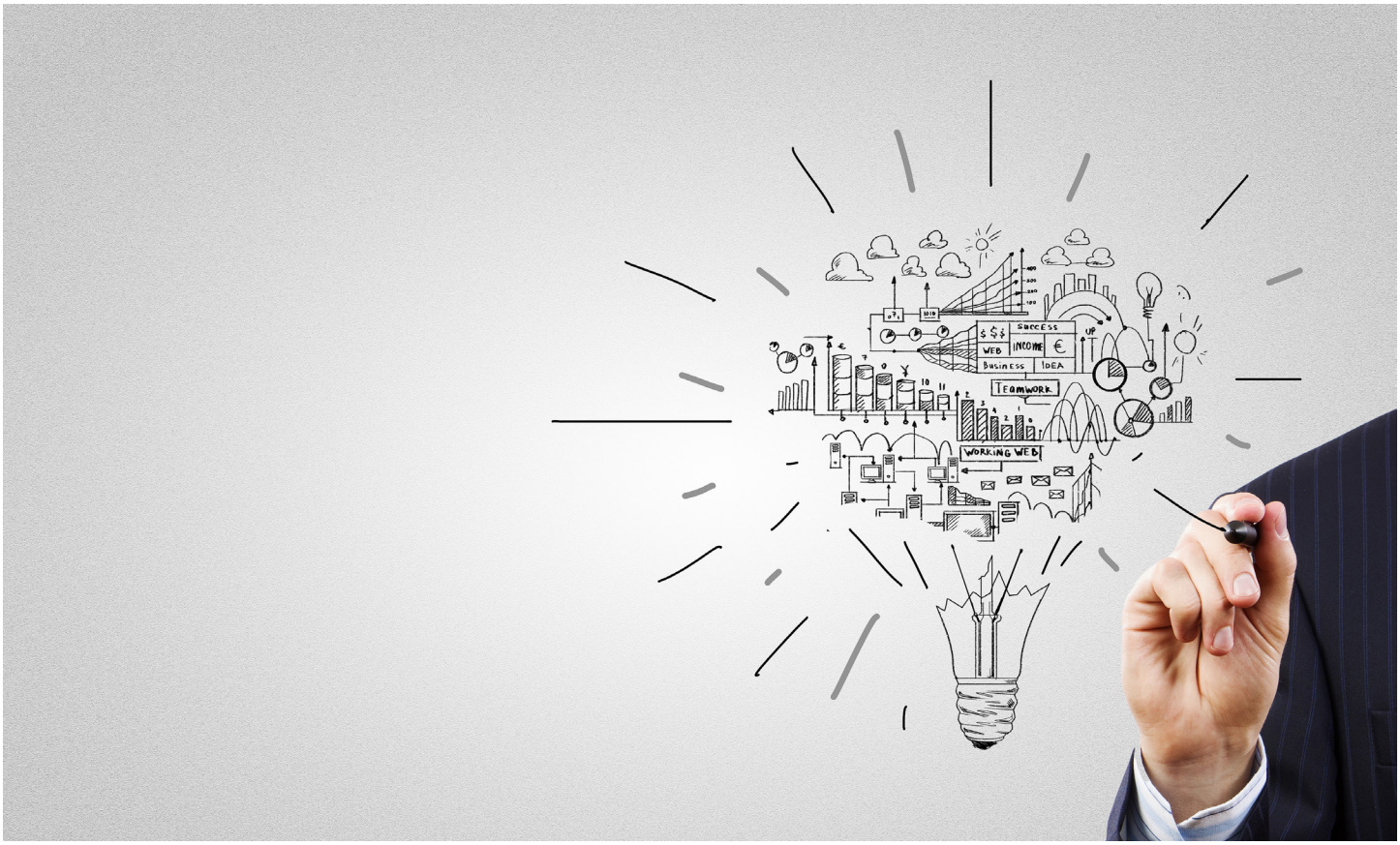


M&A Strategy Series

Due diligence for cost synergy capture: Building deals on bedrock

As corporations and private equity (PE) firms consider mergers and acquisitions (M&A) that will combine operations, they generally rely on high-level, top-down assumptions to identify cost synergies that are built into valuations. These same organizations are often surprised when assumed post-deal operational improvements aren't as significant as planned or take longer than expected to realize.

Acquirers typically spend three to four weeks on financial accounting diligence to normalize EBITDA and commercial diligence that tests the real market opportunity and customers' satisfactions and dissatisfactions with the target. Unfortunately, diligence teams often gloss over cost reductions that are perceived as easy to achieve: the "magic 10 percent." This oversight can have huge ramifications on realized value and management credibility if those synergies do not occur or are delayed. Prospective acquirers may be able to negate this issue by performing synergy-capture diligence – a vital piece of operational due diligence that can be done alongside typical financial and commercial diligence.

The story is a familiar one. Post-close, when an acquirer needs to quickly launch critical integration activities around geographic, headcount, and functional alignment, the executive team belatedly realizes that projected cost reductions have not been fully tested and related decisions have not been made. What often happens next? Integration teams are forced to perform diligence that should have taken place pre-close, and the resulting integration slowdown causes confusion and angst in the workforce. Questions then surface about the credibility of the deal's true value or, even worse, the deal's overall investment thesis.

Synergy-capture diligence, a bottom-up approach that puts management's

skin in the game early on, can help identify where specific cost reductions may be achieved. Such diligence can help justify valuations and drive early alignment around the new operating model for the combined businesses.

Pre-close synergy-capture diligence may enable acquirers to avoid predictable problems such as:

- Planning delays, lack of management focus, and unrealistic integration schedules
- Failure to think through costs that will be incurred to achieve each benefit
- Deal team vulnerability to increase the bid price without a credible fact base
- Lack of accountability for specific synergies
- No input from management about responsible parties
- Little consideration of scenarios that might help or hinder projected performance improvements, often leading to surprises
- Delayed attention to customers and revenue-generation, opening the door to competitor actions

Synergy-capture diligence by the numbers

Acquirer management teams should consider structuring a bottom-up approach to synergy-capture diligence. This approach should test initial top-down assumptions about synergies and build a blueprint for accelerating synergy capture during post-merger integration. Based on Deloitte's work with clients in numerous industries, we have identified five steps in the "diligence and plan" process (Figure 1):

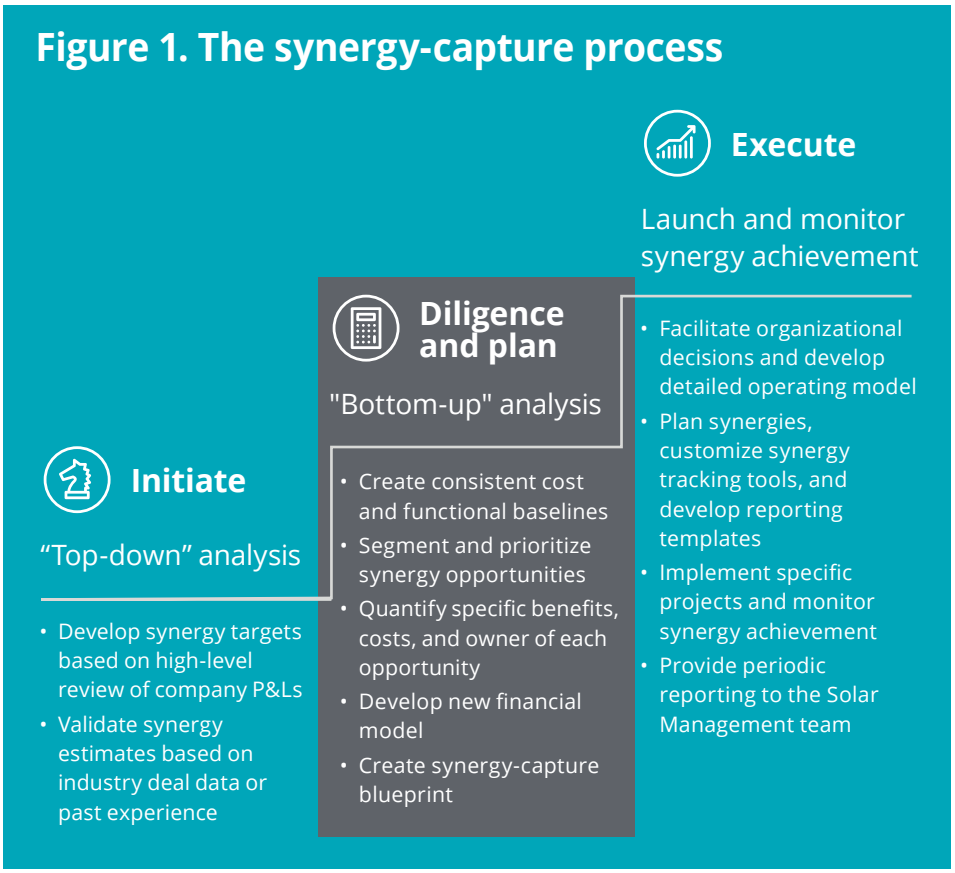
1. Create consistent cost and functional baselines. The acquirer's management team should begin by gathering profit & loss (P&L) data from recent financial statements for both companies to view the total "pie" and normalize the statements by removing one-time, nonrecurring costs. The team can use this information to create a consistent baseline that maps the cost pools from the combined P&L to specific functional areas such as finance, HR, and marketing.

2. Segment and prioritize synergy opportunities. Team members should make initial hypotheses about synergies that can be realized quickly (Phase I), such as full-time-equivalent (FTE) rationalization, corporate insurance, public company costs and audit fees, and management overhead. Also important are hypotheses about synergies that require additional information (Phase II), such as information technology (IT) and customer relationship management (CRM) consolidation, fleet and vendor rationalization, and corporate facilities and customer service site rationalization.

3. Quantify specific synergy opportunities and cost-to-achieve by functional area. Through detailed interviews with executives and functional leaders, the acquiring company should identify redundancies across all functional support areas for Phase I synergies. This helps to build the new organization from the ground up, identifying responsible parties who are "signing up" for the plan. Other parts of this step are determining the costs to achieve synergies, such as severance pay, lease termination, and other one-time exit costs; and identifying additional overhead cost pools that may have been missed in initial assumptions.

4. Develop new financial model and explain variances from initial assumptions. The buyer's management team can use the bottom-up cost-reduction and cost-to-achieve estimates to develop a new financial model (and resulting P&L) to present to the company's board of directors. The model should identify and explain all variances – positive and negative – from the initial top-down analysis.

Figure 1. The synergy-capture process



5. Create a synergy-capture enterprise blueprint and integration road map. An enterprise blueprint is a definitive statement of how the new organization should operate to achieve the deal's intended business results. Developing this blueprint is a critical final step in the "diligence and plan" process because it functions as a road map, with milestones, dependencies, and potential bottlenecks. It also guides the organization from overarching deal rationale through post-deal value-capture measures. While the combined organization's end-state vision likely will evolve as new information is assimilated during the M&A transaction, an enterprise blueprint provides a valuable frame of reference and focuses the entire organization on desired results.

The economics of M&A deals are straightforward: the cost-of-capital clock begins ticking the moment capital is invested. As a result, unexpected and needless delays in realizing synergies can become costly to investors. By following the above steps to pre-deal synergy-capture diligence, acquirers should be able to surpass traditional testing of top-down cost reduction assumptions, whether they are provided by bankers or based on past industry experience. This process also encourages relevant management involvement, input, and personal commitment from the outset. (See sidebar: "Practical lessons for working with buyer and target teams.") It stress tests the valuation according to size, timing, and investment required to achieve specific cost-reduction targets, and is designed to generate a flexible financial model to accommodate new information. Because responsible functional parties are identified along with specific synergy initiatives, senior management can focus much earlier on the new end-state operating model, serving customers, and preserving and growing revenue – the life blood of any acquisition.

Synergy-capture diligence in action

The following examples illustrate how Deloitte's synergy-capture diligence professionals have supported organizations in their efforts to determine realistic synergies, costs to achieve those synergies, early blueprints for end-state operating models, and tactical steps for effective translation of the strategy into execution during the integration process.

Pre-deal synergy assessment: Regional utilities company

Business issue: Assess the client's synergy estimates for its largest-ever potential acquisition.

Scope and approach

- Deloitte supported the executive team by performing due diligence to validate its synergy estimate and update the company's final bid.
- The evaluation encompassed general and administrative (G&A) and support-function cost elements – for example, operations, finance, marketing, and HR – where a "bottom-up" analysis was conducted.
- We gathered financial data and conducted interviews with senior executives to provide estimates of net efficiency gains focused on reducing headcount redundancies (for example, two operators serving customers in the same region), consolidating span of control and reducing redundant senior management positions, and identifying new synergy opportunities not previously considered (for example, inclusion of corporate insurance and audit fees).

Value achieved

- Our client identified 50 percent more incremental synergies than its previous top-down synergy estimates indicated would be possible.

Pre-deal synergy validation: Life sciences tools company

Business issue: Validate and refine the client's synergy opportunities by cost pool and function for its acquisition of a target twice its revenue size.

Scope and approach

- Deloitte supported the executive team's pursuit of a life-event transaction for the acquirer by conducting pre-deal synergy identification to inform the deal valuation.
- We engaged both acquirer's and target's functional leaders in validating and quantifying synergies across COGS, R&D, sales and marketing, and G&A, with timing and cost-to-achieve considerations. This facilitated leaders' buy-in on synergy targets.
- Deloitte provided pre-deal support from 40 days pre-signature through the announcement date.

Value achieved

- Our client identified approximately $150 million more in incremental synergies, than initial estimates, and front-loaded synergy capture to 50 percent in the first year.
- We helped the client determine a purchase price that was accretive for investors, and our work helped boost management's confidence and clarity regarding objectives for jump-starting the synergy-capture process.

Practical lessons for working with buyer and target teams

Potential implications for the buyer

Assembling the right team: Numerous target company functional areas may offer post-deal synergy opportunities. It is critical, therefore, that buyer team members who are conducting the pre-deal synergy assessment be knowledgeable about those functions.

Gaining rapid access to internal data: A buyer may miscalculate the time required to gain access to their internal data, which may slow analyses that require financial information from both target and buyer. Product purchase and selling prices, detailed functional cost breakdowns, and other internal data are typically required to build functional baselines and assess potential synergies.

Appreciating synergy-realization challenges: A buyer's M&A team may underestimate the time and costs required to achieve anticipated synergies as well as overestimate run rate benefits. A senior executive should play the "pressure-testing" role across each function before synergy assumptions are built into valuation models.

Safeguarding deal confidentiality: One of the common challenges of performing bottom-up synergy diligence is maintaining deal confidentiality. Because this is essential, the buyer's diligence team should be as small as possible. Where it is not possible to have representatives from each function, external advisors can help fill any gaps.

Building a flexible synergy model: The synergy team should build a flexible financial model that accommodates multiple scenarios (for example, initial estimates, worst case, and best case). As management uncovers new information throughout the diligence process, having a flexible model can help the team quickly adjust the high and low ranges by function and facilitate discussions about which cases are most realistic for each function.

Potential implications for the target

Requesting and prioritizing data: Because rapid access to target data is critical during a pre-deal synergy assessment, establishing a quick, simple, and trackable data request process will help the buyer team avoid delays and missed data as it becomes available. Prioritizing requested data enables the target's management to focus on and invest time in providing the most important data first.

Coordinating with the entire diligence team: Buyers only get so many opportunities to interact with target management, so it is important that the synergy, accounting, commercial, and operational due diligence teams are coordinated. That enables the buyer to leverage data already captured from the target.

Asking questions that yield unbiased answers: Cost synergies can be a sensitive subject, so questions should be phrased to elicit unbiased responses from the target's executives. For example, rather than asking about poor performers, questions could focus on current employee evaluation policies and recent results.

Accessing confidential and sensitive data: Bottom-up analyses of cost and revenue synergies often involve accessing sensitive target company information. This may include employee salaries, hire dates, and termination policies for possible headcount reductions; or pricing information for potential cross-selling initiatives. Management teams can use external advisors to help manage confidentiality concerns related to this information and help avoid potential antitrust issues.

Assisting the target with data preparation: Tactfully communicating the buyer's knowledge about the target company's IT systems and data sources, such as enterprise resource planning (ERP) systems and data warehouses, may help to expedite the data-gathering process with the target's employees.

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