Elliott Golden

Where **mergers** go wrong

Most buyers routinely overvalue the synergies to be had from acquisitions. They should learn from experience.

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It's known as the winner's curse. When companies merge, most of the shareholder value created is likely to go not to the buyer but to the seller. Indeed, on average, the buyer pays the seller all of the value generated by a merger, in the form of a premium of from 10 to 35 percent of the target company's preannouncement market value. The fact is well established, but the reasons for it are less clear.[1]

Our exploration of postmerger integration efforts points to the main source of the winner's curse: the fact that the average acquirer materially overestimates the synergies a merger will yield.[2] These synergies can come from economies of scale and scope, best practice, the sharing of capabilities and opportunities, and, often, the stimulating effect of the combination on the individual companies. However, it takes only a very small degree of error in estimating these values to cause an acquisition effort to stumble.

Acquirers must undoubtedly cope with an acute lack of information. To help them assess synergies and set targets, they usually have little data about the target company; limited access to its managers, suppliers, channel partners, and customers; and insufficient experience. Even highly seasoned buyers rarely capture data systematically enough to improve

[1] Hans Bieshaar, Jeremy Knight, and Alexander van Wassenaer, "Deals that create value," *The McKinsey Quarterly*, 2001 Number 1, pp. 64–73 (www.mckinseyquarterly.com/links/10272).
[2] Richard H. Thaler, *The Winner's Curse: Paradoxes and Anomalies in Economic Life*, Princeton, New Jersey: Princeton University Press, 1992.

their estimates for the next deal. And external transaction advisers—usually investment banks—are seldom involved in the kind of detailed, bottom-up estimation of synergies that would be needed to develop meaningful benchmarks before a deal. Fewer still get involved in the post-merger work, when premerger estimates come face-to-face with reality.

Lessons learned

To address this challenge, we have used our extensive experience of postmerger integration efforts across a range of industries, geographies, and deal types to set up a database of estimated and realized merger synergies.[3] After combing through the data from 160 mergers (so far)—as well as our knowledge of the companies and their industries—we have found six practical measures that executives can take to improve the chance of achieving synergies from acquisitions.

For starters, executives should cast a gimlet eye over estimates of top-line synergies, which we often found to be inflated. They should also try to anticipate common "dis-synergies" (such as the loss of customers and difficulties reconciling different service terms) and consider raising their estimates of onetime costs. Additional steps include vetting assumptions about pricing and market share, making better use of benchmarks to deliver cost savings, and forming more realistic assessments of how long it will take to capture synergies. When applied by an acquisition team chosen for its expertise and its ability to counter gaps in information, these six measures should help buyers avoid the winner's curse and improve the quality of most of their deals.

Reduce top-line synergy estimates

Wall Street wisdom warns against paying for revenue synergies, and in this case it is right. The greatest errors in estimation appear on the revenue side—which is particularly unfortunate, since revenue synergies form the basis of the strategic rationales for entire classes of deals, such as those pursued to gain access to a target's customers, channels, and geographies. Almost 70 percent of the mergers in our database failed to achieve the synergies expected in this area (Exhibit 1).

Acknowledge revenue dis-synergies

Another common reason for errors in estimating revenues is the failure of most acquirers to account explicitly for the revenue dis-synergies that befall merging companies. These dis-synergies sometimes result from the disruption of a company's ability to execute and sometimes directly from efforts to reduce costs.

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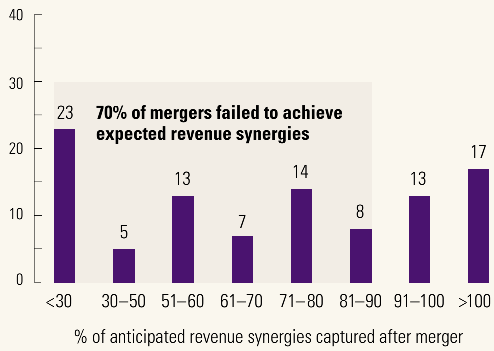
[3] As our database expands, we will continue to deepen our understanding of realized merger synergies and share the insights that emerge.

EXHIBIT 1

Top-line tribulations

% of companies (n = 77)



Source: 2002 McKinsey postmerger-management survey

In retail banking, for example, important cost-based synergies are expected to come from consolidating branch networks. The acquiring bank assumes that while some customers might leave, cost savings will more than make up for the losses. But when one large US bank acquired a competitor with a substantial geographic overlap, the acquirer suffered unusually high losses among the target company's customers, rendering the deal unprofitable and exposing the merged entity to a takeover. Due diligence on the target's customers would have revealed that they were heavy branch users and thus especially likely to defect as a result of an integration process that closed more than 75 percent of the acquired company's branches. This experience may be relatively extreme, but our experience indicates that the average merging company loses 2 to 5 percent of its combined customers.[4]

Most acquiring companies can do better, especially in industries, such as retail banking, that have already seen a good deal of consolidation. Data on the level of customer losses experienced by merging banks are available from a range of sources, including industry associations, regulatory filings, and articles in the press. Examples are numerous enough to help buyers identify not just helpful benchmarks (for example, when a branch closes, 8 percent of retail deposits will be lost to competitors) but also the underlying factors that determine whether a deal produces losses above or below the benchmark (for instance, the number of customers who also bank with a competitor, the distance to the next-closest remaining branch, and the presence of competitors to take over closing branches). In other industries, a search of this kind might yield no more than two or three good precedents and only limited data on them—but even that much information can greatly improve revenue estimates.

Increase estimates of onetime costs

Many deal teams neglect or underestimate the impact of onetime costs. A chemical manufacturer, for instance, publicly committed itself to reducing annual expenses by $210 million, at a onetime cost of $250 million.[5] Had the company put as much due diligence into that onetime figure as it did

[4] In the 124 mergers for which we have relevant data, these are the 25th- and 75th-percentile figures, respectively. Not all merging parties lost customers, but some lost more than 30 percent.

[5] In this and other examples derived from our client experience, we have altered the figures (but not the proportions) as needed to disguise the company's identity.

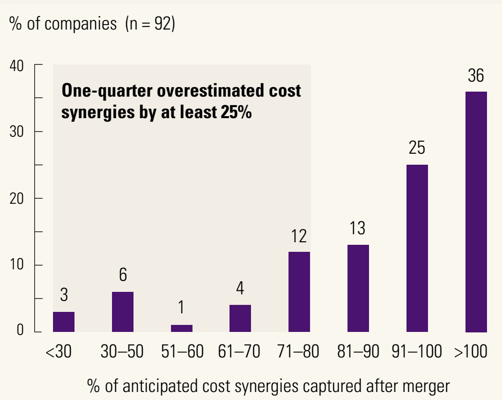
into the annual synergy target, it would have found a few relevant earlier transactions suggesting that the onetime cost wasn't likely to be less than $450 million. In trying to fulfill the original commitment, the company ended up running over budget, underdelivering on promised synergies, and falling well short of revenue growth targets.

Compare projections with realities

Many acquirers rely too heavily on assumptions about pricing and market share that are not consistent with overall market growth and competitive realities. One global financial concern estimated that a recent acquisition would net €1 billion ($1.18 billion) in mostly top-line synergies within five years and 13 percent profit growth in the first year. But limited overall market growth meant that these goals could be achieved only if the company took significant share from competitors through cross-selling, and then only if the competitors didn't respond successfully. Actual profit growth was a mere 2 percent. The message is that acquirers need to calibrate the market share and margin assumptions in their pro forma analysis with the realities of the market.

EXHIBIT 2

Mixed results



Source: 2002 McKinsey postmerger-management survey

Apply outside-in benchmarks to cost synergies

While managers in about 60 percent of mergers deliver the planned cost synergies almost totally, in about a quarter of all cases they are overestimated by at least 25 percent (Exhibit 2), a miscalculation that can easily translate into a 5 to 10 percent valuation error. In one merger we assisted, the target's net present value (stand-alone value plus "base-case" synergies) was $2.5 billion; if the acquirer's cost synergy estimates had been 25 percent too high, the NPV would have been only $2.3 billion.

A company risks overestimating synergies if it neglects to use the available benchmarks as a sanity check. One European industrial company that acquired another planned for cost savings of €110 million from selling, general, and administrative expenses, even though precedents suggested that a range of €25 million to €90 million was more realistic. Furthermore, the company neglected to conduct a bottom-up analysis to justify the higher figure. Still worse, it was especially risky to aim for deep cuts in sales and marketing expenditures because this approach puts revenue growth at risk, and the net present value of presynergy revenue growth was roughly four times greater than all synergies combined.

Be realistic about timing

Deal teams often make simplistic and optimistic assumptions about how long it will take to capture synergies and how sustainable they will be. As a result, important deal metrics, such as near-term earnings and cash flow accretion, can end up looking better than they deserve, which leads companies to overestimate the net present value of synergies substantially.

One company we worked with budgeted head-count cost savings as if they would be spread out evenly over each quarter. In practice, managers tended to wait until the last month of a quarter before making reductions. As it happened, this error didn't have a material impact on the transaction's net present value, but it did cause the postmerger integration leaders to miss their projections for first-year synergies, thereby undermining the credibility of the process.

Moreover, many savings, while real, aren't perpetual and must be phased out. Often, for example, companies plan to reduce their operating costs by squeezing production capacity and logistics across the merged organization. But if each merging company is growing quickly in its own right, sloppy incremental analysis might attribute to the merger certain benefits that would be realized anyway by the individual companies. One of our medical-product clients, which had been growing by 10 to 15 percent a year, forecast that without a merger it would be using the full capacity of its own plants within three to four years. At that pace, much of the money saved by closing or streamlining plants in the context of a proposed merger couldn't really be expected to last very long, because closed facilities would soon have to be reopened. In general, we believe that it is overoptimistic to include the full amount of targeted annual synergies in the "continuing-value" calculation of a net-present-value model.

The problem isn't just properly translating the timing of synergies into present values: bad timing can prevent synergies from occurring at all. Persistent management attention is needed to capture them. We have found evidence to suggest that unless synergies are realized within, say, the first full budget year after consolidation, they might be overtaken by subsequent events and wholly fail to materialize. We have also observed that synergies are captured more quickly and efficiently when a transaction closes at the start of the merging companies' annual operational-planning and budgeting process. One financial institution even found that its plans to migrate its own IT systems to an acquired company's platform had to be radically altered to accommodate a relatively narrow window of opportunity between peaks in the lending season.

Effective deal teams

While estimating synergies is difficult, doing so is vital and requires more investment than it usually gets. The companies we studied used various ways to improve their synergy estimates.

Involve key line managers

Involving line managers in problem solving and due diligence improves the quality of estimates and also builds support for postmerger integration initiatives. Synergy analysis also illuminates issues that will shape due diligence, the structure of deals, and the negotiations that lead up to them.

One of our clients had its head of operations take the lead in estimating the savings from rationalizing manufacturing capacity, distribution networks, and suppliers. His knowledge of the unusual manufacturing requirements of a key product line and of looming investment needs at the acquirer's main plant helped improve the estimates. He also learned from a due-diligence interview with the head of operations at the target that it had recently renegotiated its supply contracts and had yet to implement an enterprise-resource-planning (ERP) system, both facts that made it possible to refine synergy estimates. All of this helped his employer (the buyer) during the negotiations and deal structuring: the buyer knew, for instance, that it could promise to retain the main European location of the target but could not give similar promises about that company's main US facility. Moreover, his involvement ensured that he was prepared to act quickly and decisively to realize savings once the deal closed.

By contrast, another company with substantial acquisition experience left the estimation of synergies up to the M&A department and paid the price. Using an accurate but high-level financial analysis—total cost per customer served—the department concluded that integrating customer service operations would have no value. Had line managers been involved, their due diligence would probably have revealed the fact that the target's smaller centers had much lower labor productivity but compensated for it with an innovative Web-servicing program. Consolidating operations could have both improved the merged entity's labor productivity and brought the Web-servicing program into the acquirer's larger service center. But the acquirer missed the "unfreezing" time immediately following the merger announcement and lost the opportunity.

Codify experiences

Internal M&A teams should do more to codify and improve their synergy-estimation techniques. Every deal represents a valuable lesson, and some specific procedures, we have discovered, make a difference. They include holding a formal postintegration debriefing session with the integration and M&A teams (which ideally should overlap), requiring future M&A and integration leaders to review the results of past deals, tracking synergies against the plan for two years, and calculating retroactively what the net present value of a transaction turned out to be.

Having said all this, we must sound a note of caution. Companies shouldn't overstate what can really be learned from experience, since not all deals are alike. One bank skillfully balanced what it discovered from its first acquisition against the idiosyncrasies of its second big acquisition. The first had gone badly; the bank underestimated the integration costs by a factor of three. The second time around, the executives leading the deal understood that they had to get the estimates for costs (and deposit losses) right. Instead of simply applying the loss data from the first merger, which involved much less geographic overlap than the second, they brought in a line manager who had worked on a recent branch-closure program. By applying benchmarks carefully and consulting line managers, the bank avoided making the same estimation error twice.

Companies with access to reliable data can develop sound benchmarks for estimating realistic synergies and finding insights into the sources and patterns of error in estimating them. Obviously, these efforts can be thorny, but in our experience they are well worth the effort.

A more comprehensive database would help to resolve other strategic issues—for instance, whether some synergies are consistently embedded in the acquisition premium paid while others are captured by the acquirer and whether the stimulating effect of a transaction is necessary to improve the acquirer's stand-alone performance. The answers to the first question will obviously inform price-setting and negotiation strategies; those to the second could lead companies to consider tactics other than acquisitions to raise their performance. Finally, it's important to recognize that a well-designed postmerger integration effort can sometimes help companies do even better than they had hoped.[6] Q

[6] In our experience, companies are routinely amazed to find that "unbeatable" deals they negotiated with suppliers are inferior to their merger counterparts' deals—sometimes with the same suppliers.

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