Arne & Co.

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Merger & Acquisition Synergies

This issue is devoted to Synergy – first discussed in the March 2008 issue of *Business Transaction Marketplace*^{SM}. In that issue, we indicated that 7 out of 10 Merger & Acquisition (M&A) transactions failed to create shareholder value – the ultimate goal of M&A. One reason for these failures being management's wishful thinking on synergies which often leads to excessive acquisition premiums being paid.

Synergy can be defined as the incremental increases in competitiveness and resulting cash flows beyond what the two companies are expected to accomplish independently. The formula to value synergies is as follows:

Synergy Value = Combined Values – Separate Values

We will be discussing how to indentify synergies within the various operating components of a business, business combinations that create potential synergies, and a framework to insure synergies are realized.

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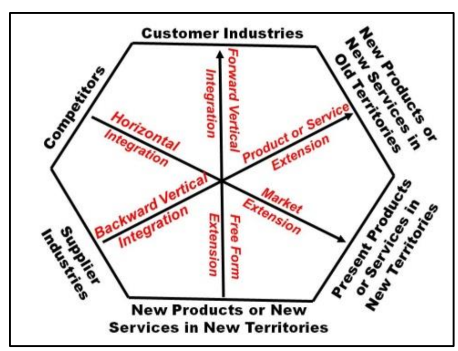
Identifying Synergies

The primary objective of merging with or acquiring another business is to increase the value of the acquiring company. This is accomplished by increasing operating cash flows and/or reducing business risks – *incrementally* – from what these are on a stand-alone basis. Synergistic opportunities may arise in all operating components of a business as follows:

Marketing and Sales: (i) cross selling activities; (ii) completion of product range offered; (iii) multi-usage of distribution channels; (iv) advertising cost savings.
R&D, Purchasing and Production: (i) knowledge transfer; (ii) broader use of existing IP; (iii) better negotiation position with suppliers; (iv) production economies of scale and scope.
Accounting, Finance and Tax: (i) redundant accounting expense reduction; (ii) more sources and lower cost of capital; (iii) intercompany financing; (iv) tax attribute utilization.
Administration, HR and IT: (i) increased management talent; (ii) redundant HR and IT expense reduction; (iii) employee benefit cost savings; (iv) common procurement of IT hardware, software and services.

Business Combinations that Create Synergies

Here are business combinations that create potential synergies:



Horizontal Transactions
A horizontal transaction combines businesses within the same industry having the *same* product/service offering; essentially, they are competitors. These transactions are done to strengthen strategic positions, gain market share, improve efficiencies and increase product/service quality.

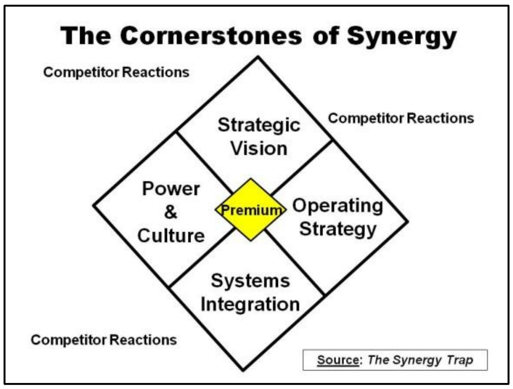
Synergies typically transferred between horizontally combined businesses include: (i) management functions; (ii) financial resources; (iii) product know-how and innovation; (iv) sales channels and logistic processes.

Vertical Transactions
Companies that combine in vertical transactions generate *different* products and services; they are not competitors. These companies are generally suppliers and customers of each other prior to the transaction.

Synergies typically transferred between vertically combined businesses include: (i) new products/services in old territories; (ii) new products/services in new territories; (iii) reduction in supplier/customer dependency.

Conglomerate Transactions
Here the combining companies are completely unrelated to one another.

Synergies typically transferred between conglomerate businesses include: (i) centralization of treasury activities; (ii) improved credit rating; (iii) sharing core competencies in areas of technology, marketing and distribution.



Realizing Synergies

In the seminal book on synergy titled “The Synergy Trap”, the author offers a managerial framework (the cornerstones of synergy) that must be in place for there to be any likelihood of synergy; and therefore, whether paying an acquisition premium is justified.

I. Strategic Vision: It’s where all M&A transactions begin. Management’s vision should be shared with the stakeholders as a framework for planning, decision making and reacting to changing conditions. The vision must be clear, yet adaptable to unknown circumstances. However, without the other three cornerstones, the vision if of little use.

II. Operating Strategy: Many M&A transactions involve little pre-acquisition planning, and therefore have no real operating strategy on the day the deal is completed. Instead, it’s merely a restatement of the strategic vision; but without an operating strategy, the vision is just words with no action to back it up. The operating strategy must address how the newly combined company will be more competitive along the entire value chain.

III. Systems Integration: Systems integration must be carefully considered before the acquisition and must support the clearly defined operating strategy. The focus with systems integration is on physical integration plans that must be in place. For example: integrating sales forces and marketing efforts, distribution systems, information and control systems, R&D, IT and HR.

IV. Power and Culture: It’s easy to forget the soft side of M&A (culture and power) when management is caught up with the legal and financial aspects of the deal. The issue for acquirers is not whether the cultures are similar or different; but, whether changes necessary to support the strategy will clash with either culture. Unless rewards and incentives support a real strategy with real integration plans, managing culture means very little with regards to realizing synergy.

Upcoming Darrell Arne Seminar

Succession Planning: Exit Strategies for the Privately Held Business Owner	New England Business Brokers September 7, 2011 – Chelmsford, MA

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