

M & A

N E E D N ' T

B E A L

G A M E

Most takeovers devour buyers' wealth. But acquirers who understand they're actually buying customers can avoid disastrous deals and find ones that work.

by Larry Selden and Geoffrey Colvin

O S E R 'S

DOES THIS SOUND like a recipe for disaster? Your business is throwing off loads of cash each year, available to be invested. You've cut costs like crazy, maybe a bit too much; customer care and new product research are starting to suffer. Wall Street is demanding significant growth, but you know (and are trying not to admit) it just can't be found in the business as is.

The disaster is what often happens next: a great big acquisition, which brings you that shot of top-line growth your shareholders are clamoring for. Trouble is, hard experience shows that 70% to 80% of acquisitions fail, meaning they create no wealth for the share owners of the acquiring company. Most often, in fact, they destroy wealth. The problem is huge. Deal volume during the historic M&A wave of 1995 to 2000 totaled more than \$12 trillion.

By an extremely conservative estimate, these deals annihilated at least \$1 trillion of share-owner wealth. For perspective, consider that the whole dot-com bubble probably cost investors \$1 trillion at most. That's right: Stupid takeovers did more damage to investors than did all the dot-coms combined. And while M&A activity has slowed, it hasn't stopped and never will. Unless practices change, misguided managers will keep right on making their share owners poorer.

The situation is remarkable when you think about it. Many of these failed mergers are done by the world's biggest, most successful companies, advised by highly educated Wall Street investment bankers who do this for a living. In light of such dismal performance by the "experts," can buyers have any hope of improving their odds?

The answer is yes. What's needed is a fundamentally new approach to buying companies, a reconception of M&A through a customer perspective.

For the past two years, we've been analyzing companies—not in the traditional way, as a portfolio of products, services, territories, or functions, but rather as a portfolio of customers. One implication of this research is that managers who want to increase the value of their company must understand the true economic profitability of customers. They must also understand that their company's value is actually the aggregated value of their customers. We've done this analysis and interviewed senior managers at more than 40 companies in a range of industries around the world. We've found that customer profitability varies far more dramatically than most managers suspect. A small group of customers typically accounts for all of a company's market capitalization, while another group reduces that value significantly. This research brings a whole new perspective to M&A. By understanding the economics of customer profitability, companies can avoid making deals that hurt their shareholders, identify surprising deals that do create wealth, and salvage deals that would otherwise be losers.

Look at the Balance Sheet

In evaluating potential acquisitions, companies must look beyond the lure of profits the income statement promises and examine the balance sheet, where the company keeps track of capital. It's ignoring the balance sheet that causes so many acquisitions to destroy shareholders' wealth. Unfortunately, most companies never look there. Managers see sales and profits going up, never realizing that they've put in motion a plan that will do great harm.

To see how this works, imagine a company with the following financials. (See the exhibit "A Target: Before and After.") It has sales of \$1 billion and costs of \$900 million, meaning it has an after-tax operating profit of \$100 million. But that's not its real bottom line, of course. A business's true bottom line is its economic profit, which takes into account a charge for the money invested in it. Economic profit is simply the net operating profit (\$100 million in this case) minus an appropriate charge for capital. The charge is determined by applying the company's cost of capital (we assumed 10%) to its total invested capital

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(\$500 million). Subtracting that leaves an economic profit of \$50 million.

Let's assume further that this is a growing company and that Wall Street has rewarded it with a market value of \$2 billion, which implies a price-to-earnings ratio of 20. (We've made the simplifying assumption that the company has no debt.) Since the company has invested only \$500 million in capital, it has done what all companies are supposed to do: It has created share-owner value, in this case \$1.5 billion worth.

A Target: Before and After

In assessing acquisitions, most companies see the promise of sales and profits going up, without taking into account a charge for invested capital. Factor in that cost, as in the example below, and a deal that seems like a winner can turn out to be a big loser, destroying investors' wealth.

	Before Acquisition	After Acquisition
Revenue	\$1,000	\$1,000
Costs	\$900	\$900
Net operating profit after tax	\$100	\$100
Invested capital	\$500	\$3,000*
Return on invested capital	20%	3.3%
Cost of capital	10%	10%
Economic profit	\$50	-\$200
Market value/intrinsic value	\$2,000	\$2,000
Share-owner value creation	\$1,500	-\$1,000

*\$2,000 market value + 50% control premium
Dollar amounts are in millions.

Now suppose you want to buy this company. Acquirers almost always pay a premium over the market value of a company, known as a control premium, on the theory that it's worth more to control a company than to own a small stake and go along for the ride. A 50% premium is not out of line for an attractive target; for this company, that would mean a price of \$3 billion.

If you buy it for that price and do nothing to change its operations, here's what happens. Revenues, costs, net operating profit after tax, and preacquisition invested capital remain the same; so does the cost of capital. Of course, when a publicly traded company gets bought by another company, its market value is no longer observable in the stock market. Still, the business has an "intrinsic value," a term used by Warren Buffett to mean the value of a company based on its financial characteristics. As long as

those characteristics don't change, the intrinsic value doesn't either.¹

If operating profits were all you looked at, the deal could seem attractive. For an acquirer with earnings of \$300 million, this acquisition would increase profits by a huge 33% (that is, from \$300 million before the acquisition to \$400 million after, ignoring acquisition costs). Further, acquirers often claim they'll achieve cost synergies with their new acquisitions, increasing their profits even more. Suppose this buyer believed it could cut costs to the extent that the acquired company's profits would double above acquisition costs, to \$200 million; then the profit jump would be a fantastic 67%. That's the perspective from the income statement, and it looks great.

But now let's consider the balance sheet. The acquirer has invested \$3 billion in the target company, so its profit of \$100 million represents a tiny 3.3% return on invested capital (ROIC)—a huge comedown from the predeal 20%. Even \$200 million in cost-cutting synergies, which experience shows is unlikely, wouldn't repair the damage. The ROIC would still be just 6.7% (a \$200 million return on \$3 billion of invested capital). Assuming investors are looking for at least a 10% return, this deal more than likely will destroy value for share owners of the acquiring company.

It doesn't matter that the CFO is waving around discounted cash flow analyses (heavily loaded on the back end, with the payoff coming five to ten years out). Nor does it matter that managers and Wall Street analysts have shown that the deal will not dilute earnings. Indeed, talk about earnings dilution is symptomatic of the preoccupation with the income statement. What investors should really worry about is not earnings dilution but rather dilution of ROIC and economic profit. The acquisition in our example is hugely dilutive to economic profit, which declines from \$50 million to negative \$200 million.

In its basic outlines, this is a completely typical acquisition. So what is the acquiring company thinking? When a company considers an acquisition, the acquiring CEO is often under tremendous pressure from Wall Street to reinvest cash and grow reported earnings. Investment bankers may be telling the CEO that if he doesn't make a deal, a competitor will. Merely completing an acquisition may be the CEO's definition of success. That's one reason many acquirers simply ignore the balance sheet effects. They don't care and maybe don't even know that they've whacked ROIC down to a value-destroying level.

And if they do know, they typically believe they can make a deal pay off in one of two ways, through cost savings or by increasing revenue. Neither of these works well.

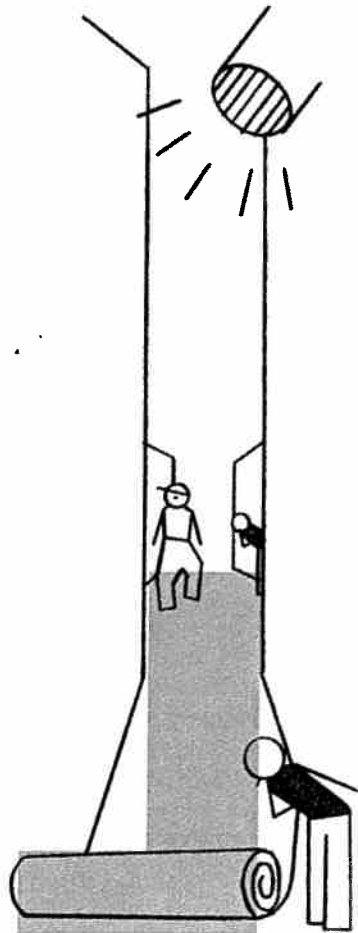
Consider cost cutting. The acquirer usually hopes to save tons of money by combining the companies' functions. If two banks merge and each has a branch at a certain intersection, they'll close one. The two companies had two CFOs, and now they need only one; ditto for many other staff positions. The merged company will buy supplies, services, and raw materials in larger quantities and so may get larger discounts.

Cutting costs deeply enough can certainly solve the problem. But such substantial savings usually don't materialize, in part because acquirers, caught up in the excitement of the deal, tend to overestimate what's possible. In the example above, to achieve a 10% return on invested capital would mean profits would have to rise from \$100 million to \$300 million. To realize such a gain just by cutting costs would mean scissoring \$200 million out of the acquired company's \$900 million cost structure—a brazen and almost certainly impossible goal. In fact, integrating operations of two companies often incurs large incremental new costs—often disguised as onetime

charges—as workers struggle to merge incompatible systems or battle over turf. What's more, managers may feel they have little time to analyze where to make cuts, so they hack away across the board, often severely harming customer care, service, and top-line growth in the process.

An often overlooked reason that cost cutting doesn't work is that the savings may have already been bargained away in the negotiation of the selling price. The seller can usually estimate potential savings at least as well as the buyer, so its managers know they can push for a price that conveys to them (and their share owners) nearly all the value of the savings.

Increasing revenue is the other way acquirers believe they can make high-priced mergers pay. Probably the most frequent claim for big deals is that they will create enormous opportunities for cross-selling. When Citicorp merged with Travelers, Citi was going to sell Travelers' insurance and brokerage services to its millions of customers, and Travelers was going to sell Citi's retail and commercial banking to its customers. When AOL bought Time Warner, each would sell ads and subscriptions for the other, and Time



Darlings

How to Measure the Profitability of Your Customers

Making smarter acquisitions begins with understanding customer profitability. Crunching the numbers is a straightforward exercise, though few companies get it right. Some managers worry that the information demands will be overwhelming. They are not. We can assure you from experience that with available data, sometimes on a sample basis, companies can estimate their customer profitability in 60 days.

Step One: Measure product and service profitability, taking into account all costs, including capital costs. This means going well beyond the gross-margin measures that many companies use. For example, a retailer needs to include a store's operating expenses: sales associates' salaries, rent, electricity, maintenance, and so on. If the shoe department occupies 10% of the store, or draws 10% of the customer traffic, it should bear 10% of the operating costs. Just by allocating those expenses, one well-known retailer we worked with found that 25% of its product categories were unprofitable and many were very unprofitable. Charges for capital—not just inventories, but also things like store fixtures, improvements, leases, or capital investments—must be considered as well. Subtracting those capital charges from net operating profit after tax yields economic profit. Companies often find that when they allocate capital appropriately, many of their products and services turn out to be unprofitable. The retailer we mentioned found that more than half of its product categories were generating negative economic profit. In fact, some had returns on invested capital of -25%, far below the company's 9% cost of capital.

Step Two: Once you know the true economic profitability of your products and services, you can learn a lot by identifying which customers buy which ones. Some customers buy mostly unprofitable baskets of products and services, while others buy highly profitable baskets. This analysis will give you a preliminary understanding of your customers' profitability. Gathering this data is easy if your customers pay by credit card or are otherwise identifiable, not so easy if they pay by cash. But even in this case, companies can gather useful information by observing customers on a sample basis.

Step Three: Subtract from the preliminary estimate of customer profitability all customer-specific costs. Customer profitability involves more than just what customers buy. It depends also on how they behave. Some customers tie up salespeople or account executives for huge amounts of time, while others barely interact with them. Some customers make lots of returns, while others make none. Some always pay their bills late, while others pay on time. Again, gathering the

data is easier for some companies, such as business-to-business companies with a few large customers, than for others, such as mass-market retailers. But getting this data, even if only by observing samples of customers, is worth the effort because the information is crucial to understanding customer profitability.

Step Four: Finally, all the costs in the business that haven't been assigned already—for example, overhead costs for the CEO's jet or capital costs for the headquarters building—must be divvied up and accounted for in the customer profitability figures. Managers often object to this requirement, arguing that in an established business, it's incremental costs that count. But that thinking is deeply flawed. To see why, suppose a company loses its biggest customer. That customer had been covering a big chunk of its fixed costs, and now those costs aren't being covered anymore. Would one still argue that the next customer through the door should be evaluated only on whether it covers incremental costs? If so, then how will those fixed costs ever get covered? If all revenue comes from customers, then which customer is the source of the revenue to cover those costs? Somebody has to be. Eventually it becomes clear that unless customer profitability includes all costs, managers could end up in the absurd situation of running an unprofitable company in which every customer appears to be profitable.

When it comes to M&A, most acquiring companies will not have profitability data on the targets' customers, but in many cases it's possible to make a useful first cut at the analysis. In some industries—financial services, cable television, and wireless phone services, among others—companies routinely possess and may even publish data such as number of customers, customer acquisition costs, and churn rates. These are usually average figures, but a prospective acquirer in the same industry—especially one that knows its own customer profitability—may be able to combine them with its own experience, market surveys, and third-party data to get a rough idea of a target candidate's customer profitability. In other industries, estimating customer profitability may be extremely difficult without access to internal data, though this may become available in the due diligence process.

Regardless of how much data is available, a prospective acquirer must carefully consider customer profitability including allocating all costs. This is no theoretical exercise; all the best-practice companies we've studied allocate costs fully. (They've also learned that once measured, customer profitability won't get managed unless someone is made accountable for producing results from each customer segment.) This analysis will give it an advantage over competitors in deciding which companies (or parts of companies) to buy, which to leave alone, and what to do to turn a loser deal into a winner.

Warner would deliver AOL over its cable TV systems. And so on with most of the big deals of recent years.

Cross-selling does happen, but almost never to the extent the acquirer hopes. Most analysts, for example, think Citigroup found the process much harder and less productive than expected; the company's decision last year to spin off its Travelers property and casualty insurance operations underscores the point. The problem is often organizational. In many cases, product, territory, and functional silos are doubled. Salespeople often don't know how to sell the new products or services and may not be compensated sensibly for doing so. No wonder cross-selling efforts often disappoint.

Result: The typical merger fails. In our example, an acquisition turned the target company from a big winner into a big loser. But you'd never know it if you considered only the income statement. When managers or investment bankers justify deals on the basis of earnings, earnings per share, or EBITDA – without addressing the balance sheet effects – watch out.

It's All About the Customers

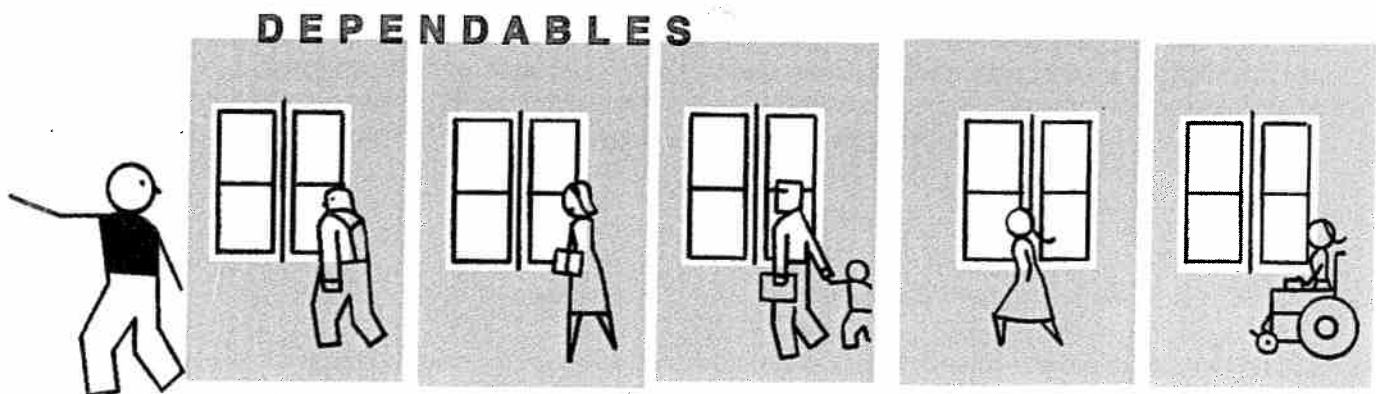
Companies buy companies for many reasons, but the most common is to acquire customers. Consider the ten biggest deals ever (as of spring 2003), all of which happened in the past few years: AOL and Time Warner, Pfizer and Warner-Lambert, Exxon and Mobil, Comcast and AT&T Broadband, Verizon and GTE, Travelers and Citicorp, SBC and Ameritech, Pfizer and Pharmacia, Nations-Bank and Bank of America, and Vodafone and AirTouch. It's clear that most of these acquisitions were acquisitions of customers. SBC bought Ameritech, for example, mainly to reach a huge new group of customers to whom it could sell telecommunications services.

Of course, there are other reasons to buy a company: to get real estate or other facilities; to get brands, trademarks, patents, or technology; sometimes even to get em-

ployees. But ultimately, it's still about the customers. The acquirer buys those capabilities to help it serve existing customers better or to help it acquire new ones. For example, when IBM buys a small, specialized software company, it's probably not buying new customers; most likely, the target company's customers are IBM customers already. But IBM is buying new ways to serve them.

Once the managers of an acquiring company understand that they're really buying customers, they can take the next, far more revealing step in the analysis: understanding that some customers are more profitable than others. At most companies, this is an unfamiliar perspective. Companies are generally organized around products, territories, or functions, so that's how they measure and manage profitability. They can tell you to the penny how much they made or lost in the brake shoe division or the home mortgage division or in Latin America – but how much they made or lost on a particular customer? Most managers have no idea.

The extent of corporate ignorance and misinformation on this crucial topic is staggering. A surprisingly large percentage of executives we've talked to believe their companies have no unprofitable customers, which is virtually never true. When asked to name their most profitable and least profitable customers, most executives name the wrong ones or simply have no clue. Sometimes they guess that their biggest customers are also the most profitable; other times they guess the largest ones are the least profitable because of discounting and excessive service demands, adding, "But they're still profitable." When managers analyze customer profitability for the first time, their biggest "Aha!" is that the range of customer profitability is much wider than they imagined. Our study shows that it is far from rare for the most profitable 20% of a company's customers to contribute more than 100% of its profits, sometimes more than 200%, and for its least profitable 20% of customers to generate losses of an equal amount, with the middle 60% accounting for any net profits the



company may earn. (To learn how to do this analysis, see the sidebar "How to Measure the Profitability of Your Customers.")

Knowing that customer profitability varies widely, and combining that fact with the realization that most acquisitions are done for the customers, it becomes possible to analyze deals in a new way. Recall the deal we imagined above, this time supposing that the target company's customers are classified into four profitability quartiles. From most profitable quartile to least, we'll call them the Darlings, the Dependables, the Duds, and the Disasters. (See the exhibit "Salvaging the Deal.") For simplicity, the company's capital is divided equally among the four quartiles.

We've assigned each customer quartile an after-tax operating profit; we won't take you through the spreadsheet behind the numbers, but with this data we've calculated the share-owner value created by each customer segment. For example, the Darlings have an intrinsic value of \$3 billion, while \$125 million of capital has been invested in them, so the segment's shareholder value creation is \$2.875 billion. The total share-owner value creation of the target company is \$1.5 billion.

We observe that just one quartile of customers, the Darlings, generate 200% of the economic profit and 192% of the share-owner value creation, while the Disasters are almost symmetrically abysmal. The Disasters' negative

Salvaging the Deal

Once an acquiring company realizes that acquisitions are about customers, the next step is to understand that some customers are more profitable than others. Consider again the target company presented in the exhibit "A Target: Before and After," this time supposing that its customers are broken into four profitability quartiles. Before the acquisition, the Disasters dragged down the value of the company (in green). After the acquisition, they wreck the whole deal (in yellow). But if the acquirer understands which customers are profitable, it can salvage the deal. For example, it can shut down the worst customers, taking some of that capital off the books, and reallocate capital to profitable customer segments (in red).

	Darlings	Dependables	Duds	Disasters	Total
Customer Profitability Before Acquisition					
Revenue	\$250	\$250	\$250	\$250	\$1,000
Net operating profit after tax	\$113	\$63	\$13	-\$88	\$100
Invested capital	\$125	\$125	\$125	\$125	\$500
Return on invested capital	90%	50%	10%	-70%	20%
Capital cost	10%	10%	10%	10%	10%
Economic profit	\$100	\$50	0	-\$100	\$50
Intrinsic value	\$3,000	\$1,600	\$125	-\$2,725	\$2,000
Share-owner value creation	\$2,875	\$1,475	0	-\$2,850	\$1,500
Customer Profitability After Acquisition					
Revenue	\$250	\$250	\$250	\$250	\$1,000
Net operating profit after tax	\$113	\$63	\$13	-\$88	\$100
Invested capital	\$750	\$750	\$750	\$750	\$3,000
Return on invested capital	15.1%	8.4%	1.7%	-11.7%	3.3%
Capital cost	10%	10%	10%	10%	10%
Economic profit	\$38	-\$12	-\$62	-\$163	-\$200
Intrinsic value	\$3,000	\$1,600	\$125	-\$2,725	\$2,000
Share-owner value creation	\$2,250	\$850	-\$625	-\$3,475	-\$1,000
Changing the Customer Portfolio					
Revenue	\$300	\$270	\$250	\$50	\$870
Net operating profit after tax	\$160	\$90	\$13	0	\$263
Invested capital	\$850	\$800	\$750	\$100	\$2,500
Return on invested capital	18.8%	11.3%	1.7%	0%	10.5%
Capital cost	10%	10%	10%	10%	10%
Economic profit	\$75	\$10	-\$62	-\$10	\$13
Intrinsic value	\$4,500	\$2,010	\$125	-\$60	\$6,575
Share-owner value creation	\$3,650	\$1,210	-\$625	-\$160	\$4,075

Dollar amounts are in millions.

intrinsic value is the amount by which their continuing failure to earn the cost of capital actually reduces the total value of the company—or, to put it another way, it's how much you should be willing to pay to make them go away. Again, this wide distribution of customer profitability is far from unusual.

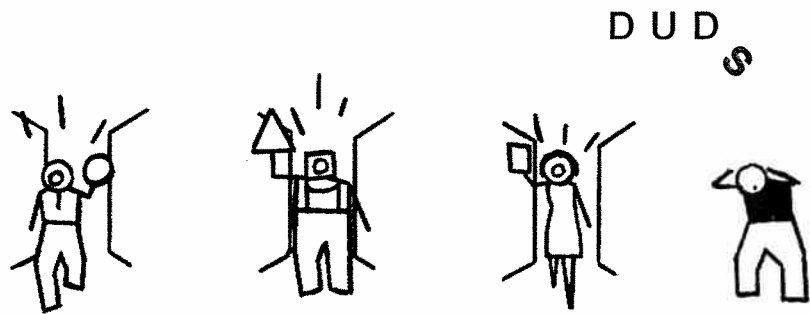
Let's assume this company is acquired on the same terms described previously. A great deal of new capital is added to the business; we've already seen how the buyer loses from this investment. Now we can see exactly how this value destruction is divided among the company's customer quartiles. (We assume that, like most companies, this firm does not know the economic profit of the quartiles; we also assume it allocates capital among them equally.)

It's clear that the acquirer's overpayment for the Disasters, the quartile comprising the company's least profitable customers, is wrecking the whole deal.² Suppose it were possible to pay the Disasters to go away in effect, by shutting down and writing off some of the assets being used for them and redeploying other assets to the other quartiles. The quartile's value destruction would be reduced (due to the writedown), while the other quartiles would increase in value (through the use of new assets). All the other numbers remain the same, but the totals change dramatically. (See again the exhibit "Salvaging the Deal.")

Just by shutting down some of the target company's worst customers and redeploying assets to other customer segments where they can be better utilized, the acquirer changes this deal from a big loser to a big winner. Share-owner value creation increases from negative \$1 billion to \$4.075 billion. And it is possible for some companies to shut down customers, though the move is drastic and most would rather avoid it. A financial services company, for example, could stop offering certain services, or it could increase fees to levels that cause unprofitable customers to leave. A local phone company, on the other hand, might be prohibited by law from doing this. A retailer can't stop people from walking into its stores, but it can change its inventory, layout, marketing, and customer service in ways that discourage unprofitable customer behavior. At the very least, it could stop pursuing and encouraging unprofitable customers, which many companies unwittingly do. And of course a retailer can close stores that attract disproportionate numbers of unprofitable customers.

While jettisoning customers produces dramatic results in this example, in practice there would probably be better alternatives. Most companies can find ways to make unprofitable customers profitable. For example, Fidelity

Investments found that many of its unprofitable customers were unprofitable because of the time they spent on the phone with company call centers. So the company routed calls from these customers into slightly longer queues, then trained the phone reps to educate these callers about use of the Fidelity Web site (a much lower-cost channel) and made the Web site far more helpful. The result was a shift in channel usage by these customers, many of whom became profitable, and an increase in



Fidelity's economic profit. If an innovative acquirer could create new ways to make some of the Disasters profitable, the resulting increase in share-owner value would be even greater than that shown in the exhibit.

It's worth mentioning that the customer-focused acquirer in our example turned a bad deal into a good one—but a customer-centered target company could have been an even bigger winner without a deal. If, before the deal, the target company had eliminated the Disasters and made small additional investments in the Darlings and Dependables on its own, share-owner value creation would have increased from \$1.5 billion to nearly \$6 billion (the new market value, \$6.575 billion, minus the original invested capital of \$500 million and the small additional investments). Indeed, performance like that would probably have earned the company an even higher market value, because investors would have given this stellar outfit a P/E multiple higher than 20, the one we gave it. In all probability, the company would never have become an acquisition target in the first place.

Choose Wisely

At the supermarket in the autumn, you see apples by the thousand. As you walk into the produce department, you arrive first at display cases loaded with brightly polished apples, from which you may choose the ones you want; they're \$1.29 a pound. Nearby you'll often find big brown paper bags already filled with apples. You can see only the ones on top, and you have to buy the whole bag; the price

is 89 cents a pound. Depending on your wants and needs, you make your choice and you pay your money.

When one company buys another, it is buying customers in a big brown paper bag, and it usually can't see even the ones on top. If the target company is like most companies, it will have no customer financial analysis; no one will know which customers are economically profitable and which aren't, nor how to find out. Almost certainly, no one will know how customer profitability is distributed. In our example, the average customer ROIC is 20%, but neither the target nor the acquirer is aware of the -70% Disasters and break-even 10% Duds, which constitute half the company. The acquirer is probably just as clueless about the profitability of its own customers and hence can't approach due diligence in the right way. It has to buy all the customers, rotten apples and good.

And don't forget, acquirers generally pay a control premium to buy a company. Customer financial analysis places the concept of the control premium in a new light. Control may indeed be worth paying for, but only after analysis tells the acquirer what it's really getting. Otherwise, the acquirer may end up paying not 89 cents a pound or even \$1.29 a pound, but \$1.89 a pound for the apples in the big brown paper bag.

A buyer that understands customer profitability can avoid this blunder. When Royal Bank of Canada bought Centura Bank of North Carolina in 2001, it used its own world-class customer finance skills to analyze at an aggregate level Centura's extensive customer profitability data, which was more detailed than most banks', and calculated the economic profit lift it could expect. Royal Bank was able to buy Centura for a price that led to increased economic profit.

So does it make more sense to acquire customers in bulk through acquisitions or one by one through marketing, opening new stores, and other means? The dynamics of M&A suggest an answer.

It all depends on price, of course—virtually any deal can be worthwhile if the price is low enough. The trouble is that in most acquisitions, especially if the target is a publicly traded company, more than one bidder is in the picture. Indeed, if the first bidder's offer is low, another bidder is almost certain to jump in. The problem for bidders that have analyzed the target's customer finances is that competing bidders often

have not done this analysis and may therefore be willing to offer far higher prices. (That's another way an acquisition's potential cost savings are competed away during the buying process.) The managers at the customer-savvy bidder, who know these prices are too high and cannot lead to a value-creating deal, are forced to drop out. They know that to prevail they would have to pay \$1.89 a pound for customers in bulk, and they also know that they have a much better alternative: paying \$1.29 a pound for exactly the customers they want.

If managers are surprised by the wide variation in customer profitability, they're positively shocked by the amounts they could afford to pay to acquire just the best customers of a target company. In our acquisition example, let's suppose the target company has 1 million customers at any one time. So the company's preacquisition market value of \$2 billion works out to \$2,000 per customer. The acquirer who pays \$3 billion is thus paying \$3,000 per customer, and as we've seen, this price makes the deal a big loser.

But suppose it were possible to buy just the best customers, the Darlings. How much should be spent (including, of course, incremental expenses and capital costs)? Assuming the company's 1 million customers are divided equally among the quartiles, 250,000 each, the remarkable answer is that the deal would increase economic profit at any price below \$4,500 per customer. That assumes the Darlings hold steady in number and merely continue to earn \$113 million of net operating profit after tax each year, which would just cover their cost of capital. If that profitability could be increased—and remember, the firm's predeal market value of \$2,000 a customer was based in part on assumptions of future growth—then an acquirer could pay even more. And a seller that hadn't analyzed customer profitability might be willing to sell these customers for much less, not knowing their worth.

In many businesses, it may be possible to broker just such a deal. In retailing, it's possible to open or buy certain stores as a rough proxy for customer segments. In credit cards or certain other financial services businesses, it may be possible to buy certain customer segments directly. But even if the seller wouldn't or couldn't sell just the best customers, this analysis shows that companies can afford to spend remarkably large amounts—in the form of marketing and other customer-acquisition costs—to get customers that

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match the criteria of the Darlings. In this case, bringing in those customers at any price below \$4,500 each (again assuming the company can retain them) would make the acquirer more valuable and would be far superior to buying a whole company full of customers, even at the much lower price of \$3,000 each. Managers often fail to appreciate just how much they could and should pay to win the most profitable customers – investors with more than \$10 million in investable assets, repeat customers at restaurants and casinos, frequent fliers who pay full fare in first class, and department store shoppers who never buy items on sale or make returns, for example.

Is M&A the Answer?


Most companies make acquisitions to grow, often because the core business isn't growing enough, while the CEO is under pressure to reinvest cash from operations. But acquisitions aren't the only way to grow, and as currently executed they often aren't the best way. Consider what these dozen companies have in common: ADP, Bed Bath & Beyond, Dell, Harley-Davidson, Johnson & Johnson, Kohl's, Medtronic, Microsoft, Pfizer, Starbucks, Walgreens, and Wal-Mart. Obviously, they have been terrific performers. In fact, they are the only companies in the S&P 500 that maintained P/E multiples consistently higher than the market's over the five-year period from December 1997 to December 2002. That's an extraordinary achievement, but you can't help noticing two other common traits. First, these have been preeminent growth companies, generating almost double the revenue growth of the S&P 500, succeeding at what all those corporate acquirers are trying to do. And second, most of these companies don't make many acquisitions, and the few they make tend to be small. Instead, they've grown organically in ways that create share-owner value. You'll note that one of these companies, Pfizer, made two of the all-time biggest deals—but its performance declined after each one, moving this stellar company from near the top of this list to near the bottom.

We believe the success of many of these "dynamite dozen" can be attributed to their understanding of customer profitability. For sure it is true of Dell, one of the few companies that truly understands and applies customer financial analysis. It is less true of the others on the list—certainly they do not analyze customer profitability to the extent we advocate. However, most of them do have a much better grasp of these factors than average companies do. One reason is that many of the dynamite dozen are retailers, and, by the nature of their business, they have a rough understanding of customer segment profitability. Retailers' stores can be thought of as representing customer segments, characterized by the traits of the customers who live around them. Retailers can tailor merchandise to the local customer segment's needs and

can staff appropriately. They can choose to fix, close, or sell unprofitable stores, which means they are making a reasonable first cut at eliminating the unprofitable customers that sap value from so many companies. Of course, plenty of retailers fail; just being in retailing doesn't force managers to understand or care about customer finance.

Are we saying acquisitions are a bad idea? Not at all. We're saying the M&A process as it stands is dangerously misconceived. M&A, like other aspects of running a company, works best when seen as a way to create share-owner value through customers. Some deals will be sought to help create better value propositions for the business or to better execute current strategies—or to block competitors from doing these things. But most deals are about customers and should start with an analysis of customer profitability. To the extent that an acquirer understands the profitability of its own customers, it will be better positioned to perform such analyses on other companies. Before entering into any deal, prospective acquirers must ask and answer the following questions: At what price would the deal create economic profit and pay off for share owners? What are the customer financial traits of the prospective target, including the distribution of customer profitability? Would it make more sense to buy just some of a prospective target's customer segments rather than the whole company?

After the deal closes, a company should identify the target's value-destroying customers and seek ways to turn them into value creators. Companies could also close down unprofitable customers or find opportunities to sell them to less knowledgeable competitors. Indeed, every company's M&A thinking should include the possibility of divesting rather than acquiring, selling unprofitable customers to someone else rather than buying a mixed bag in the market.

Whether such an approach to M&A, universally adopted, would result in more or fewer deals is impossible to say. Deals that destroy value perhaps wouldn't happen nearly so often, and acquirers with an advanced understanding of customer finance might see new and different acquisition opportunities. One thing's for sure: If executives saw M&A in this new way, share owners would be a lot better off. 

1. For simplicity, we've assumed that before the acquisition, intrinsic value and market value were the same. Of course, that's not always so. Sometimes companies are overvalued; sometimes they're undervalued. In either case, top management should try to align intrinsic and market values—working internally to raise intrinsic value or externally to raise market value.

2. Purely from an accounting perspective, it makes no difference whether the acquisition capital, most of which is deemed goodwill, is assigned to the customer quartiles equally or proportionally according to each one's intrinsic value. The deal is still a loser. It's the operational changes resulting from an analysis of customer profitability that can make it a winner.

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