Synergies can be the competitive advantage for a strategic buyer in a bidding process. They are also the narrative that buyers use to explain the strategic objectives of a transaction to their own boards, shareholders and the market. And an acquirer’s corporate development and business unit leaders should be credited with achieving a successful transaction once synergies have been realized.

Strategic buyers should have a plan for identifying and capturing synergies prior to negotiating with sellers. Acquirers need to understand the potential magnitude and timing of the synergies, and their impact on cash flow, in order to understand the value that the company represents to them.

Use synergies as a competitive advantage

Acquirers can use company-specific synergies as a competitive advantage, particularly when they bid against private equity firms. Previously, private equity firms outbid strategic buyers by utilizing financial leverage to achieve return goals. The current economic environment doesn’t enable that strategy; private equity firms can only embed synergies in their bid price when they merge the target with an existing portfolio company. Therefore, strategic buyers are identifying synergies and incorporating them into their bid price to win in the competitive sales process.

Boardroom issues

- To what degree should buyers increase their bidding price for synergies that are specific to their company?
- How can buyers most effectively time the implementation of synergy targets?
- How should synergy achievement be measured?
- How can you bring business units on board to meet synergy targets?

Identifying synergies

From the beginning, executives responsible for transactions should have a dedicated implementation team in place to identify, quantify and model synergies.

The identification process requires deal teams to look at the full range of positive synergies related to cost, revenue, taxation, balance sheet and “capabilities,” (e.g., marketing programs that bring together the strengths of newly combined assets to deliver higher sales and lower marketing costs).

A buyer is more likely to incorporate market-based synergies into its bidding price than those synergies that are unique to that buyer. There is a clear trade-off for buyers to identify synergies jointly with a seller. While sellers are most familiar with untapped potential, buyers must weigh this knowledge advantage against the probability that a greater percentage of the benefit will be allocated to the seller.

Executives should also be realistic about potential negative synergies, including customers that may be unable to continue their relationships with the new entity, additional regulatory costs or underfunded pension obligations. Negative synergies also result from losing focus during the transactions process.

In addition, teams should distinguish between one-time and ongoing costs or benefits; categorizing synergies inaccurately can substantially skew deal value.
Modeling synergies

Get the timing right
Timing of realized synergies, (e.g., which customers are locked into contracts with the company, and for how long) as well as the cost of achieving those synergies, is as important as synergy identification. Many clients report being able to achieve their full synergy run-rate by two to three years after deal close. Aggressive timing, rather than the original calculation of synergies, often creates a gap in realized targets. For instance, buyers targeting supply chain synergies may assume that new contracts can be executed on Day One to achieve an immediate 100% run rate, while in reality, they may need to implement a ramped-up timetable during the first year to achieve savings more gradually. This can result in a potentially significant drop in realized savings in the first year. For example, one integrated oil and gas company assumed it could redesign its newly combined organization in the midst of the integration process. It dismissed redundant personnel, only to have to take time and resources to hire them back to help implement the reorganization process. If buyers are overly ambitious about realized first-year savings, they may face pressure to achieve additional synergies to make up the gap. One-off savings can bridge this deficit and, ideally, should be included in the original model estimates.

Learn how to share
In our experience, buyers are willing to incorporate approximately a third to half of total synergies in their bid price. Many companies are confident in their ability to identify and achieve cost synergies, which they usually include at full or nearly full expected value in their models. While revenue synergies can be equally beneficial and more often drive the transaction, companies are commonly divided on whether to include these values in deal analysis. Many deal teams perceive revenue synergies as more difficult to achieve and they don’t want to overpay for the business. The table below shows how different synergy types are represented in an average buyer’s purchase price.

Sample bid price breakdown

<table>
<thead>
<tr>
<th>Percentage of synergies a buyer will pay for</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost synergies</td>
<td>50%</td>
</tr>
<tr>
<td>Revenue synergies</td>
<td>31%</td>
</tr>
<tr>
<td>Tax considerations</td>
<td>9%</td>
</tr>
<tr>
<td>Balance sheet considerations (e.g., working capital, carrying costs)</td>
<td>10%</td>
</tr>
</tbody>
</table>

The more strategic a deal is overall, the more buyers are likely to add revenue synergies into the deal model. Some modelers account for the reduced certainty related to revenue synergies by including a higher discount rate for the associated cash flows.

Revenue synergies don’t last forever
Revenue synergies, in particular, generally will not serve as a competitive advantage into perpetuity. Competitors will eventually imitate the new strategy or product. For example, revenue synergies in technology companies or pharmaceuticals may last much shorter time periods than those in slower-paced industries. While many buyers continue to calculate synergies into perpetuity, we recommend estimating a finite period for synergies and calculating that time period into the purchase price.
Capturing and monitoring synergies

Identify key performance metrics
Acquiring companies will capture synergies effectively only if they map them out in the first place and assign accountability for monitoring them along the way. Ideally, those responsible for achieving synergies should play a direct role in identifying and valuing specific synergies. Business units should help develop synergy assessments and promote buy-in very early in the process.

Key performance metrics may include the rate of on-time personnel departures, or employees of the acquisition target who leave when they are expected to (neither too soon nor too late); product bundling; and personnel and non-personnel cost reductions. A transaction can also serve as the catalyst to make pending operational improvements more of a priority. Another substantial source of value is procurement. Volume discounts and price reductions are common; however, more significant value is frequently found in contract compliance, demand management and product standardization.

Attention to detail is also an essential part of the monitoring process. For example, one company was initially relieved that top-line performance indicators showed strong performance of a recently acquired asset. However, a closer look revealed that the performance was the result of an unanticipated synergy, while performance against projected synergies was well behind expectations. If the company had not monitored the deal carefully, it would not have understood where value was being created or destroyed.

Finally, companies should avoid being overly formulaic in managing deal synergies. Forcing all deals, regardless of size, through similar stress tests and reviews can result in an over-commitment of management time.

Creating accountability

Look to corporate development and business units
Successful companies give a specific individual, frequently the head of the acquiring business unit, responsibility for achieving synergies. Many companies set additional targets and measure performance on a regional or functional level. Some companies also link a portion of the synergy owner’s compensation with the achievement of synergy objectives.

Corporate development offices traditionally place a high value on completing transactions, but we believe this function should also be accountable for integration success and synergy achievement.

The corporate development and business unit teams need to work together to produce a realistic, detailed synergy calculation that makes both teams comfortable, including operations. As operational teams are often hesitant to publish an estimate that they can’t achieve, the corporate development office must bring the business unit into the plan early in the process and give them the appropriate amount of time and information to calculate a synergy estimate.

We have seen corporate development offices telling operational professionals what the synergy estimates should be, and the operations professionals were held accountable. However, this strategy isn’t effective – the corporate development office must be accountable not just for deal completion and deal value, but also for synergy achievement.

Formal performance monitoring, including using a scheduled timetable to track synergy performance and reporting to corporate boards, is key to enforcing accountability. Many companies review cost and revenue synergies at least quarterly.

Top 5 synergy lessons learned

1. Synergy targets should drive integration approach. Companies must calculate which synergies offer the most value and deploy resources accordingly – focus areas should not be uniform across functions.

2. Consider timing just as much as the dollar amount. A business case for achieving synergies should include the cost of achieving them, the level of effort and timing. Assuming that synergies can be achieved too soon can result in lost savings which necessitate achieving additional synergies.

3. Develop internal stretch targets to increase probability of synergy target attainment. Targets for transaction teams should be around 20%-30% greater than publicly stated goals.

4. Use quick wins to avoid losing momentum by Day 1 post-close. People often re-focus efforts on the next project too soon. Communicating quick wins keeps people engaged in important integration work after the deal closes and the diligence work ends.

5. Tie personal success to achieving synergies. Link individual bonus/compensation to synergy realization in order to improve accountability and ownership.
Provide on-call transaction synergy professionals
The most successful buyers have an internal group of skilled transaction professionals capable of forming internal planning and integration teams at a moment's notice. The experience, skills and insight of such synergy-focused professionals are invaluable for future transactions. Further, the types and depth of synergy targets help shape the integration approach and level of focus. And above all, integration efforts need to have teeth, with reporting all the way up the chain of command.

Communicating synergies
Find the balance between too much and not enough
Communicating effectively with external stakeholders about deal synergies can help acquiring companies avoid the perception that their deals fail to deliver intended results. Buyers who consistently overstate benefits can raise skepticism about future deals.

Companies need to strike a delicate balance. They need to communicate a convincing and strategic story that creates excitement about a deal, while avoiding messages that are either too conservative or, especially in the case of revenue synergies, excessively forthcoming. In particular, CEOs need to clearly differentiate among expected, annualized and realized synergies.

When synergies are achieved, dealmaking pays clear dividends. Telling the market a solid story, while holding onto specific synergy-driven, value-creating details until they flow to financial statements, is the best way to ensure that the company is on track to realize the full value of its acquisition.

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