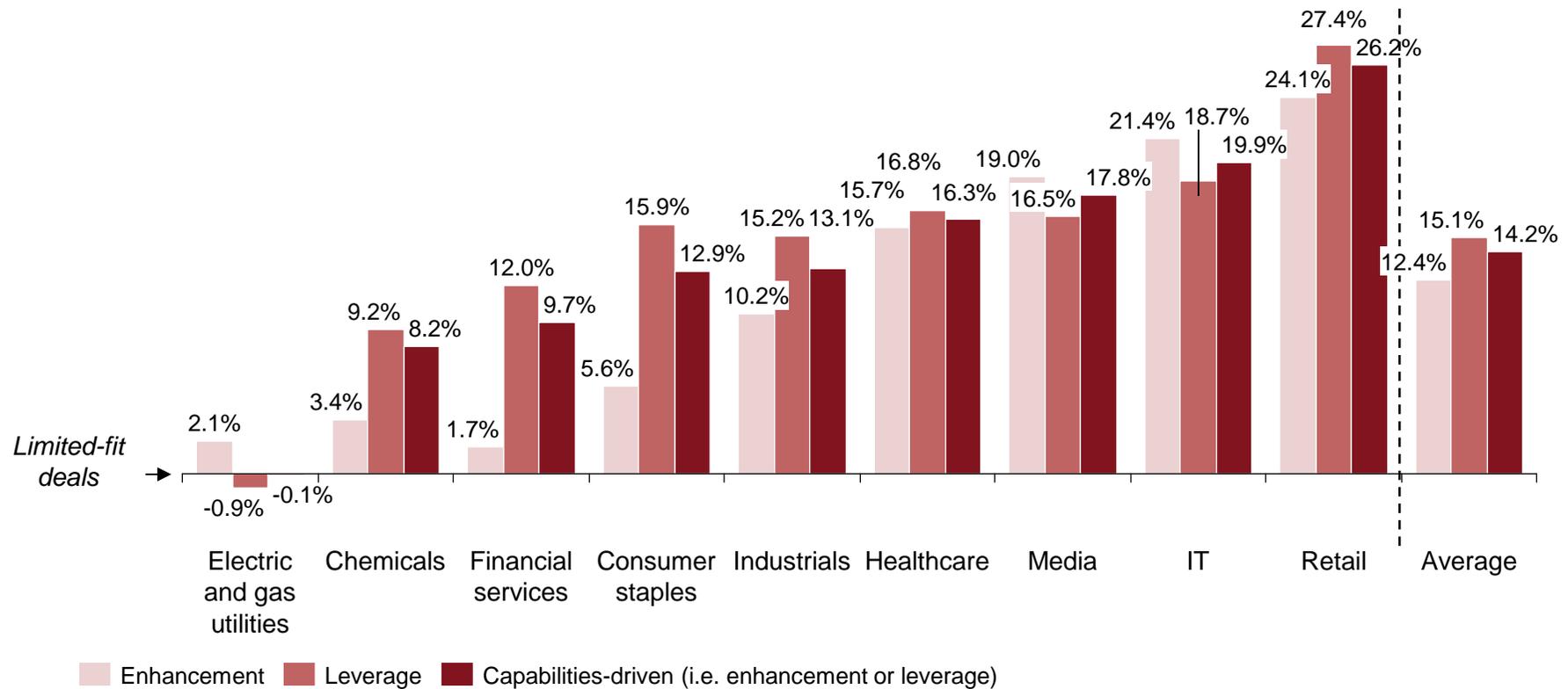


- Capabilities-driven deals outperformed limited-fit deals by 14.2% of TSR
- Limited-fit deals produced returns that are 9.8% worse than the local market index
- Both capability enhancement and capability leverage deals outperformed the local market index - by 2.6% and 5.4%, respectively

Source: Capital IQ; Strategy& analysis

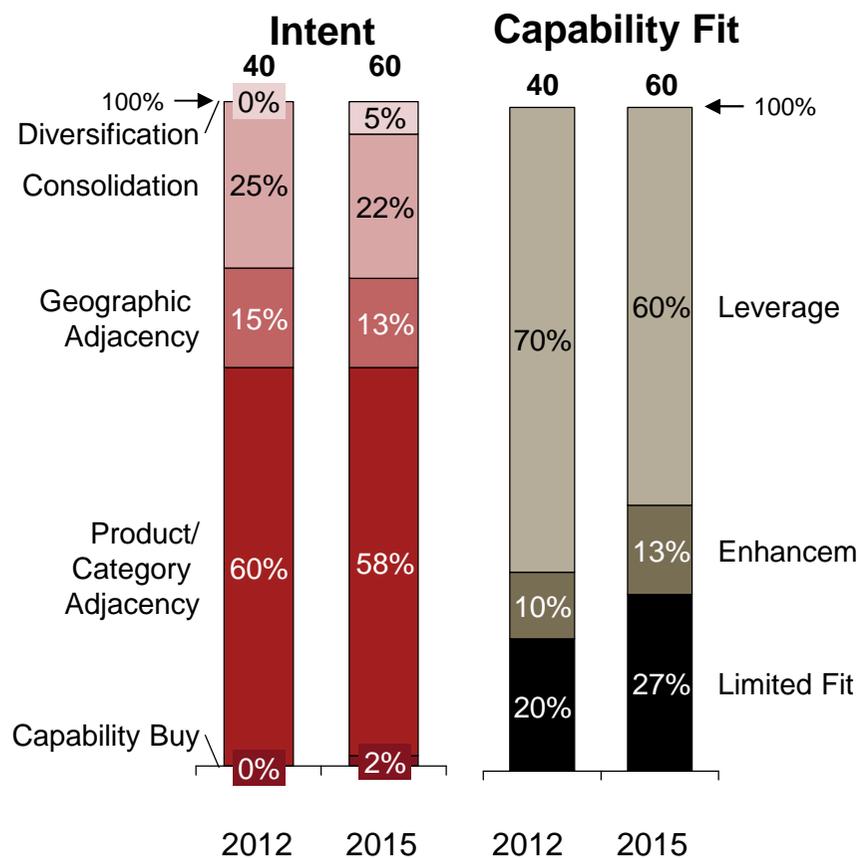
8 out of 9 sectors surveyed showed outperformance of capabilities-driven deals, led by retail, IT and media

Premium over returns of limited-fit deals, by sector¹



Source: Capital IQ; Strategy& analysis

The Chemicals industry conducted predominantly Leverage deals, which were also the highest-yielding



Number of Deals by Intersection 2015

	Limited Fit	Enhancement	Leverage	TOTAL
Capability Access	1	0	0	1
Product/Cat. Adj.	9	8	18	35
Geographic Adj.	3	0	5	8
Consolidation	0	0	13	13
Diversification	3	0	0	3
TOTAL	16	8	36	60

Avg. Return¹ of Deals by Intersection 2015

	Limited Fit	Enhancement	Leverage	TOTAL
Capability Access	-1.8%			-1.8%
Product/Cat. Adj.	-0.6%	1.2%	4.3%	2.3%
Geographic Adj.	-0.3%		13.0%	8.0%
Consolidation			8.4%	8.4%
Diversification	-9.2%			-9.2%
TOTAL	-2.2%	1.2%	7.0%	3.8%

1. TSR vs local market index return

How to get started – think about capabilities at the earliest stage of M&A strategy and target assessment

Key capabilities oriented questions to ask in due diligence

- What is unique about the target company's capabilities system? How does this company create value for customers?
- How does the target company's capabilities system differ from our own?
- If we are buying the company for its product and service portfolio (a leverage deal), are we sure that those products and services will thrive within our current capabilities system?
- If we are acquiring the target company for its capabilities (an enhancement deal), will we be able to preserve and integrate them?
- How will this newly merged entity deploy and execute its evolving capabilities system? What are the risks of incoherence?
- Which facilities, processes, suppliers, and employees are critical to bring on board, for the sake of a separated, combined or integrated capabilities system? Are any of them (or any key customers) vulnerable to poaching by competitors?

Contact information

John Jullens
Principal, Strategy&
Formerly Booz & Company

john.jullens@strategyand.pwc.com
www.johnjullens.com

Relevant Publications

Strategy+Business

- “Deals That Win” – July 2015
- “Solving China’s M&A Maze” – April 2013

Strategy&

- “Deals That Win” – October 2015 (podcast)
- “Best Practices for China M&A” – July 2013 (podcast)

Harvard Business Review

- “How Emerging Giants Can Take on the World”– December 2013
- “Why So Many Emerging Giants Flame Out” - February 2014 (podcast)

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