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Here's how he did it—and how you can, too.

CREATING SHAREHOLDER VALUE THROUGH M&A—AND BEYOND

MOST ACQUISITIONS by public companies fail to create long-term value for their shareholders. However, a few companies have demonstrated the ability to consistently generate shareholder value through inorganic investments. What distinguishes these companies is a set of decision standards and integration skills that lead to outstanding returns on external investment.

How are value-creating acquirers different?

Value-creating corporate M&A programs focus on three key deal requirements:

• **Attractiveness:** What are the economic profit pools in the target's market, what is the level and driver of the target's share of those economic profit pools, and how does the target's business model align with the acquirer's?

• **Affordability:** What are the opportunities to recapture acquisition premiums and how do they compare to the transaction price?

• **Integration:** What are the key actions needed to align the company's strategy, operations and governance in order to improve cash flow and re-capture the control premium associated with most acquisitions?

When deals fail to create value for the acquirer, it's usually because one or more of these considerations has been overlooked or insufficiently vetted. The most common problems are:

1) Strategy Failures: Buying companies that are exposed to markets with limited economic profit pools and/or have little ability to capture share of those economic profit pools. This often occurs when management pursues top-line growth without fully understanding the concentration of profit pools in the target's markets and where and why the target captures share of those profit pools.

2) Pricing Failures: Paying transaction prices that exceed the value of the target after accounting for all combination benefits and costs. This is usually the result of overly optimistic assumptions about the size of cost and revenue synergies, the incremental investment that may be needed and especially the time required to realize those opportunities. It can also be due to internal political pressure to "get the deal done" that makes it more difficult for well-intentioned managers to walk away from deals when prices become economically unattractive.

3) Integration Failures: Failing to define the actions and accountabilities needed to align strategies and operations of the combined business and establish the governance conditions to track integration, manage performance commitments and drive further value creation post-integration.

Acquirers who consistently create shareholder value recognize these challenges and use repeatable, systematic processes, prescribe required deal information and set clear decision "gates" with explicit go/no-go criteria to develop thorough plans for integrating both operations and strategy well in advance of the deal close. Most importantly, executive management and Boards of these companies constantly reinforce the discipline to stick to these governance standards.

What governance conditions and leadership characteristics ensure disciplined M&A practices are followed?

Clear definition of winning: Successful acquirers begin with a clear understanding that "winning" means sustainably creating more shareholder value than peer companies. They also know that "winning" in the capital markets requires "winning" in their product and customer markets—by creating more value for customers and capturing a larger share of the resulting profit pool than competitors. They also "win" with employees, attracting and retaining talent better than competitors. When companies do so, they build a reinvestment advantage that strengthens their competitive position and drives superior shareholder returns over time.

TransDigm Group, a highly acquisitive provider of commercial and military aerospace components, is one such company. Management and the Board set the clear objective of delivering "Private Equity-Like Growth in Value with Liquidity of a Public Market" and target total shareholder returns of 15 to 20 percent per year. The company exceeded that goal over the last 10 years, delivering compounded annual total shareholder returns over 35 percent, well above its peers and in the top decile of the S&P 500.

Focus on where and why shareholder value is being, or can be, created: Over 100 percent of the value of most businesses is generated by less than 40 percent of employed capital, while 25 to 35 percent of employed capital often destroys shareholder value. Successful acquirers

understand that value is concentrated. They begin with a granular and quantified view of where and why the markets, products and customer segments in their own business, as well as the target's, are and are not economically profitable over time.

A robust understanding of these concentrations provides useful due diligence intelligence and builds a concrete understanding of where and how to improve the value of the combined businesses. This value growth "agenda" of opportunities sets a clear upper limit for the transaction price and helps the company build specific and robust integration plans well ahead of close.

Illinois Tool Works (ITW) employs its "80/20 Front to Back" process to identify the 20 percent of its businesses, markets, products and customers where profit, growth and value are concentrated. Following its process, ITW selectively pursues acquisitions that will be accretive to its long-term organic growth and where it can improve profit margins to ITW-caliber returns. ITW aims for its acquisitions to match its own margins by the end of year seven and generate a 10-year return on invested capital above 20 percent. As a result, ITW has grown economic profits by 14 percent compounded annually over the last five years, nearly triple the rate of its peers, and delivered top quartile shareholder returns.

Manage to a continuous value growth agenda: Having already identified and defined plans for realizing the largest value creation opportunities in the combined business, upon closing these acquirers can immediately begin executing the required integration actions. This provides clear direction and structure for post-close activities, including accountability for achieving each opportunity and managing progress of each initiative against strategic and financial objectives.

The same process that helped form this integration agenda also drives additional organic value growth post-integration. By updating key facts about where and why value growth opportunities are concentrated in the combined business and adjacent markets, management can refresh its value growth agenda with new opportunities, evaluate new strategy alternatives and resource allocation choices, and continue managing execution.

Danaher Corporation uses its Danaher Business System (DBS) to guide the company's culture, organic growth and M&A activity. The company implements DBS across its entire portfolio, describing it as "who we are and how we do what we do", and uses it to drive "a never-ending cycle of change and improvement". This disciplined and continuous approach to managing the value of its businesses has helped Danaher deliver compounded total shareholder returns of 19 percent over the past five years, outperforming the S&P 500 by nearly 8 percent.

Danaher, ITW and TransDigm Total Shareholder Returns vs Peers

As os 12/31/2019	1-Yr TSR	3-Yr TSR	5-Yr TSR
Danaher	49.6%	26.1%	19.3%
Weighted Peer Average	31.5%	25.7%	18.6%
S&P 500	31.4%	5.3%	11.7%
Danaher Outperformance vs. Peers	**+18.1%**	**+0.4%**	**+0.7%**
ITW	45.6%	16.4%	16.3%
Weighted Peer Average	37.2%	15.3%	10.8%
S&P 500	31.4%	15.3%	11.7%
ITW Outperformance vs. Peers	**+8.4%**	**+1.1%**	**+5.5%**
Transdigm	84.4%	39.7%	30.5%
Weighted Peer Average	31.0%	19.1%	14.6%
S&P 500	31.4%	15.3%	11.7%
Transdigm Outperformance vs. Peers	**+53.4%**	**+20.6%**	**+15.9%**

Source: Company Financials, Factset

Implement differentiated business models and differentially allocate resources: TransDigm, ITW and Danaher are examples of firms with distinct and disciplined management processes. These capabilities lead to highly differentiated business models and disciplined allocation of resources and enable M&A to contribute to shareholder value growth long after acquisition integration, resulting in sustainable shareholder returns well above their peers.

Sharpen organizational conditions and capabilities: Mergers and acquisitions are inherently challenging and require a disciplined focus on execution long after closing the transaction. Ultimately, the success of the deal and continued value creation of the acquirer depend on a culture where employees think and act like entrepreneurial owners. When continually applied, the same principles and processes that help make value creating acquisitions also build the ongoing management capabilities that maximize organic value creation and ultimately create a formidable reinvestment advantage that is difficult for competitors to overcome.

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