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Organization Practice

Eight basic beliefs about capturing value in a merger

To maximize deal value in a merger, focus on critical principles.

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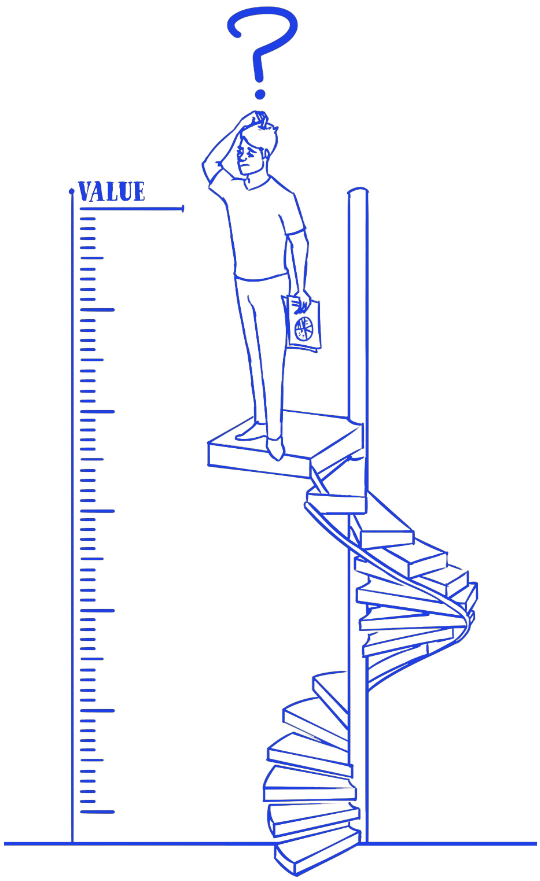
"Show me the money!" That demand, heard throughout *Jerry Maguire*, could provide the rallying cry for most mergers. But maximizing deal value requires more than repeating a catchy slogan. It requires embracing eight basic beliefs. In this article, we lay them out and offer key takeaways for each one.

Due diligence is not the be-all and end-all foundation to maximize value



At the start of a typical integration effort, the integration team uses the deal model and due-diligence results to identify opportunities and set synergy targets. But financial due diligence is seldom deep or exhaustive enough to provide a solid foundation for maximizing value because the effort focuses on justifying the deal, not on creating value (in other words, "figure out what to pay for the asset versus what to do with the asset"). Additionally, diligence proceeds quickly, with limited access to target information, and management bias toward the deal can skew diligence results.

Studies have shown that opening the aperture—or looking for new sources of synergies and value beyond the value that justified the deal—can increase synergies by 30 to 150 percent above due-diligence estimates.[1] Our survey showed that due diligence often ignores as much as 50 percent of potential merger value because it does not take full transformational synergies into account.[2] Survey respondents admitted that more than 40 percent of their deals suffer from inadequate due diligence, and they emphasized that companies need to think beyond due diligence if they want to capture truly transformational value.[3]

Key takeaway: Open the aperture to maximize integration value.

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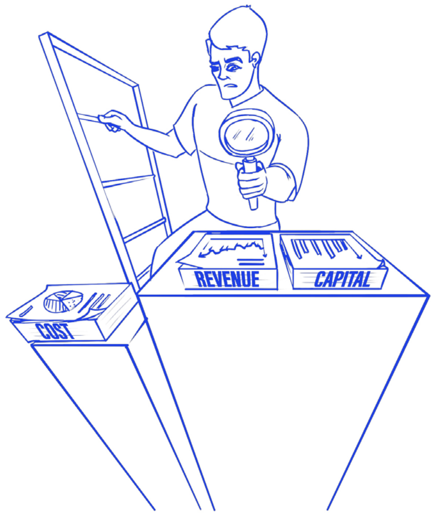
[1] Oliver Engert and Rob Rosiello, *Opening the aperture 1: A McKinsey perspective on value creation and synergies*, June 2010, McKinsey.com.
[2] Ibid.
[3] Clay Deutsch and Andy West, *A new generation of M&A: A McKinsey perspective on the opportunities and challenges*, June 2010, McKinsey.com.

Revenue and capital synergies are as important as cost synergies



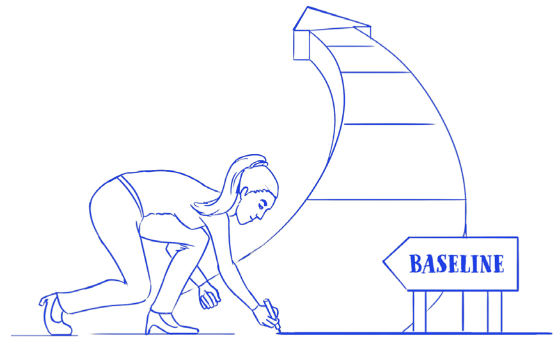
Senior management and integration teams often focus single-mindedly on cost synergies during merger integration. This is understandable. Cost synergies deliver faster and more reliably than revenue synergies, are easier to track, and improve the bottom line; moreover, analysts are skeptical of revenue synergies.

But revenue and capital synergies can be extremely important for specific industries or deal archetypes—for example, in growth industries and high-margin industries, such as pharma, and for companies seeking a compelling equity story. Actions that improve the balance sheet by restructuring working capital, fixed assets, and borrowing or funding costs can capture often-overlooked capital synergies. One consumer client created significant value by redesigning its order-to-cash process and optimizing the utilization of warehouses.

The CFO and integration teams need to prioritize the highest-potential sources of value aligned with overall deal rationale to maximize overall synergy value.

Key takeaway: Locate the most critical sources of value, recognizing that revenue and capital synergies may deliver more value than cost synergies.

Desire to perfect the baseline should not compromise implementation planning



The baseline lays the foundation for identifying opportunities to create value, assigning ownership of the opportunities, and planning ways to execute the task and track and report results. Many CEOs and CFOs hanker to perfect the baseline because they believe, as one CFO says: “If you don’t have a robust baseline, it’s like building a skyscraper on quicksand.”

Building a baseline requires clear apples-to-apples output, and getting the critical categories right is essential. In one telecommunications merger, the failure to define customers correctly created significant dis-synergies and led the integration leader to cite a “mysterious loss of one million customers.”

But many integration efforts spend too much time pursuing perfection—and perfection is the enemy of efficiency. Instead of fixating on the perfect baseline, leaders should do the following:

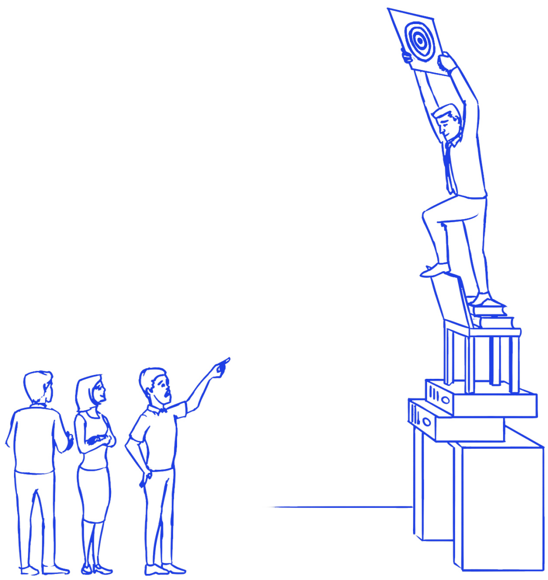
— Balance the desire for baseline perfection with willingness to move quickly to create and capitalize on initiatives. Moving forward actually encourages thoughtful iterations of the baseline.

— Endeavor to show the baseline in a way that leaders of both companies will recognize. This increases the likelihood of buy-in. If the apples-to-apples process changed familiar numbers, the baseline should include well-documented links to those numbers.

— Set clear synergy rules about what counts and how to transfer costs and targets.

Key takeaway: Draft the baseline quickly and kick-start the plan to identify and capture synergies.

Stretch synergy goals should be ambitious but not too aggressive



"The sky's the limit," many CFOs and value-capture leads say when they set synergy goals. Of course, stretch goals are important to achieving the overall deal ambition, ensuring more than marginal improvements, and encouraging pursuit of transformational opportunities.

Synergy goals fall into three categories: announced, internal, and stretch goals. While the announced goals should enable overdelivery, the internal goals should be achievable. Our research shows that acquirers typically set internal goals 30 to 100 percent above their announced synergy goals—and, in more transformational deals, even up to 400 percent above them.

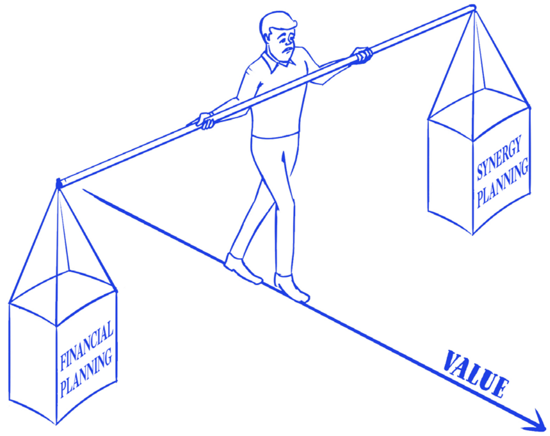
Stretch goals communicated to teams should be ambitious enough for targets to be achievable despite leakage. They should also make teams feel accountable for achieving the goals but not demotivated by facing a bar that is too high. In one telecommunications merger, the stretch target for teams was so strained that it froze the team and forced adjustment of the target, leaving lots of value on the table. There is a fundamental difference between "stretch" and "strain," and no one wants to strain the organization.

Target setting should take into account the cultures of both companies. Some organizations have a culture of setting unrealistically high bars to push teams out of their comfort zones and then accepting their failure to reach targets. The culture of one tech giant known as a serial acquirer emphasizes employee rotation. In setting very-ambitious stretch targets for endlessly rotating teams, the company has created a culture that condones failure to reach targets.

Overstretched goals are often too ambitious or based on bad or incomplete information. In many company cultures, such goals are counterproductive because failing to reach targets becomes excusable, expected, and even acceptable.

Key takeaway: Set realistic internal goals and ambitious but not too-aggressive stretch goals that are in line with the company culture, high enough to accommodate leakage, and realistic enough to make teams accountable.

Synergy planning cannot succeed without strong links to financial planning



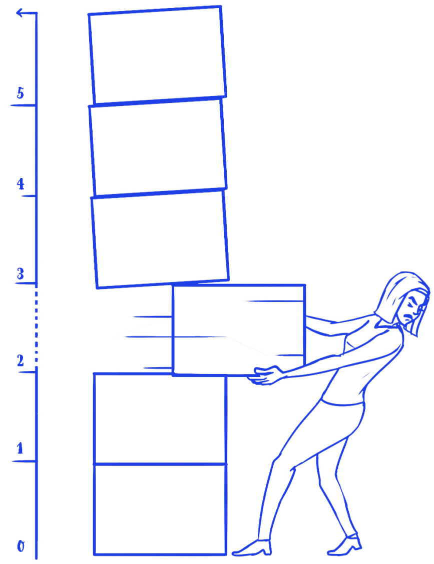
Synergy planning and financial planning should be joined at the hip, especially in the early stages of synergy planning. This close relationship enables the true budget adjustments, increased accountability, and improved tracking needed to capture value.

Financial controllers should be involved in synergy planning as soon as possible to sign off on bottom-up initiatives, reduce synergy leakage, and avoid double counting across integration work streams. They can keep the synergy and financial planning closely connected.

To capture the synergies and have them truly fall to the bottom line, where it will be noticeable by analysts, companies need to pursue the triumvirate: dollars saved, margins expanded, and workforce reduced. Only when measuring all three does the impact really show up.

Key takeaway: Invite the financial planners to the table early as full-fledged members of the integration team.

The first 12 months postclose are the most critical for capturing synergies

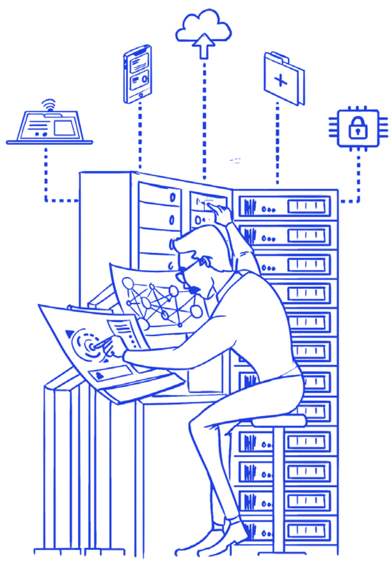


Developing something bigger and better requires building and sustaining momentum. Strong execution of synergies from the get-go helps in capturing wins early and visibly and creates a basis for measuring progress on other longer-term efforts.

Synergies get less and less attention on earnings calls as other business changes materialize. Our research shows that the deal is 2.6 times more likely to succeed (and deliver 40 percent more total returns to shareholders) if the company meets its synergy targets within the first two years postclose, compared with taking more than four years to achieve those targets.

Key takeaway: Start the value-capture process early and don't lose momentum.

The IT blueprint is critical to delivering synergies



In many industries, capturing more than half of deal synergies depends on the IT blueprint. For example, the business model in the aviation industry is based heavily on the IT backbone of the enterprise.

That represents a huge portion of deal value, and our research shows that some 35 percent of the value does not materialize until year two or later, when the IT blueprint is implemented. As a result, strategies to accelerate IT implementation (for example, preclose data alignment and cloud-platform migrations) by linking the IT blueprint to future business operations and tapping IT to capture new sources of value (such as automation and analytics) can unlock significant synergies.

One merger of automotive suppliers paid little attention to the IT blueprint and, as a result, did not integrate technology capabilities properly. Three years after the deal announcement, top-line performance dramatically lagged competitors, and the CEO attributed the underperformance to negative customer and employee experiences caused by the inadequately integrated platforms and duplicative supply-chain infrastructure.

Key takeaway: Link the IT blueprint to deal rationale and synergy timing and seek ways to accelerate synergy capture.

Achieving synergies requires understanding their one-time costs

Organizations typically focus on integration synergies rather than costs, even though one-time costs can exceed actual synergies in the first few years after deal close. Errors in predicting one-time costs can be massive, and weighing synergies against the costs associated with capturing them is essential. This is especially true for organizations that have limited cash flows or that are seeking more transformational synergies because those deals require greater investment.

Integration costs can vary from 70 to 160 percent of run-rate synergies and average 120 percent. Integration costs are susceptible to deal-specific factors, like a heavily unionized environment; a large presence in Europe, where severance is often high; significant functional or geographic overlap between legacy organizations that raises costs as well as synergies; plans to consolidate large facilities; complex legal agreements (for example, transitional-services agreements); and inefficient management of budget submissions.

Having a clear process for budgeting integration costs can support decisions on which initiatives add significant value and contribute to achieving the deal rationale.

Key takeaway: Establish a process to budget and set realistic targets for integration costs.

Taking these basic beliefs about value capture into account during integration planning can help achieve value beyond Jerry Maguire's wildest dreams.

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