COMPANIES THAT PURSUE growth through acquisitions take a lot of heat these days. Study after study proclaims the same kind of thing – that the impulse to buy other businesses is a sign of weakness, that corporate cultures don’t mix, that the majority of acquisitions simply fail. After reading all that, it’s hard to believe any company in its right mind would attempt one.

Yet a close look at the world’s most successful companies reveals that, in general, they rely heavily on acquisitions to achieve their strategic goals. Despite the challenges, their managers affirm, acquisitions are faster, cheaper, and less risky than organic expansion. It’s a seeming paradox, until you realize what’s going on: Some acquirers have figured out how to do it right. Many have not.
When we at Pitney Bowes embarked on our acquisition program six years ago, we were one of the companies that had not yet figured it out. But we had one good idea going for us: We believed that we should develop a disciplined approach to making acquisitions and learning from them as an organization. We did not subscribe to the school of thought that says shrewd deals come from a smart CEO’s instincts and sheer force of will. For us, buying other companies couldn’t be a seat-of-the-pants adventure; it had to be treated as a business process.

More than 70 acquisitions later, we have that process firmly in place and have achieved enough success to believe in it. I certainly would not claim that we’ve made no mistakes. To some degree, they’re inevitable—and are even valuable if they inspire process improvements. What matters is the net sum of what we’ve accomplished. In aggregate, these acquisitions have allowed us to meet our strategic goal of shifting our business portfolio from a hardware orientation to a focus on software and service offerings that have greater potential for growth and profitability. Our acquisitions have increased the company’s revenue by more than 25%, substantially accelerated our organic revenue growth rate, and made a significantly positive contribution to our net income and cash flow.

What’s behind the program’s success? Like any good process owner, I could address that question in great detail. Our due diligence checklist, for example, now covers 93 separate points of concern. But as we’ve gained experience, I have been struck by the continued importance of a few key guidelines. I’ve also come to believe that this set of basic rules, stated in general terms, may apply just as well to other companies’ acquisition efforts. I would have benefited from knowing these five principles at the outset of our acquisition program. Perhaps you can benefit from them now.

Rule 1 > Stick to Adjacent Spaces

Every American sports fan knows the one major embarrassment of Michael Jordan’s otherwise amazing career: when he retired from basketball and decided to try his hand at major league baseball. But as we’ve shaken our heads at the folly of that move, yet it’s not much different from the decisions routinely made by corporate strategists. Companies’ acquisitions often take them just as far afield.

Plenty of evidence suggests that a better approach is to pursue what are called adjacencies—logical extensions of a company’s current business mix, which can be taken on incrementally. Procter & Gamble, for example, uses acquisitions to expand its product lines and grows the acquired brands through its powerful marketing and distribution capabilities. It typically starts with a core acquisition (think Charmin or Clairol), followed by aggressive expansion deeper into the product category (think tissue or hair care). The wisdom of this approach was borne out by a 2001 McKinsey study that found that adjacent acquisitions correlate with increased shareholder value, whereas diversification into nonrelated areas actually reduces shareholder value. Another research project, by Profit from the Core author Chris Zook, looked for patterns in 2,000 companies’ growth initiatives and concluded that adjacent moves were the most successful.

Our own experience has taught us why adjacencies prove so valuable. First, they take advantage of the tacit strengths of an organization—management know-how, customer insights, and cultural orientation—that are often ignored by strategists. With an adjacent acquisition, these organizational attributes go a long way toward making the integration work and allowing the acquirer to capitalize on what it has bought. But when an acquisition takes a company into remote territory, these strengths are neutralized—and can even be liabilities.

Adjacencies also have the advantage of being brand consistent. For a business to succeed, it must not only be well managed, it must also be trusted by the marketplace. In a sense, customers must grant a company permission to enter a new space. At Pitney Bowes we test our acquisition ideas by gauging the likely reaction of our existing customers. In many cases, this involves actively soliciting their input. Perhaps our customer base is particularly open to sharing opinions (we are an on-site presence at many sophisticated companies, including more than 120 of the Fortune 500), but I suspect that most companies’ customers would offer use-
Which Comes First – the Strategy or the Attractive Deal?

When it comes to linking acquisitions to strategy, our fundamental approach has been unlike that of many other companies. In the traditional model, a company identifies – either on its own or with a consultant’s help – a new business strategy or a new space and then buys something. By contrast, we work with our board of directors to develop a general sense of our strategic direction and then refine our strategy along the way through the process of acquisitions.

We’re constantly using our acquisition campaign to force the question “What is the right strategy?” In this way, we operate much like the American system of jurisprudence. Certain basic concepts and principles are in place, certainly – but only by proceeding case by case does the meaning of the law in real life emerge. Likewise, Pitney Bowes management might make a general declaration that we would want to go in a certain direction – say, into the direct mail space. But until we look at actual opportunities, we don’t have the specificity required for that strategy to be meaningful. For example, we originally set the strategic goal of being a market leader in mail and document management, but as we ventured further into the broad area of document management, we realized the goal would quickly take us outside our comfort zone. So we redefined our strategy in terms of the mail stream – the flow of information, mail, documents, and packages into and out of a business.

In general, we believe that looking at acquisitions is an excellent way to develop knowledge about our priorities. We purposely consider more acquisition proposals than we can possibly act on. Forcing ourselves to choose among many options is a method of prioritization that informs other managerial decisions. This approach also stresses the importance of looking at opportunities in a very disciplined manner, using consistent criteria and a highly standardized process.

Bruce Nolop is an executive vice president of Pitney Bowes in Stamford, Connecticut, and the company’s chief financial officer.

ful feedback. In fact, a few of our most successful acquisitions have grown out of unsolicited customer suggestions. Our move into litigation support is an example: It would never have occurred if we hadn’t been serving law firms with on-site photocopying centers. A few of them encouraged us to take on a specialized set of document management activities required by corporate trial lawyers. Two acquisitions grew out of that notion, and we are now a leader in a fast-growing segment. We received equally good guidance from a few of our larger mailing-machine customers that were using mailing efficiency software to lower their postage costs; they told us how convenient it would be to have those two things bundled into one offering. We moved into that space aggressively with the purchase of Group 1 Software, the market leader in that niche.

We test for adjacency at Pitney Bowes by asking ourselves: Can we really add more value to the target company than any other acquirer can? If we’re convinced that no one is better suited than we are to make the deal, that’s an important indication that we’re on the right track. The same consideration works for us on the other side of the deal. We like it when the acquired company’s management believes that we bring something unique to the table – when it’s focusing not just on the money but on the chance to grow faster and better. From our standpoint, the ideal situation is one in which we are the only logical acquirer. Naturally, this avoids a competitive bidding situation in which we might overpay; it also reaffirms the clarity and distinctiveness of our strategy.

For all these reasons, adjacent acquisitions make for a much more compelling growth strategy than diversification does. There is also this: Communications about an acquisition have to bring a lot of people – including customers, employees, and financial analysts – around to its logic. When a deal doesn’t require a stretch of the imagination, the story simply holds together better. That turns out to be crucially important, given that all of these people have to believe in an acquisition’s potential for it to succeed.

Rule 2 > Bet on Portfolio Performance

My second rule is to manage acquisitions as you would a portfolio of investments. That is, rather than making one or two big bets and hoping for the best, a sound approach is to make multiple smaller acquisitions. The notion that smaller is better is backed by research. One study by Bain & Company looked at deals conducted by some 1,700 firms over a 15-year period and concluded that the probability of success in an acquisition was strongly influenced by the size of the target relative to the market capitalization of the acquirer. The economic returns were greatest from acquisitions that represented 5% or less of the acquirer’s market capitalization. In Pitney Bowes’s case, the sweet spot for success is a company in the $100 million to $500 million range.

A portfolio approach means that acquisitions will not only be of a manageable size but will also be of sufficient number to hedge the risk that any
one will go awry. No one has a perfect record—not even the savviest private equity firms, which arguably are the consummate deal makers operating today (and which, it should be noted, typically diversify each of their investment funds across multiple transactions). We try not to get discouraged by the few deals that haven’t panned out. Rather, we see them as proof that a diversified approach is critical and try to learn from them.

The classic benefit of a portfolio strategy, whether for acquisitions or any other type of investment, is that it produces more-predictable financial results over time. This is especially helpful for companies that, like Pitney Bowes, attract investors by being consistent performers in a broad range of macroeconomic environments. Diversification also helps us meet the investment requirements of businesses that are in varying stages of development. For example, when we purchased PSI Group (a company that helps large mailers earn postal discounts), we knew that we would be investing in its national infrastructure. And now that those investments are completed, we are enjoying their benefits as we find additional adjacent businesses to bring into the fold. This cycle of “buy, invest, profit” develops its own rhythm, which helps to keep our financial results both predictable and improving.

Given all these benefits, why would anyone favor a single large acquisition over a set of smaller ones? In some cases, I suppose, egos are involved: Megadeals garner headlines that tend to hail the conquering hero. But the usual, and more compelling, logic is that, because small deals are just as hard to execute as larger ones, it’s a better use of time to focus on a truly game-changing transaction. I would respond to that argument, however, by noting that a company can also learn as much from smaller deals as from larger ones, and this learning curve experience is itself a valuable asset. Indeed, various studies indicate that frequent acquirers have better acquisition track records than companies that pursue larger, less frequent transactions.

Rule 3 > Get a Business Sponsor—No Exceptions
I’ve mentioned that Pitney Bowes planned from the outset to manage acquisitions as a disciplined process. In line with that thinking, we created a corporate development group early on, and it has matured into a capable and sophisticated function. If other companies plan to create the same (and I recommend they do so), then I strongly suggest that they follow another rule we’ve learned the hard way: Never let staff department drive the acquisitions. The leaders of business units are in the best position to gauge a potential acquisition’s strategic and cultural fit, identify potential business synergies, and establish the road map for delivering expected outcomes. They need to be the sources and owners of acquisition proposals. The corporate development group’s role should be to facilitate and execute the details of the transaction.

It’s amazing how quickly an acquisition loses its glamorous overtones and starts being real work. In my time as an investment banker, I never saw this; my involvement ended right after those few days of glory, and I never saw what it took to pull these things off. Some clearly defined leader has to be personally focused on executing the business plan for the acquisition: achieving revenue targets, engineering cost synergies, and delivering the expected return on investment (or more). At the same time, the business sponsor (who invariably appoints an integration manager) must drive all the behind-the-scenes infrastructure projects that are essential to operational success, including the integration of IT systems, HR policies, financial controls, management reporting, and talent retention. It’s hard to imagine anyone who didn’t have a real passion for the acquisition from the start putting a shoulder to all these tasks.

Sponsorship by business leaders is especially important to talent retention. It is imperative that our people establish and maintain strong working relationships with the new management teams to smooth their entry into our culture and their adoption of our operating procedures. This process begins during the courtship of a potential acquisition, when it’s up to our business sponsor to develop a personal bond with the target company’s leadership. It intensifies after the new company is aboard. We know by now that the bureaucratic processes of a Fortune 500 company can be a significant turnoff to talented executives from a smaller firm. Our business sponsors have to explain why it’s all necessary while ensuring that corporate functions, however well-meaning, don’t overwhelm the newly acquired team with requests for time and information beyond what is really needed.

All this should make it clear why, during my tenure at Pitney Bowes, there has never been a transaction without a business sponsor personally responsible for its success. Sponsors are held accountable through regular status reports to our CEO and board of directors on the integration of acquisitions. Over time, we’ve come to be very disciplined about these reviews. We impose a standard format on the reports, which forces us to compare actual performance against the business plan that was drawn up at the time the deal was proposed. This may seem obvious, but in practice it’s easy to lose this rigor. Some regrettable misfires in our first couple of years drove home the need for regular follow-up and consistent measurements. It’s an efficient
When business sponsors report on the progress of acquisitions, what, exactly, are we looking for in terms of growth potential, market leadership, management teams, and financial objectives? How much near-term synergy and what degree of integration do we expect? We realized early in our efforts that not all acquisitions could be held to the same yardstick, and yet it was important to approach such questions consistently.

It was tremendously helpful when we recognized a fundamental difference in the types of acquisitions we were undertaking. One type, the bolt-on, fits neatly into a business or market we are already in; the other, the platform, takes our company into a new (though adjacent) business space or activity. If a bolt-on acquisition is the equivalent of a swan dive, a platform is a reverse two-and-a-half somersault with a half twist. The higher degree of difficulty entails more risk (but a potentially higher reward) and less frequency; platforms represent less than a sixth of our transactions (although about two-thirds of our total investment) to date.

Making this distinction between bolt-ons and platforms is of critical importance because it leads to different criteria for evaluating potential deals.

When the purchase of an existing company allows our company to establish a beachhead in a new market space, it is a platform acquisition. The way we think about platforms—from what we’re willing to pay to how we measure success—is different from the way we think about other acquisitions. We know we are looking at good platform potential when we see:

- A market space that is adjacent to our existing businesses and is growing at a double-digit rate.
- The likelihood that Pitney Bowes can become a market leader and grow even faster than the market.
- An opportunity to generate significant revenue within five years (through either organic expansion or subsequent bolt-on acquisitions).
- Brand attributes that are compatible with and enhance our own.
- Little potential to do significant harm to our existing customer relationships.
- A low probability of competitor reaction that could change the underlying attractiveness of the new market.
- A strong management team that is committed to staying with the business and capable of leading a growth strategy.

With a bolt-on acquisition, such considerations are bypassed because the strategic question “Do we want to be in this business?” has already been answered. Instead, our focus is on probable business synergies and how they will show up in revenues and expenses. We target companies that can help us cross-sell products and services. We look for opportunities to combine facilities or staff with our existing businesses. We seek complementary technology or intellectual property that can help us gain a competitive advantage and that would be more expensive to develop on our own. And, particularly with acquisitions of independent dealers or distributors, we seek opportunities to strengthen our presence in attractive markets.

In terms of financial returns, our requirements for bolt-on acquisitions are decidedly more short-term than the ones we set for platform acquisitions. We typically expect bolt-ons to be at least neutral to earnings from the outset and accretive shortly thereafter. And we expect them to generate an unlevered return on capital of at least 10% within three years. Criteria like these keep us highly price conscious at transaction time.

Certainly we also run every platform acquisition through a series of financial screens to ensure that we are paying a fair price. These screens include a discounted cash flow analysis, a comparison of similar transaction multiples, an economic value-added analysis, and so on.
TOOL KIT | Rules to Acquire By

There are various ways of ministering to a faltering business, but buying another business usually isn’t one of them.

a review of the accounting impact (profit margin, earnings per share, return on capital, and so on) of the transaction. But our criteria for platform acquisitions put far less emphasis on standard financial metrics. We even allow platform acquisitions to be slightly dilutive to earnings in the first year; our goal is for them to be neutral to accretive within two years. (However, the newly acquired company should be accretive to cash earnings from the outset, meaning that the company would add to our earnings if we did not have to amortize the intangible assets created by acquisition accounting rules.) More important to us is the likelihood that profitability will improve every year to the point that the target company eventually would earn at least a 10% unlevered return on investment. The focus on nonfinancial criteria to evaluate platform acquisitions reflects their fundamentally different purpose in our corporate strategy. With platform acquisitions, we are much more concerned with the long-term growth projections for the business than we are with the short-term opportunities to increase revenue or reduce costs.

Rule 5 > Don’t Shop When You’re Hungry

The final rule comes courtesy of one of our directors: He told us, “Don’t shop when you’re hungry.” We understood the reference to grocery buying. It’s an all-too-human tendency to purchase more than is needed – and to be less price sensitive about it – when shopping on an empty stomach. Over time, we’ve realized how apt the analogy is and thought about how it should guide us.

First, on a strategic level, “hungry” can mean that the business is missing an element that management feels it urgently needs. That doesn’t have to translate into impulsive purchasing, however. If managers can define the strategic possibilities broadly, they’ll have alternative paths to consider. When a management team gets mentally locked into a particular path, and an investment banker keeps stressing the “scarcity value” of a transaction, the acquiring company’s shareholders are probably due for some indigestion.

Just as problematic are acquisitions made to compensate for poor performance in a company’s existing operations. There are various ways of ministering to a faltering business, but buying another business usually isn’t one of them. Perhaps this explains why there was so much resistance to Hewlett-Packard’s acquisition of Compaq. It clearly violated this rule. Another way to express this point is to say that you should expand from your strength, not your weakness.

Hunger can also warp the individual executive’s judgment. That’s why at Pitney Bowes we don’t include potential acquisitions in any of our internal budgets or external financial commitments to Wall Street. Likewise, we generally don’t include the execution of new acquisitions in our bonus incentives. We often set objectives to “consider” or “pursue” strategic transactions to keep our growth goals at the forefront of executives’ minds. But we think that going further would make our “shoppers” hungry for revenue to an unhealthy degree.

The classic result of shopping while hungry is buyer’s remorse, and avoiding it requires both analytical and emotional discipline. The first of these, implementing the right analytical tools and ensuring their correct use, is relatively straightforward. Less so is avoiding “deal fever” – a dangerous frame of mind that can infect an executive team when it has set its sights on a specific transaction. As a last line of defense, we subject acquisitions to two steps of review by people who were not personally involved in the earlier stages.
Doing Due Diligence

Every company in the midst of an acquisition performs a due diligence review to identify and eliminate major sources of potential risk before the transaction is closed. At the beginning of Pitney Bowes’s acquisition program six years ago, this was yet another area about which we had much to learn. The good news is that the more you do, the more you know – and we have come far along the learning curve.

There is no shortcut for companies that are new to acquisitions. Nevertheless, I can offer some general advice.

First, start small, keep doing deals, and learn as much and as fast as you can.

Second, do not expect to get by with off-the-shelf checklists. There are plenty available, and having one provides a good starting point – but you must begin honing it immediately to fit your particular business profile and issues.

Third, use a consistent team to perform due diligence. Our team includes specific representatives from each of the corporate staff departments who work closely with our core corporate development people and the business unit sponsor. Over time, this team has developed and deployed an extensive checklist of queries to put to a target company (a sample section is shown here) and has become quite skilled at ensuring that we receive complete and accurate information in response.

Fourth, use what you discover in due diligence to guide the integration effort that follows the acquisition.

When Pitney Bowes acquires a company, the completed checklist becomes the foundation of the integration plan. It highlights areas where the acquired company’s way of doing things is different from ours or where weaknesses exist, allowing us to see what needs to be managed especially carefully.

Every Acquirer Needs Its Own Checklist

Pitney Bowes’s homegrown checklist ensures that we collect needed information in 13 areas:

- Financial Information
- Corporate Data
- Products, R&D, and Manufacturing
- IT Infrastructure
- Distribution and Marketing
- Customers, Competition, and Markets
- Strategy
- Legal Information
- Environmental Matters
- Acquisition/Disposition
- Tax Matters
- Governmental Regulations and Certain Filings
- Other Information

The small excerpt below suggests the level of detail pursued in each area.

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<th>Description</th>
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<td>VI. CUSTOMERS, COMPETITION, AND MARKETS</td>
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<td>1. Key customers’ relationship with company</td>
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<td>4. Overview of customer behavior (including anticipated shift in customer segments)</td>
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<td>6. Basis of competition (price, performance, service, quality, others)</td>
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<td>7. Perceived future competitive threats</td>
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<td>8. Detailed market overview, including:</td>
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<td>c. Regulatory conditions</td>
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if others have lost sight of the fact, our top executives and board of directors know we have the flexibility to say “no.”

Living by the Rules

The five rules I’ve outlined have been critical to Pitney Bowes given that our approach resembles that used by private equity and venture capital firms. That is, we consider many more deals than we ever expect to complete. Winnowing down the possibilities to the best ones requires a solid framework. We could not succeed with our bottom-up approach, where acquisition proposals emanate from the business units, if we did not also have disciplined thinking – and consistent governance procedures – to ensure balance in our overall portfolio and progress toward the company’s long-term goals.

Governance over acquisitions is closely managed and begins almost as soon as a business leader has an idea for a deal. The first step is for that executive to bring the idea to a committee that is led by our corporate development officer and made up of a small number of senior executives. Our role is analogous to a venture capital review committee’s. At this early stage, the business sponsor does not distribute a lot of material. Instead, we get the “elevator speech” – the few statements that would answer an investor’s first line of inquiry: Why are we doing this deal? What do we hope to get out of it? And why is Pitney Bowes the logical acquirer? Brevity is required because in a two-hour meeting, our executive committee may review as many as ten candidates. Some will get a green light for further pursuit. Most will not.

It may seem like a mistake to have such an informal screen so early in the process play such a crucial role in determining which opportunities enter our pipeline. But these rapid-fire reviews have strong benefits. Because the initial screen doesn’t involve hundreds of staff hours of preparation, business unit leaders are encouraged to think broadly about possible deals. And the nature of the pitch gives the executive committee a reliable sense of whether the business unit leader is truly passionate about the opportunity.

The candidates that we choose to pursue further are subjected to more rigorous governance mechanisms as the stakes increase. What had been summarized in a few words is soon expanded to a handful of PowerPoint slides that offer more detail about the business rationale for and probable financial returns of an opportunity. The business unit sponsor then continues to update the group frequently at key stages, such as making formal contact with the target company, signing a non-disclosure agreement, performing due diligence, and preparing an offer.

Once a deal reaches the stage where we are ready to consider terms, we require preparation of a “decision memorandum.” The format is consistent, with
the major exception that different checklists are included for bolt-on than for platform acquisitions. Each memorandum covers the history of the transaction, its rationale and the synergy being sought, the integration plan, the implications for branding, and other important considerations. It also includes financial analyses that serve two major goals: to ensure that we know our point of indifference (the price beyond which we will walk away from the deal) and to show that the acquisition will create value for shareholders. After the finance committee of our board of directors reviews the memorandum, it is distributed to the full board.

It would be hard to overstate how important this memorandum is to our process. Far from being a perfunctory exercise, it is essential to disciplining our decision making. I’ve been amazed at how many elements of a deal that seemed clear in PowerPoint can fall apart when they’re subjected to prose. In bullet-point format, the rationale for a deal might be summed up in a phrase, such as “cross-selling.” But a memorandum demands clarity about exactly who is cross-selling what to whom – and how and why. What specific sales force are we talking about? Which customers would this apply to? Why would a customer want us to cross-sell?

It’s important to note that directors are given ample time to read and reflect on this narrative document. Our thinking is never “How do we ram this through the board?” Quite the contrary: Many of our board members are very experienced in acquisitions, and we regard their thinking as one of our best process checks. I understand the other viewpoint – that opportunities often materialize that need quick decisions. But our view is that if fast action is required, the deal is probably not right for us. Flexibility to act fast can be seen as a virtue. But if it means less discipline, it’s a vice.

The Process Continues
Whether or not the particular rules and procedures in this article are a perfect fit for other companies, the general lesson applies to all businesses: acquisitions should be managed as a process. That means mapping the complex chain of actions typically involved in an acquisition, paying attention to what can go right or wrong at different stages, standardizing effective approaches and tools, and continually improving on those approaches through closely observed tinkering. Like all business processes, this one can be documented, practiced, improved, and mastered.

Particularly for a serial buyer like Pitney Bowes, a process-based approach is vital. It has made us a smarter and more efficient buyer, encouraged our business unit leaders to be more disciplined about which companies get into our acquisition pipeline, and helped us walk away from deals that seemed tempting at the time but ultimately would have been disappointing. It has ensured that the transactions we end up completing are far more likely (although not guaranteed) to make strategic, business, and financial sense.

Business researchers will continue to debate whether organic growth is preferable to acquisition-fueled growth – and they will probably continue to come down on the side of the former. But perhaps that debate has been framed incorrectly. Our experience growing Pitney Bowes shows that the two approaches can be effective and complementary means for meeting strategic objectives. What makes a growth program successful is not strict adherence to one form or the other but mindful and superior execution of both.