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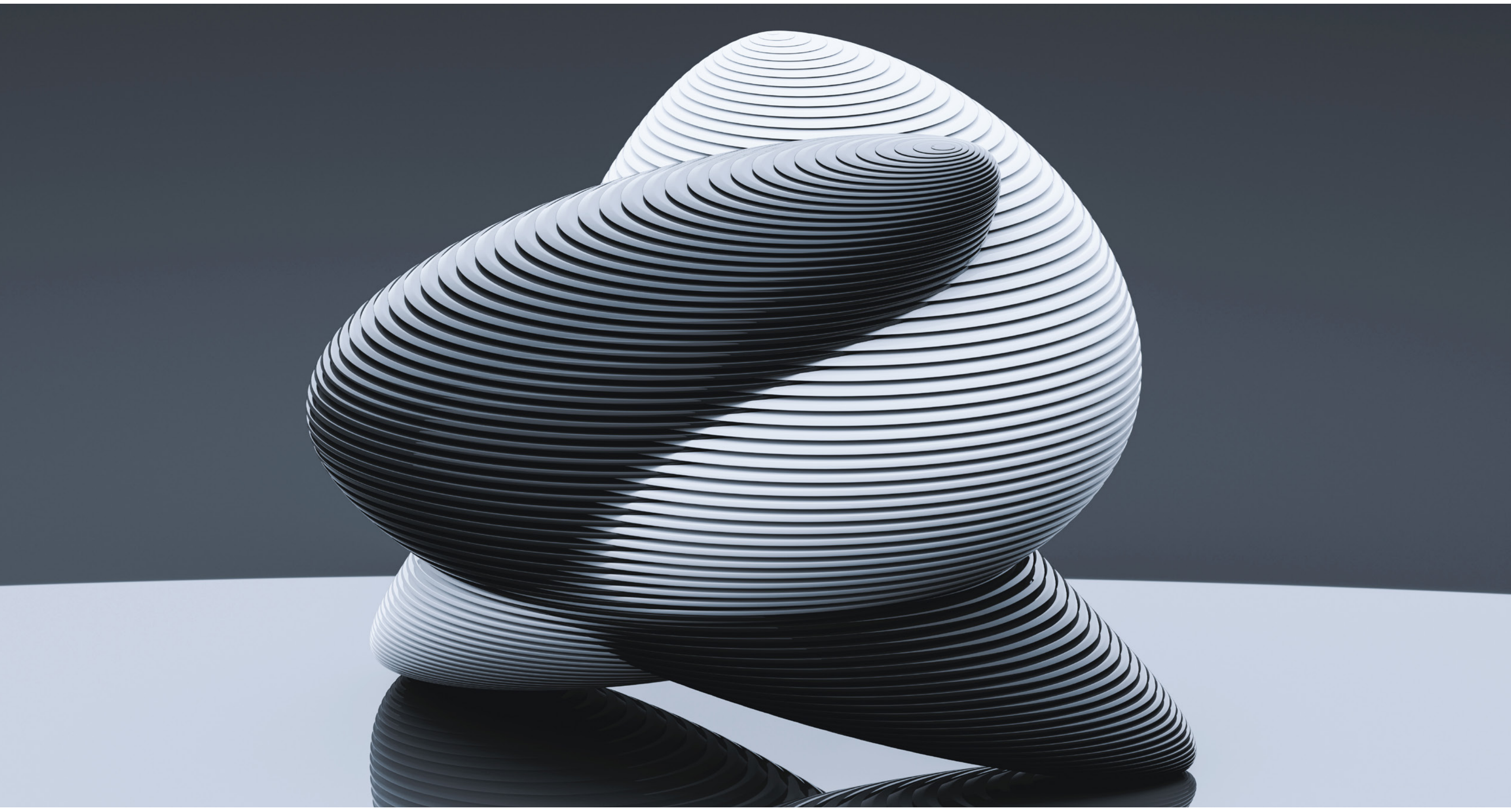
Advanced Industries Practice

# The next wave of M&A in advanced industries: Are you prepared?

This may not seem like a promising time for M&A, but industrial companies that act now may emerge stronger after the COVID-19 pandemic.

*This article was written collaboratively by members of McKinsey's Advanced Industries Practice and Strategy & Corporate Finance Practice, including Frank Coleman III, Tarun Khurana, Asutosh Padhi, Justin Sanders, and Jannick Thomsen.*





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**With COVID-19 continuing to spread** and the pandemic disrupting normal life, few business leaders are green-lighting M&A transactions. Out of an abundance of caution, many deals have been held back or abandoned altogether. While M&A activity might remain limited in the very near term, we expect to see it increase dramatically when the path to economic recovery comes into focus.

In the wake of the 2008 financial crisis, a wave of M&A transformed advanced industries—including the automotive, machinery, semiconductor, electronics, aerospace, and defense sectors—and the post-2020 wave promises to be larger and more disruptive. Now is the time for a call to action: industrial CEOs need to prepare. This is the moment to lean forward, shape the future of the industry, and set the stage for the next S-curve of innovation, growth, and leadership.

McKinsey research suggests that the companies that act boldly, quickly, and decisively improve their odds of outperforming competitors over the long run. They do so by understanding their M&A capacity ("dry powder"), transforming their approach to value creation, and strengthening their programmatic-M&A muscles. After almost three full quarters of high-speed decision making, many industrial companies are still in the planning stage, but they must quickly find the conviction to capitalize on the trends shaping the future of industry, which are only accelerating.

## Reshaping advanced industries: Trends accelerated by the COVID-19 crisis

Accelerated by the COVID-19 crisis, four trends are reshaping the industrial sectors. Industrial companies should consider the shifts described here as they plan their M&A activities.

**Digitization**

High-performing industrial companies have been undergoing digital transformation for a few years now, but they have been doing so at an uneven pace. Many focus their efforts in specific pilots—for example, using the industrial Internet of Things (IIoT) in factories, digital-thread engineering, and predictive analytics in servicing—giving them the edge in automating processes while delighting customers and moving sales motions online through e-commerce.

With digitization, companies in the broader industrial segment could raise revenues and margins by as much as 4 to 7 percent, which translates to an increase in earnings before interest, taxes, depreciation, and amortization (EBITDA) of up to 9 percent. Successful organizations will reemerge with digital and speed wired into their companies in and around their products in how they collaborate with and sell to customers.

**Supply-chain disruption**

Over the past two or three decades, supply chains have grown increasingly global, with every link in the chain optimized and little slack tolerated across the system. But digitization of the supply chain didn't keep pace. While companies knew their immediate suppliers well, they lacked visibility into the full spans and layers of their suppliers, so they couldn't see all the potential vulnerabilities.

The COVID-19 pandemic has made the supply chain a top-of-mind priority for CEOs and boards. As a result, supply-chain digitization is increasing, and companies are gaining greater visibility into their supply chains end to end. Industrial companies will be better equipped to understand the concentration of their suppliers and manage risks. Lessons learned during the crisis may also encourage the development of local leading-edge capabilities to ensure that mission-critical parts are available in times of need.

# ACES trends are disrupting traditional industrial boundaries and spurring the development of ecosystems predicated on technology.

**Shift toward ACES**
Advanced industries have felt the impact of ACES (autonomous, connectedness, electrification, and shared mobility) trends for several years. Tech players have brought significant innovation to the sector, but much work is left to do to transform hardware and global infrastructure into areas that can handle the shift.

ACES trends are disrupting traditional industrial boundaries and spurring the development of ecosystems predicated on technology. As the conventional boundaries blur, connectedness through the IIoT is likely to grow at an unprecedented pace, and disruptions caused by the COVID-19 crisis are only accelerating the shift.

**Energy transition**
Calls for serious actions to address the climate crisis are resulting in an intensifying push for energy transition by company stakeholders, industrial leaders, and regulators. Increasingly, customers are seeking out green products, and automotive OEMs are demanding environmentally responsible products from their suppliers. Nations are requiring airlines to reduce their carbon footprints in exchange for governmental support, spurring additional innovation in the aerospace sector.

## An uneven starting point: Where's the growth?

A K-shaped economic recovery from the COVID-19 crisis is beginning to form across industrial sectors. End-market exposure and applications have left some subsectors struggling to grow, while others have continued on at a precrisis pace. The industries predicated on consumption in public spaces (such as the aerospace industry) and the ones focused on discretionary capital spending have been hit especially hard.

For the lower part of the K shape, companies' financial performance has declined significantly in 2020. For example, operating margins for automotive OEMs have dropped as much as 700 basis points. OEMs' growth expectations have plunged, and their annual revenues are expected to shrink about 2 to 3 percent over the next two or three years. Similarly, commercial-aerospace OEMs and suppliers are experiencing huge drops in demand as the future of air travel remains uncertain. Companies in such sectors have a lower starting point, but the same questions remain: Which companies will use this time as an opportunity to reshape and reinvent? Which will simply batten down the hatches?

Companies that have weathered the market well and are in a healthy financial position, such as defense players, have even seen new market opportunities emerge or strengthen. They have an excellent opportunity to take share and exceed market growth both organically and through well-placed M&A strategies. Such moves are likely to be seen by defense and industrial players and are already underway by semiconductor companies, with several large deals in progress.

## M&A: More important now than ever

Industrial companies have historically looked to M&A for growth and value creation, and they have undertaken multiple deals over the past decade (Exhibit 1). Many have taken a programmatic approach to M&A, conducting several deals as part of a systematic M&A program sustained throughout economic cycles.

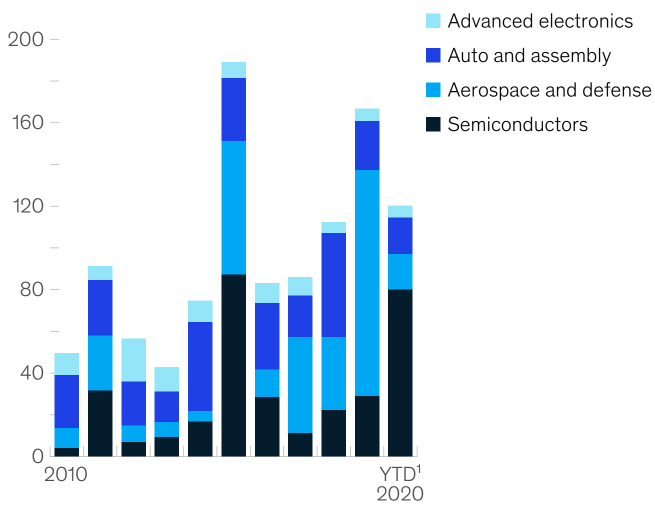
That programmatic approach has historically been the most successful strategy, delivering far more total returns to shareholders (TRS), on average, than other approaches have, with less volatility and risk (Exhibit 2). In fact, across industrial companies, we see that programmatic M&A is a tried-and-true strategy to create excess value over multiple time horizons. Large-deal strategies designed with strong underlying industrial logic have also outperformed during industry-consolidation cycles (vertical or horizontal), but execution and integration rigor becomes critical with them.

When the pandemic wanes, it will not be surprising to see M&A volume increase. As recently as 2019, the number of deals in most subsectors approached historic highs, and the total deal value reached $167 billion.  As the next normal becomes more clear, we expect M&A activity in advanced industries to rebound to prepandemic levels. In fact, we are already seeing signs of recovery, as the number of deals announced increased by around 70 percent between the second and third quarters of 2020, with an aggregate deal value of more than $30 billion in the third quarter versus around $1.5 billion in the second quarter. That early bounce is consistent with more than 20 years of McKinsey research showing that maintaining a through-cycle approach to M&A leads to outperformance on TRS and that some outperformers make twice as many deals during downturns as their peers do.

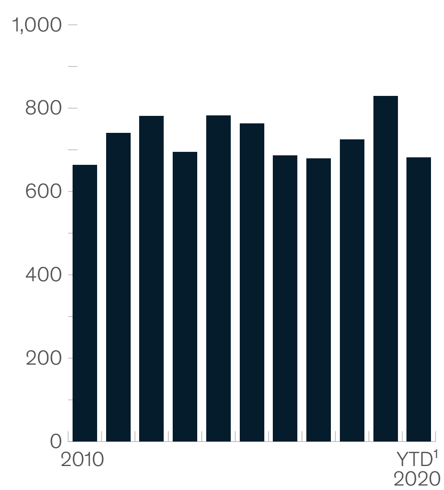
Exhibit 1

### Industrial companies have been very active in M&A over the past ten years.

**Deal value by sector in North America,** $ billion




**Deal volume by year in North America,** number

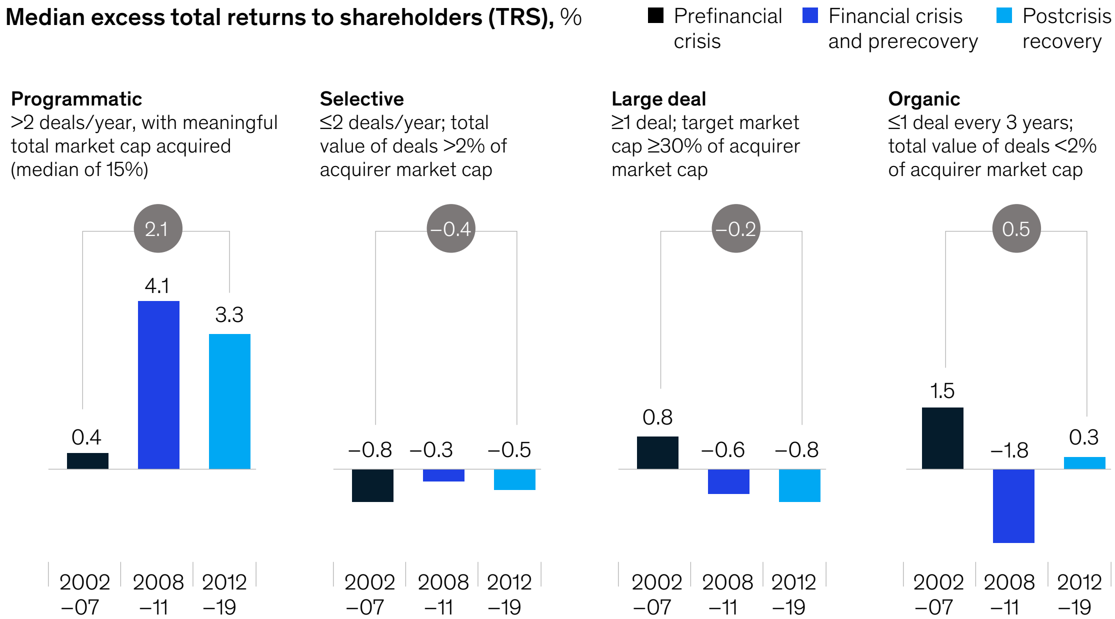



[1]Year to date, as of Dec 31, 2020.
Source: S&P Capital IQ

Exhibit 2

## Across industrial sectors, a programmatic-M&A strategy produced good results that sustained throughout economic cycles.

**Median excess total returns to shareholders (TRS),** %




Note: M&A program is classified dynamically by company M&A activity within the specified period.
Source: Dealogic; S&P Capital IQ

Several characteristics of the current environment favor a positive perspective:

— Low interest rates are probably here to stay.

— Governments appear willing to support economic growth through policies and funds.

— Despite appearances, many industrial companies are financially strong, with limited leverage and significant amounts of dry powder available to invest. In fact, the sector has more than $400 billion that is ripe for investment.

## Getting ahead: Thinking big and transforming through M&A

As industrial companies rethink their growth strategies for the postpandemic environment, we expect that many will find M&A critical to their quests for value creation. We further expect to see seven M&A themes—areas in which a company needs M&A to achieve its strategy and in which it can add value to targets—that reflect the sector-shaping trends:

— *Leverage M&A for scale and consolidation.* Companies will consolidate at the OEM and supply-chain levels to reduce fixed costs, gain competitive scale, increase downturn resilience, and strengthen supply chains.

— *Realign portfolio, products, and channels.* Companies will divest unprofitable geographic locations and noncore businesses, especially as they focus on the strategic assets in their portfolios. They will expand into new products built around their core businesses and rely more heavily on autonomous processes and electrification.

— *Expand into services.* Companies will offer maintenance and other services (such as mobility as a service and fleet management). They will enter the maintenance, repair, and operations; aftermarket; and parts businesses.

— *Enhance digital capabilities and digitize.* Companies will implement data analytics to support the customer experience and value-added services they offer. They will also use next-generation software, telematics, and digital capabilities to enable improved products and operations.

— *Acquire technology and innovate.* Companies will invest early in attractive market segments, such as artificial intelligence and machine learning, the IIoT, and the future of mobility.

— *Regionalize the supply chain.* Companies will revamp their supply chains (for example, through onshoring and export control).

— *Increase sustainability.* Companies will embrace electric-mobility infrastructure, electric-mobility-battery technology, urban air mobility, autonomous-flight systems, and electric propulsion to meet demands for sustainability.

The companies that can both create conviction in riding the trends and execute their M&A strategies should find themselves ahead of the pack coming into the recovery. Those that strive for top-quartile performance will stretch their rethinking even further and consider this moment as a time for real transformation.

## Preparing for the next wave: Five steps

M&A will be the foundation for the transformation of many industrial companies over the coming years. To get ahead and ride the next wave of M&A, players should take five steps today:

— Revisit the corporate and business strategies, pressure-test the portfolio across economic scenarios, and review the financial and organizational abilities to make transactions.

— Refresh the M&A blueprint by asking and articulating how M&A advances the corporate strategy.

— Translate M&A objectives into specific, prioritized M&A themes and take a wide view on value creation—companies should think of using M&A as an opportunity for transformation by considering both combinatorial and transformational synergies (Exhibit 3).

— Boost M&A capabilities and set up dedicated M&A teams to perform scans and conduct pre-due-diligence activities.

— Secure alignment across the organization and between management and the board on the role of M&A.

Exhibit 3

## Companies should look beyond traditional synergies by taking a wide view on value creation during M&A.

**Value-creation opportunities**

■ Typical deal focus ☐ Opening the aperture

| | Cost | Capital | Revenue |
|---|---|---|---|
| Seek/select transformational opportunities | • Product/supply-chain transformations<br>• Automation in corporate functions<br>• Manufacturing consolidation<br>• Engineering transformation | • Multisite working-capital transformation across all levers: AP, AR,[1] and all forms of inventory<br>• Capital-spend consolidation | • Use “clean teams” to accelerate new product/program/ solution development<br>• Deploy new digital solutions |
| Capture combinational synergies | • Corporate function overlap<br>• Best-of-best supply-chain pricing<br>• General and administrative efficiency<br>• Office overlap closures | • Capex efficiency<br>• Working-capital savings via inventory consolidation | • Cross-fertilize products, geographies channels |
| Protect base business | • Maintain ongoing cost-reduction programs (especially in programs/ product lines) | • Maintain capital efficiency in production<br>• Increase controls on capital spending/allocation | • Talent retention<br>• Protect current program and ongoing product development |

[1]Accounts payable, accounts receivable.
Source: Dealogic; S&P Capital IQ

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In today’s market environment, which is affected by the uncertainty caused by the COVID-19 pandemic, industrial-company CEOs and boards are juggling many priorities and challenges. However, M&A should still be one of the top priorities. The advanced industries sector has long tapped the power of M&A to generate growth and create value, and some forward-looking companies are already preparing to ride the next wave of M&A activity. When the path to economic recovery comes into focus, those companies will be ready to execute their through-cycle M&A strategies quickly and effectively. Hindsight will tell us that the companies that prepared for M&A now will be tomorrow’s success stories. Will you be ready?

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