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The Synergy Enigma

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The Synergy Enigma

By Kristin Ficery, Tom Herd and Bill Pursche

The M&A boom of the last few years shows few signs of easing up. Most acquirers have the abundant wherewithal to continue making deals and paying plump premiums. The implication is clear: the executives doing the deals are bullish that they can realize synergistic value.

Yet many observers and many independent studies question the idea that M&A truly adds value. Many executives also point to the unfulfilled realization of synergies. Only half of the senior executives polled in a 2006 Accenture/Economist Intelligence Unit survey believed that their companies had achieved the revenue synergies they'd expected from their M&A activities, and just 45 percent affirmed that expected cost synergies had been captured.

Although many acquirers are getting better at identifying and capturing synergies, it's an unfortunate truth that many deals still do not recover their acquisition premiums and many others fail to achieve the hosts of benefits touted by management as the rationales for doing the deals in the first place.

Some of those failures are clearly the result of overpaying for targets. But others are due to an incorrect understanding of what exactly synergies are and how they should be captured.

Evidently there are several factors that are easy to overlook—or at least to under-appreciate—when deal-making emotions are running high.

It is time to correct a few misconceptions—and to send out a reminder of why it is so important to take a fresh look at the work of pinpointing and extracting M&A synergies.

Rethinking Synergy Capture

When the term "synergy" is used loosely—as it almost always is—acquirers set themselves up for a host of problems as they set out to find, capture, and track the synergies in the deal. Executives at acquiring companies use synergy expectations to justify deal rationales and premiums. But what they are talking about are expected increases in cash flow, not actual synergies. Synergies can only be realized after a deal is consummated.

At the same time, synergy expectations often are not monetized; they are usually described as intangible benefits such as access to new markets, skills or even culture. It is critical to realize that while these benefits may be valuable, they should not be included in synergy calculations unless they can be translated into dollars. That requires the executives driving the acquisition to account for the difficulty of achieving the benefits, the cost to implement them, the timing of their capture, and any negative effect that the synergy implementation (or the deal itself) has on other cash flows (that is, the cash flows of the existing business). It also requires those executives to distinguish between what theoretically *could* add value

What exactly are synergies?

Identifying and capturing synergies requires a rigorous definition of exactly what synergies are—and are not. Here is a definition that helps reset expectations of those who will benefit most from any business combination:

***Synergies* are the present value of the net, additional cash flow that *is* generated by a combination of two companies that could not have been generated by either company on its own.**

Net means that the synergy calculation must take into consideration the cost to achieve the synergies and include any dis-synergies that the deal itself creates. Synergies must also create incremental cash flows. If the acquiring company could have captured the cash flows on its own, then by our definition they are not synergistic.

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and what is most likely to add value—and then to decide how much to pay for the chance to achieve those value improvements.

Right there is the crux point: Paying a premium for "synergistic value" is not the same as paying for a sure thing—it is about paying for an *opportunity.* For while some synergies will be relatively easy to capture, others will be more difficult and in some cases impossible to identify, locate and put a price on.

In many business combinations, there are robust opportunities for creating net incremental cash flows from both cost reductions and revenue gains. For the most part, acquiring executives do an adequate job of extracting value wherever there are "low hanging fruit" synergies—for example, during the merger of two companies serving the same customer base. In such cases, it makes sense that there will be duplication of jobs; the combined organization doesn't need two heads of sales or HR. And when, for example, a merger reveals distribution centers or retail operations whose territories overlap, it is evident that some real estate facilities can be shuttered.

But it's the less easily defined synergies that acquiring executives most often fail to identify, value, and capture. These include revenue synergies and the kinds of improvements that can result from a transfer of skills. Revenue synergies are especially controversial, because they are often difficult to calculate and capture, and are also often overvalued. Because of this, some make the argument that revenue synergies should not be included in determining the value of a deal, or even that they do not exist. But revenue synergies can be a real source of value. They key is to avoid the error of assuming that incremental revenue is a synergy, and to instead carefully define and identify revenue synergies as the positive present value of the net cash flows that result from revenue increases.

Two quick examples support the point that revenue synergies do exist: Access to a new geographic market and access to a new customer segment or channel. Think about the example of a company trying to sell products into a country it does not currently serve. It could, perhaps, achieve such access on its own. But at what cost? How long would it take? Acquiring a target company that already has such access can be synergistic, as long as the criterion of net incremental cash flows is met. The synergy calculation would then take into consideration how much faster (and cheaper) such geographic access is to achieve.

Cisco's acquisition of Linksys is a good example of capturing potential revenue synergies by accessing a new customer segment. Cisco knew that the retail market for wireless routers and associated products used in the home was growing many times faster than the corporate market that Cisco had traditionally served. The company knew that its in-house engineers could design products for this market. But Cisco also realized that it would take a year or two to design and test the products. That, combined with the fact that Cisco was not well known outside of the corporate space, led to the decision to buy Linksys, an established player with proven overseas sourcing and customer service capabilities. The resulting synergy would generate the incremental cash flow that would come from the acquisition contrasted with the cash flow that Cisco could have achieved on its own.

In another recent scenario—the merger of two large casino operators—the acquirer realized that the target company had a massive customer database that was not being used to maximum potential. The acquiring casino leveraged this asset to extract additional revenue from improved marketing efforts, increased cross-sales, and from adoption of its successful customer loyalty program by the target company.

Revenue synergies can often be found in unexpected functions, such as R&D and product design. For instance, in its acquisition of Adams, the maker of Halls medicated confectionery and Dentyne chewing gum, Cadbury Schweppes was able to exploit Dentyne's radical flavors and formats (such as pellet gum) and spice up its own gum offering relatively quickly in the saturated Western European markets.

Six Synergy Problems to Avoid

So why aren't more synergies being captured? Here are the six most common mistakes that acquiring executives make—and here's what can be done to improve the success of achieving synergistic benefits (see also Figure 1):

1. Defining synergies too narrowly or broadly.

Executives at acquiring companies often fail to capture all the deal synergies they can because they define those synergies too narrowly. For example, they do not aggressively try to capture revenue synergies, even when they were used to justify the deal, because these synergies are considered harder to track. Business managers also do not want to have to achieve revenue growth rates that are over and above what they were already given as goals for their standalone business.

On the other hand, some acquirers spend so much time running around

Figure 1: Correcting Synergy Slip-Ups

Slip-Up	Correction	Example
Defining synergies too narrowly or too broadly	Post-close integration priorities should precisely match the value and type of synergies that drove the deal in the first place. When done correctly, pre-deal synergy estimates should determine the total valuation and premium.	When Sony and Bertelsmann formed Sony BMG Music Entertainment, they mapped financial and overhead spending for 60-plus geographies and businesses to identify baseline elements such as payroll expenses (one company classified them as HR expenses, the other as Finance). Only when the baseline was agreed to by both parties was it possible to implement the synergy targeting.
Missing the window of opportunity	Successful acquirers tend to capture 70-75 percent of synergies in the first year after the deal. The synergy capture effort should be "front loaded" so that the emphasis is to go after the biggest synergies as soon as possible.	When a major specialty chemicals company began to plan its acquisition of a large global rival, it focused ruthlessly on planning and achieving the major source of synergies—savings from procurement of direct materials. That singular focus led the client to exceed its publicly stated cost synergy target of $200 million by more than 40 percent—a quarter ahead of schedule.
Incorrect or insufficient use of incentives	Incentive programs should be explicit and timely; they should create meaningful rewards which are directly tied to synergy goals.	After Cadbury Schweppes purchased candy and gum maker Adams, the external rallying cry was "Beat Wrigley!" Internally, it was "Beat the Model!" Personal financial incentives were tied to the performance of each functional and regional team against the integration model.
Not having the right people involved in synergy capture	Just as companies must appropriately match people with the skills needed in a given position, so too must they get the right people doing the right things in relation to capturing synergies.	Early in a large merger of wireless providers, core finance staff was tied up preparing the integration plans for their own department. The merger integration team saw that these people were needed to craft a synergy management process for the whole company. Key Finance staff were adjusted their roles accordingly.
Mismatch between culture and systems	Achieving synergies requires some degree of "measurement culture" where the idea of tracking a success and tying it to a financial metric is a way of life.	A merger of Medicare Advantage providers was predicated on achieving scale economies and sharing operational best practices to fuel continued rapid growth. But without formal budgeting and KPI processes, the NewCo could not agree to how many cost synergies could be harvested without sacrificing growth. As a result, synergies were not captured, operational dis-synergies began to show up in the absence of clear integration action, and the NewCo quickly faced a major slowdown in growth—with big profitability problems.
Using the wrong process	Companies must use a rigorous, holistic process to capture synergies. Such a process includes detailed tracking mechanisms, linking synergy targets to ongoing budgets and financial plans, and a system to quickly determine if synergy capture is on schedule (and fix it if it is not).	When Rogers Communications was merging with Microcell, clear synergy guidelines were established before the integration teams kicked off.

after anything that was used in external communications to justify a deal that they don't prioritize their efforts on the biggest and most accessible opportunities. Quaker Oats' purchase of Snapple, the beverage maker, comes to mind. Instead of using its R&D and marketing muscle to help Snapple rev up its fanciful flavors and visibility, Quaker spent far too much time trying to integrate Snapple's distribution systems and channels with those of its Gatorade brand, with horrific results and huge losses of revenue and value in the Snapple business unit.

To combat those tendencies, post-close integration priorities should precisely match the value and type of synergies that drove the deal in the first place. When done correctly, pre-deal synergy estimates should determine the total valuation and premium. By matching integration priorities to the necessary premium and deal rationale, the actual integration work will be correctly prioritized.

A key element in synergy definition and measurement is the establishment of an appropriate baseline. Unless the acquirer and the integration teams know what they are comparing synergies against, it is impossible to determine if incremental cash flows are actually being identified and captured. The baseline is the starting point to measure value realized from the deal. Once established, the baseline becomes "non-negotiable"—everything needs to be measured against one common set of numbers. Key considerations for establishing a baseline include:

- A clear definition as to what is included versus excluded. Specifically, executives must firmly establish exactly what revenues and costs are included in the standalone cash flows of the two companies.
- A multi-year time horizon, since synergy capture will not occur in one year.
- Its clear acceptance by all parties. If the baseline is considered unfair, synergy estimates are likely to be sandbagged (it helps to use existing budgets).
- Ensuring that savings or operating improvements that were already planned are included in the baseline so they are not counted as synergies later.

The establishment of the baseline can be a time-consuming task, but it is critical. Just one example: When Sony and Bertelsmann formed Sony BMG Music Entertainment, it was necessary to map financial and overhead spending for more than 60 geographies and businesses to identify baseline elements such as payroll expenses (one company classified them as HR expenses, the other as Finance), and differences in how corporate overheads were allocated to business units. Only when the baseline was agreed to by both parties (which took hundreds of meetings) was it possible to implement the bottom-up synergy targeting.

Proper base lining helps avoid many common problems, such as counting as synergies the jobs that are eliminated in one department but transferred to other departments, or where the costs related to personnel reduction are incurred in multiple departments.

2. Missing the window of opportunity.

Opportunities for synergies tend to be time-sensitive. Our experience shows that successful acquirers tend to capture 70-75 percent of synergies in the first year after the deal. Those that wait too long—and drawn-out merger integration activities are all too common—find that synergies are

Post-close integration priorities should precisely match the value and type of synergies that drove the deal in the first place.

To quickly identify the highest value synergies, best-practice acquirers often prioritize synergy opportunities by assessing them along three dimensions: size, time to implement, and difficulty of capture.

harder to capture. The reason is that it is very difficult for any acquirer to stay focused on execution for more than 18-24 months—it becomes too easy to revert back to the status quo, the next acquisition or the new big program that comes along. In fact, very few companies achieve significant synergies in cases where they have waited more than three years to finish capturing benefits. Mark Sirower's book, "The Synergy Trap," contains excellent indicators of the time sensitivities at play.[1]

To quickly identify the highest value synergies, best-practice acquirers often prioritize synergy opportunities by assessing them along three dimensions: size, time to implement, and difficulty of capture. They then work on how to make the biggest opportunities easier to implement in less time. In a merger of two specialty chemical companies, this approach resulted in the capture of $85 million of synergies over and above the original $200 million target, and the savings were achieved almost 20 percent faster than originally planned.

3. Incorrect or insufficient use of incentives.

Our experience shows that there is a direct relationship between synergy capture and the incentive systems put in place for personnel to achieve those synergies. Incentives play an important part in achieving many other corporate goals (not the least of which is hitting profit targets). So why should things be any different for achieving synergies? Yet many companies do not specifically tie synergy targets to incentive systems.

Incentive programs should be explicit and timely; they should create meaningful rewards which are directly tied to synergy goals. After the Cadbury/Adams merger, the external rallying cry was "Beat Wrigley!" But internally, the rallying of the major integration leaders was "Beat the Model!" Detailed personal financial incentives were tied to the performance of each functional and regional team against the integration model. And the model wasn't static—the Program Management Office constantly updated it to account for gains or losses in the underlying base business so there could be no sandbagging of synergies. Teams had to hit both dollar and percentage savings to achieve the maximum incentives.

In another merger, a technology company actually put 25 percent of the synergies in an incentive pool that all team members could share in if certain synergy targets were realized. Such an approach requires strong and transparent baselining up front, clear and early communications of the team synergy targets, and clear agreements on what counts as a synergy achievement.

Sometimes the most powerful incentive is simply the guarantee of a job in the new company. Many successful integrations, soon after close, explicitly promise "NewCo" positions to all integration team members up front even when the exact job titles and responsibilities have not been worked out. The goal is twofold: The team members can then focus on designing the best NewCo knowing they are on the hook for living with it and without having to worry about whether they have jobs at the end of the process. And the leaders of business units and functions have an incentive to put their "A-Team" players on the integration teams because likely candidates for headcount reduction are often those not assigned to a team.

4. Not having the right people involved in synergy capture.

Just as companies must appropriately match people with the skills needed in

a given position, so too must they get the right people doing the right things in relation to capturing synergies. Yet companies often use the "A Team"—the group that should be focusing on making the integration changes that will allow the synergies to flow—to do basic process work.

Instead, companies should have relatively generic activities done by less critical employees, or even have them outsourced. In addition, they need to make sure that certain personnel work on providing support for the overall integration effort before tackling their own departmental integration activities. Because of this, some functions (e.g. HR, IT, Finance) often delay or fail to realize any cost synergies. One example: IT must often be an investment area in the first year after close, with the goal of helping the NewCo to operate and integrate multiple systems platforms. Later, the IT department can begin to look for rationalization opportunities.

For example, early on in a large merger of wireless providers, many of the core finance staff were tied up with preparing the integration plans for their own department. The merger integration management team quickly realized that these people were needed to craft a synergy management process for all the integration teams, and to help provide detailed synergy targets. Key Finance resources were therefore shifted to roles that supported the overall merger integration process.

5. Mismatch between culture and systems.

Some cultures are just not adept at achieving synergies. The discipline requires at least some extent of a "measurement culture" where the idea of tracking a success—and tying it to a financial metric—is a way of life. Cultures that fight against tracking of metrics will always be at a disadvantage. There is a sobering example in the Medicare payments industry. Neither of the merging companies had ever conducted a formal budgeting process, established KPIs in core operational processes, or experienced anything except uninterrupted growth. The result? Chaos. When the parent company of the acquirer asked the NewCo's leadership to achieve economies of scale from the merger and to extract operating efficiencies by sharing best practices, the response was unbreakable resistance.

Lacking a budget and formal strategic planning process, the subsidiary's leaders didn't know how fast they expected to grow; they couldn't agree on a forecast of how quickly they would need to eventually rehire headcount to maintain growth if they cut staff, so they fought against achieving any headcount reductions or scale economies. Anarchy prevailed: nobody was let go, and the company eventually suffered a big drop in profitability. Several heads rolled: the NewCo's CEO and CFO were dismissed, and so too were the ParentCo's COO and chief executive.

While it is hard to create a measurement culture if one does not exist, companies should seek to leverage whatever systems they have in place that do work. For example, in most companies, the budgeting process and financial goals are widely accepted. By "baking" the synergy goals into the budgets and financial targets, companies can improve synergy capture without having to deconstruct and rebuild their business systems.

Cadbury Schweppes provides a fine example of how to do it right: when it acquired Adams, its synergy commitments were embedded in the budget, allowing existing incentive and measurement plans to play meaningful roles and giving C-suite executives confidence that synergy achievement was "real." To ensure that its acquisition moves took hold, Cadbury invested tremendous energy in developing the baseline of current revenues and operational costs. That way, the company was able to establish a clear starting point along with "buckets" for measuring synergies.

Cadbury also poured great effort into the installation in its merger's program management office (PMO) a nimble stand-alone synergy tracking and reporting system. This system was able to generate real-time reports of synergy commitments, forecasts, achievements, and integration costs spent, committed, and forecasted by merger team, region, etc., with all of the inputs self-reported by the teams. In that way, the teams and the integration leaders were able to obtain meaningful real-time insights on synergy capture progress without having to modify existing financial applications or processes. Cadbury's synergy tracking and reporting system was built with full cooperation and input from the Cadbury CFO's team, with occasional meetings between the PMO and the CFO's office to ensure that the self-reported results were actually showing up in "official" financial results and budgets.

6. Using the wrong process.

As noted earlier, Accenture found that only half of senior executives felt that most or all of the integration goals and metrics of their most recent acquisition were met. The implication of the finding is that not enough synergies were achieved to justify the deal premium. That's why companies must use a rigorous, holistic process to capture synergies. Increasingly,

leading organizations use a strategic due diligence process to identify, quantify and value, prioritize, and smoothly hand off synergy opportunities to integration teams with much more focus and detail than traditional backward-looking due diligence practices can do. (See "Avoiding the Perils of Traditional Due Diligence," July 2002, *Outlook*.) Such a process includes detailed tracking mechanisms, linking synergy targets to ongoing budgets and financial plans, and a system to quickly determine if synergy capture is on schedule (and fix it if it is not).[2]

When Rogers Communications was merging with Microcell, clear synergy guidelines were established before the integration teams kicked off. Rogers Wireless' Senior Leadership Team initiated the process by outlining the requirements by quarter for creating true deal value. They then articulated what those requirements meant for each team. Teams were then asked to identify one or two "quick win" synergy opportunities (those that would be realized in the first quarter after close) and to map out the synergy realization for each quarter afterwards. The synergy goals were 50 percent higher than what was promised to the Street, and they created tremendous pressure and focus on realization. As a result of this rigorous process, Rogers was able to achieve the target operating cost target synergies of $100 million earlier than anticipated. This contributed to the overall success of the integration of Microcell and positioning Rogers to be the largest wireless provider in Canada.

Conclusion

Synergies do not magically materialize. By definition, they are possibilities, not certainties. Yet far too many acquirers persist in thinking that by describing certain possibilities, the synergies will appear once the deal is closed—as if to talk about them is somehow enough to make them come to pass.

In practice, it takes work and commitment to identify and capture maximum value from synergies. They must be rigorously targeted, pursued and tracked by the right people, the right systems, the right process, and at the right time. Only then do synergy opportunities become real benefits—and only then can deals be truly successful.

Sources

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