

GLOBAL**Companies struggle to deliver projected M&A synergies**

by Rick van Dommelen and Ahsan Ali

A recent study 'RSM Global analyst and investor survey-January 2011' by the Rotterdam School of Management concluded that most analysts and investors believe synergies are the primary concern in assessing acquisitions. However, too often the benefit of the potential synergies is either given away to the seller or is not achieved. As a consequence, acquirers chasing a 'good' deal often do not get the 'best' deal.

In general this reflects our experience advising on transactions. Although synergies are a key reason for making an acquisition, they are notoriously difficult to deliver. Reasons include overestimating the potential synergies due to deal frenzy, poor execution, behavioural factors and over reliance on investment banks. In this article we elaborate on how to fully capture synergy value.

How to deliver?

When it comes to achieving synergies, the approach companies take determines the outcome: a well defined and transparent process increases the probability of achieving those synergies.

It all starts with the identification of potential synergies. Corporate development teams typically develop initial assumptions based on a collection of target provided information obtained from data rooms in due diligence or from discussions with the target. Although information received from the seller is crucial to model synergies, we see that in competitive auction processes this level of detailed information is often not provided by the seller. This means that companies need to develop assumptions based on their industry knowledge and publicly available information, such as analyst reports or industry surveys. We also see that repetitive acquirers use proprietary information of (historic) synergies from past transactions. Part of this process involves setting the 'right' targets. There isn't an easy way to set the 'right' synergy targets as this requires more than just analysis. It requires careful balancing of considerations: reducing costs while not constraining growth; prioritisation against other ongoing change projects; strategy versus implementation risks. In our experience most management teams leave potential synergies on the table especially if they are in the 'hard to get' buckets of operating model transformation, capturing behavioural best practice and revenue synergies.

It is crucial that acquirers working on the identification of synergy initiatives involve key operational management to quantify synergy benefits and the time and cost to realise them. In many cases the corporate development team works with the investment bankers while the financial, legal and operational teams work separately on their part of the due diligence. This often leads to synergy cases that are not 'owned' by the units responsible for executing the plan. At this stage of the deal process, the post deal period already starts, and the plan should already be owned by the whole organisation.

It has been demonstrated that post-completion, the longer it takes to start the realisation of synergies, the lower the quantum of synergies realised. In other words, the longer a buyer waits, the lower the benefits that will be secured. The implication is that acquirers should launch synergy realisation as soon after completion as possible, and use the period between signing and completion to do as much synergy development and planning as possible.

Revenue synergies are more discounted by markets than cost synergies

An important conclusion of the RSM survey is that analysts believe revenue synergies are more difficult to achieve than cost synergies. This reflects our experience that headcount reductions or eliminations of surplus capacity are easier to identify, quantify and realise. By contrast, synergies from entering new markets, new geographies, or accessing new distribution channels are more subjective and involve a greater number of variables beyond the acquirer's control, such as the behaviour of customers, resellers and even competitors. As a result, markets discount the value of revenue synergies from the transaction value. In our view, revenue synergies should be driven through the business with the same rigour as cost synergies. In our experience, while cost synergies provide immediate benefits and should be an early focus, the potential from revenue synergies should not be underestimated. Revenue synergies are often put in the 'long term' bucket, left for the 'business' to deliver, and not subject to the same level of planning and tracking rigour as cost synergies. This prevents the acquirer realising the full potential of the integration.

Negative synergies are not fully understood

One of the conclusions of the RSM survey is that analysts believe acquirers do not understand negative synergies sufficiently, such as overlapping customers, more generous employee benefits or conflicting suppliers with more favourable pricing arrangements. These types of negative synergies are often overlooked and underestimated. Studies also show that the misalignment of accounting policies – while not impacting cashflows – for instance different revenue recognition policies, can be counted as a negative synergy when they materially affect the operating margins of the business. Companies should accurately capture negative synergies as otherwise they jeopardise the ability to deliver the synergies at all.

Apart from wrong planning the risks are in the execution

When the buyer announces the deal, it typically marks the point at which the buyer gains more access to the target company personnel and information which is used to update the synergy models. In this next phase – between signing and closing of the deal – the company works out the initial business cases that were produced by a small (deal) team essentially top-down to a plan that is sufficient to produce real, quantifiable results. This requires a bottom up approach that breaks down the synergies into their component parts, including a detailed set of supporting action points allocated to each functional team. Although the company can at this stage enlarge the team utilising staff of the acquirer and the target company, it mostly cannot work with all required information as regulators do restrict this. This interim period is difficult to manage, as the company makes changes to its own organisation, but also to an organisation they are unfamiliar with, utilising limited information and relying heavily on personnel who are often sceptical of their new employer. Additionally, there is a small window of time as staff, customers and vendors need to be convinced that the acquisition is beneficial to them. As a result, the decisions made are usually less rational than in a business-as-usual environment.

Increasingly, during this critical phase between signing and close, parties operate a 'clean room' through which confidential information, particularly market, product and other commercial data from both parties is analysed and used to accelerate the subsequent implementation.

We believe that full realisation of synergies is not an option – it is a must do. The dangers of not fully realising synergies are not just missed financial opportunities: consecutive half baked or half realised synergy cases leave behind a significantly increased level of complexity in the business, for example, duplicated and inefficient organisation structures, multiple operating models, expensive and unreliable patching up of IT systems, etc. This trend was magnified for transactions which closed pre-recession, as easily available credit masked operational flaws, and a number of such businesses are now addressing these 'legacy' synergies.

Soft issues

Although this article focuses on the hard factors, such as synergy and integration planning, we find that in successful deals the hard factors are just as important as the soft factors, such as selecting the right management team, resolving people issues, and establishing clear communication. In particular, the role of senior management is crucial, as they should be visibly championing the plan, managing the change and promoting commitment. If these soft issues are ignored, they can easily impact the hard numbers.

Retention of talent is another key element to deliver the deal. Most companies apply financial incentives ranging from one to three years post completion to retain key personnel. Linking compensation schemes of integration teams to the integration goals will ensure a higher degree of success. Surveys conducted in the US say that this could lead – in total – to 10 percent of the acquisition price.

Our experience and research also suggests that keeping a balance between core business and synergy realisation is one of the hardest challenges for a CEO. Delivering synergies by focusing your best resources and management on delivery often does the trick for the synergy programme, however there is a significant risk that the core business underperforms during this period, often leading to a net loss after taking into account the gain from synergies.

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