KPMG KPMG Consulting

Synergies: A business guide

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foreword

What are synergies and why do they matter?

They are trumpeted by CEOs, paid lip-service to by deal-makers, misunderstood by the market, played down by operational managers, viewed with fear by employees…and critical to the successful creation of shareholder value.

Only by understanding the importance that synergies play in a deal can acquirers hope to pay the right price, convince the market of a deal's merits and extract full value in the post-deal phase.

Successful acquirers have recognised this and have embedded a rigorous approach to synergy analysis in their acquisition process.

In this M&A Integration report, we consider:

- What synergies are.
- Why synergies matter.
- The 'golden rules' to exploit synergies to the full.

Who is this guide for ?

We recommend this guide to any CEO or Senior Executive involved in, or contemplating a major merger or acquisition.

Our recent "World Class Transactions"[1] survey once again confirmed that the vast majority of M&As fail to deliver shareholder value. By illustrating the benefits of a structured approach to synergies and setting out some best practices in this guide, we hope to help acquirers improve this success rate.

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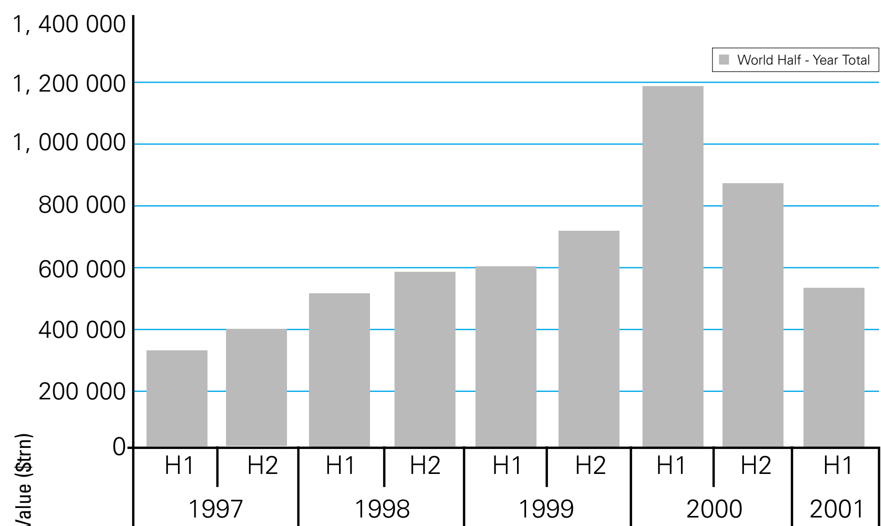
1 "World Class Transactions: Insights into creating shareholder value through mergers and acquisitions", KPMG 2001.

1 Why the increased focus on synergies?

As we reach the halfway point in 2001, it appears that the global M&A market is returning to more sustainable levels following the dot-com and telecoms frenzies that sent deal levels soaring in 1999 and 2000.

M&A Market Activity 1997 - 2001
World Total (cross - border & domestic deals)



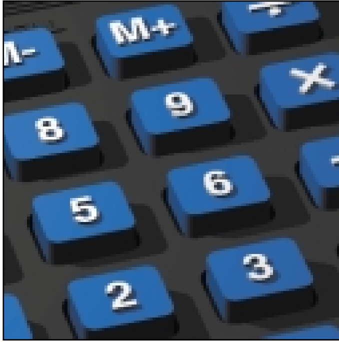
Sources: Compusoft Research / Commscan 2001.
Includes all deals completed 1st Jan 1997 - 22th June 2001. Excludes MBOs & Privatisations.

Yet despite this correction, M&A rumours and announcements continue to feature strongly in the business pages in 2001. The driving forces of M&A remain strong, as companies continue to seek growth by

- extending down the value chain (eg. Vivendi Universal- MP3.com, Schlumberger-SEMA),
- consolidating within their industry (eg. Allianz-Dresdner Bank, ENI-Lasmo)
- globalisation (BHP-Billiton, EON-Powergen)

But the market can be quick to punish those who are seen to be doing the wrong deal, or to be overpaying, as Chase Manhattan discovered when its stock price fell 10% on the announcement of its acquisition of JP Morgan last year.

As the Wall Street Journal observed in November 1999, citing JP Morgan research - "For the first time in several years, the stock price of US acquirers is falling on average upon announcement of a deal". (WSJ 29/11/99).
Deals can even be scuppered by the market before they are consummated. In



May 2001, Prudential's bid for US life insurer American General proved so unpopular with investors that its shares plunged 14% when it was announced, allowing rivals AIG to step in with a counter-offer.

And as is now widely known, the effects are often lasting. KPMG's M&A research[1] has shown that some 70%-80% of M&As fail to create shareholder value.

So how can CEOs persuade their increasingly sceptical stakeholders that, despite the evidence, the premium will not be wasted and the deal will create value - and how will they deliver this promise.

Evidence shows that successfully identifying and realising synergies is a major determinant of deal success. We explore:

- What are synergies - see page 4
- Why they are important - see page 6
- How they can be identified - see page 9
- How they can be realised - see page 11.

1 "World Class Transactions: Insights into creating shareholder value through mergers and acquisitions", KPMG 2001.

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What are synergies? 1+1 = 3?

Synergies can be defined as incremental improvements in performance following the combination of two businesses, relative to their expected performance prior to the combination.

M&As are conducted for many strategic reasons. For example, they may be to achieve market leadership (eg Glaxo Smithkline), for defensive reasons (eg Chevron Texaco), or to extend control in the value chain (Vivendi-Seagram).

With increasing attention now being paid to shareholder value, the quantitative financial benefits of transactions are coming under as much scrutiny as the strategic rationale. In all cases, investors will be looking for the acquired company to realise synergies in the transaction, either in the form of incremental revenue enhancement or in cost reduction.

In many deals in the 1990s, the focus was on cost reduction synergies. Typical examples included:

- rationalisation of premises, manufacturing plants and retail branches by eliminating duplication
- scale economies from mechanisms like combined purchasing power
- efficiency gains using best of breed process improvements
- financial engineering such as tax benefits.

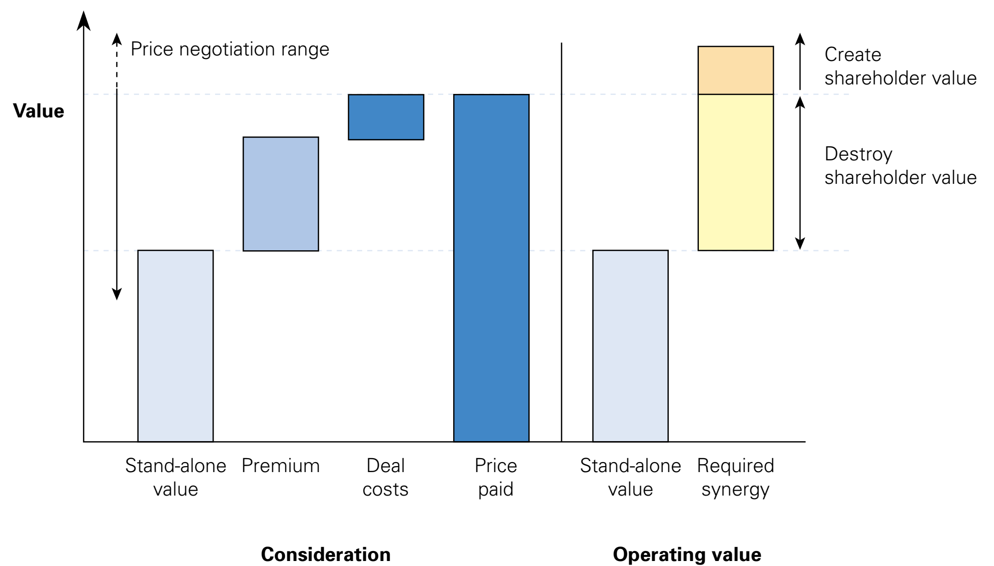
More recently, many deals have been based on revenue enhancement, particularly within the technology and telecom sectors. Commonly-cited sources of revenue synergies include:

- cross-selling
- leveraging enhanced market power
- enhanced new product development and portfolio upgrading
- skills and knowledge transfer
- faster time-to-market.

The acquisition premium sets a synergy challenge for acquirers. Prior to the acquisition, the shareholders could have bought shares of the target without paying a premium.

To repay their shareholders, acquirers must therefore deliver incremental cash flows from the combined businesses. The cash flows must be at least equivalent to the amount implied by the premium, or the value of the deal will be destroyed.

Premium table



3 Why are synergies important?

"Don't talk about synergies, they are never delivered"
\- CEO, European Multinational

Synergies are the prime hard key to deal success

KPMG's 1999 report 'Unlocking Shareholder Value: The Keys To Success' established synergy evaluation as the prime "hard" key to deal success. The report found that acquirers who focused on synergies are 28% more likely to create shareholder value from their deal.

Therefore, without synergies, an M&A is unlikely to result in any significant incremental shareholder value.

There are three key ways in which an early evaluation of synergies contributes to success:

a. To inform the price and / or valuation discussion, avoiding overpayment for the target

It is important for an acquirer to know what synergy figure is achievable when assessing the price to bid. The greater the uncertainty around the synergy figure, the greater the risk that an acquirer may be paying an unsubstantiated premium for the target. This issue becomes more acute as premia reach close to 40%.

An assessment of synergy potential and robust synergy evaluation enables the deal team to reassure the acquiring and target boards that assumptions built into the deal price are realistic. Such analysis may enable a higher price to be bid as the acquirer derives comfort about the scale and achievability of synergies. This can prove to be the difference between winning or losing a potentially good strategic acquisition.

b. To formulate effective communications to the market and other stakeholders

Information concerning synergies is now a familiar (though non-mandatory) element of the public presentation of a proposed deal, and is particulaly important in the event of hostile bids (see box overleaf).

Hostile bids and synergy statements

In 1997 the Panel on Takeovers and Mergers published its specific requirements on how statements concerning the expected benefits of a takeover should be made. The requirements include: publication of the basis of the belief (including sources of information) supporting the statement; reports by financial advisers and accountants that the statement has been made with due care and attention; an analysis and explanation of the constituent elements sufficient to enable shareholders to understand the relative importance of these elements; and a base figure for any comparison drawn.

The requirements do not apply to cash offers, and provided that the documentation contains a reasonably detailed analysis and explanation of the constituent elements of the claimed mergers benefits, the Panel will not normally insist on them in recommended offers unless a competing offer is announced and the statement is repeated in that context or is otherwise a material issue.

The Panel has identified two principal reasons for concentrating its requirements on hostile bids involving share exchange proposals: firstly the concern that the circumstances of a hostile bid can be expected to limit the ability of the bidder to obtain sufficient information concerning the target's business and prospects and hence meet the Code's standards of accuracy; secondly the concern that unless adequate detail of the basis for the statement is included, it may be difficult for the target or a competing bidder to respond in a constructive way to the bidder's claims.

Although public reporting by financial advisers and accountants is thus relatively infrequent, it is common practice on large plc takeovers or mergers for accountants to be requested to provide a private comfort letter. The element of merger benefit statements which is typically most straightforward for a bidder to substantiate is a cost reduction figure, and traditionally accountancy firms who provide comfort letters have restricted their comfort to statements based on such figures, and provided only qualitative rather than quantitative comment around the potential for revenue enhancement synergies.

However, the Royal Bank of Scotland hostile bid for Nat West provided a precedent for revenue enhancement figures to be stated. We can expect to see such a stance becoming more commonplace in the future.

It is important that the offer document and the circular, which are distributed to shareholders when gaining approval to proceed with the deal, both contain a sound explanation of the deal rationale and robust synergy figures.

There is also a growing expectation amongst analysts for a synergy figure to be stated whatever the rationale for the deal. The deal advisers and the acquirer must establish a delicate balance between a synergy figure which will reassure the market that the valuation implied by the premium is acceptable (and potentially sufficient to deter other bidders) and one that management believes is achievable (and ideally, surpassable).

Clearly then, the synergy statement can play a significant role in positively (or negatively) influencing market perceptions of the deal.

c. **To encourage planning and 'buy-in'**

Early assessment of synergies encourages managers to begin the process of planning for integration and encourages 'buy-in' to the deal of the actions required to achieve success.

Companies that perform synergy assessment and integration planning in the pre-completion phase have been shown to improve their chances of value creation by 13% to 28%.[2]

2 "Unlocking Shareholder Value: The Keys to Success", KPMG 1999.

4 How to identify and calculate synergies

There are three golden rules to be considered when assessing synergies:

a. **Take a holistic view of the business-look for both revenue and cost opportunities**

The CEO has the responsibility to articulate and share a compelling vision for a merger or acquisition.

Within that framework, management should then be tasked with rigorously developing a comprehensive picture of the strategic opportunities arising from a deal. They should examine all areas of the business which may result in cost reduction, revenue enhancement and other more strategic benefits. This approach can uncover unexpected benefits compared to the way in which many acquirers 'clutch' only at those synergies which appear easiest to deliver or most palatable.

A comprehensive view is increasingly important as competitive bidding becomes more prevalent and acquisition premia rise. Communication around innovative synergy benefits can play a vital role in market perception, for example Royal Bank Of Scotland's incorporation of revenue enhancement in its battle with Bank of Scotland over NatWest, or BP's messaging around portfolio upgrading in its acquisitions of Amoco and Arco.

For mergers where deals are primarily based on long-term benefits (for instance, in the fast-moving, volatile telecoms or dot-com environments), CEOs can alleviate perceptions of risk by also communicating short-term efficiencies and cost savings.

b. **Ensure that assumptions are sound by involving key managers**

Synergy evaluation is often conducted at a time when acquirers are under pressure to complete the deal quickly, when confidentiality is paramount and there is limited access to information.

Commercially sensitive information will often be withheld from the acquirer pre-deal. Despite this, assumptions must be made to provide the basis for synergy figures. Ideally, the CEO should ensure that operational managers and specialists have participated in the derivation of these figures and believe that they are achievable. Acquirers must remember that in thinking about **what** synergy values may be realistic, they must also begin early on to ask themselves **how** these will be achieved.

On completion of the deal, the acquirer will at last gain full insight into the target business and into accurate information on which to base implementation plans. The new management should then review the synergy assumptions again to ensure there are no surprises and to confirm the key sources of value from the deal.

c. Understand timing and phasing

Cost savings will be realised over a period of time. Proposed workforce rationalisation may require lengthy union or works council negotiations, whilst procurement savings may not be realised until contracts have expired or products have been standardised. Buildings may be held under long leases.

All these factors may delay the moment at which actual savings can begin.

Similarly, revenue enhancements may not be realised until rebranding and a promotion campaign have been implemented.

The value of synergies will also be reduced by one-off implementation costs, such as redundancy, employee relocation, site rationalisation, clean-up, IT systems integration and consultancy, which also need to be quantified and scheduled.

It is important to take all these factors into account to develop a phased financial plan, ideally with targets measured on a timescale corresponding to the acquirer's financial reporting calendar. As well as underpinning cash flow assessments and valuation models, this analysis represents a vital tool to measure progress and support communications in the integration process.

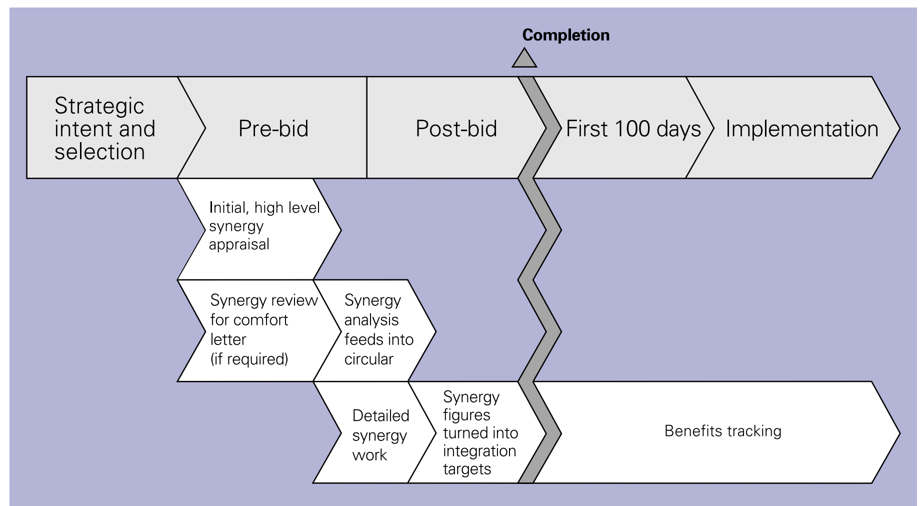
5 How to realise the synergies

a. Start identifying them as early as possible

Our research has shown that early investment in implementation planning and synergy assessment increases an acquirer's chance of delivering value from the deal. Outline implementation plans, particularly those which address key soft issues such as management and culture, are essential to provide credibility when presenting and communicating the transaction to the market.

There are several different stages during the deal cycle where synergies should be considered. Synergy evaluation should begin pre-deal and continue to be refined post-deal during the integration process, with actual synergy benefits being tracked during the implementation.

The diagram below illustrates a typical process:



As all those who have been through the process know, there are considerable demands on management time and pragmatic limits on the number of managers who can be involved in the pre-deal phase. It is easy for teams to work full-time on simply 'doing the deal'.

However the research findings are clear; time and resource allocated to synergy planning will pay back in the implementation phase.

b. Set challenging targets internally, but communicate prudently externally

Successful acquirers cultivate a reputation for over-delivering on challenging targets, ideally ahead of schedule.

Although revenue benefits are key to many deals, they cannot be treated in the same way as cost reduction since they are not usually solely within the power of management to deliver, and are more vulnerable to external market dynamics. It may be particulary prudent to 'aim off' any revenue enhancement figure, which is being publicly quoted, by building in contingency, in both scale and timing.

A similar approach should be taken with cost reductions although the market may apply more scrutiny to these assumptions.

c. Track benefits throughout the implementation phase

As identified in KPMG's report "Unlocking Shareholder Value: The Keys to Success", acquirers that focus on linking pre- and post- deal processes significantly improve their chances of success. The pre-deal evaluation of synergies should feed directly into the post-deal integration plan for further challenge.

Immediately following deal completion, management will be able to gain access to more detailed operational information. Expert teams should be formed and tasked to review the key areas of projected synergy, and develop practical implementation plans to realise them. Ideally, this effort should take place within a structured, accelerated '100 day' or similar integration plan.

Finally, during implementation, benefits should be rigorously tracked as they are realised, providing the market with effective communication on progress.

conclusion

KPMG viewpoint

To justify and deliver the maximum value from a deal, CEOs must ensure that sufficient management time is dedicated to evaluating the potential synergies.

Pre-completion

- develop an objective, quantitative view of the merger benefits and synergies as early as possible, considering both cost savings and potential revenue enhacements
- involve key managers wherever possible to verify synergy assumptions and forecasts
- understand the phasing of benefits and the implementation costs that will be incurred in integrating the acquistion
- ensure that the premium paid does not exceed the incremental value implied by the synergies
- constantly update the analysis for new information (understandings gained during the investigation process).

Post-completion

- communicate the expected synergy benefits clearly but prudently
- review all initial synergy assumptions once access to full data is available
- focus and challenge the integration plan on synergy delivery
- build synergy targets into financial budgets and targets
- ensure benefits are tracked in the implementation phase.

M&A activity is notoriously risky and no process is guaranteed to ensure success. However, our research and our experience of pre- and post-deal corporate M&A activity consistently shows the same message; that by linking robust synergy analysis with early integration planning, successful acquirers set a firm foundation for value creation.

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