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Procurement-driven synergies in mergers: Landmine or goldmine?

It's easy to underestimate just how important procurement is in finding merger synergies and executing on them. A dozen lessons help separate the goldmines from the landmines.

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Over the eight years from 2009 to 2016, merger activity in the US has grown by about 14 percent a year. Although many factors account for the spate of deals, cost synergies often rank as among the most powerful attractions for deal-making.

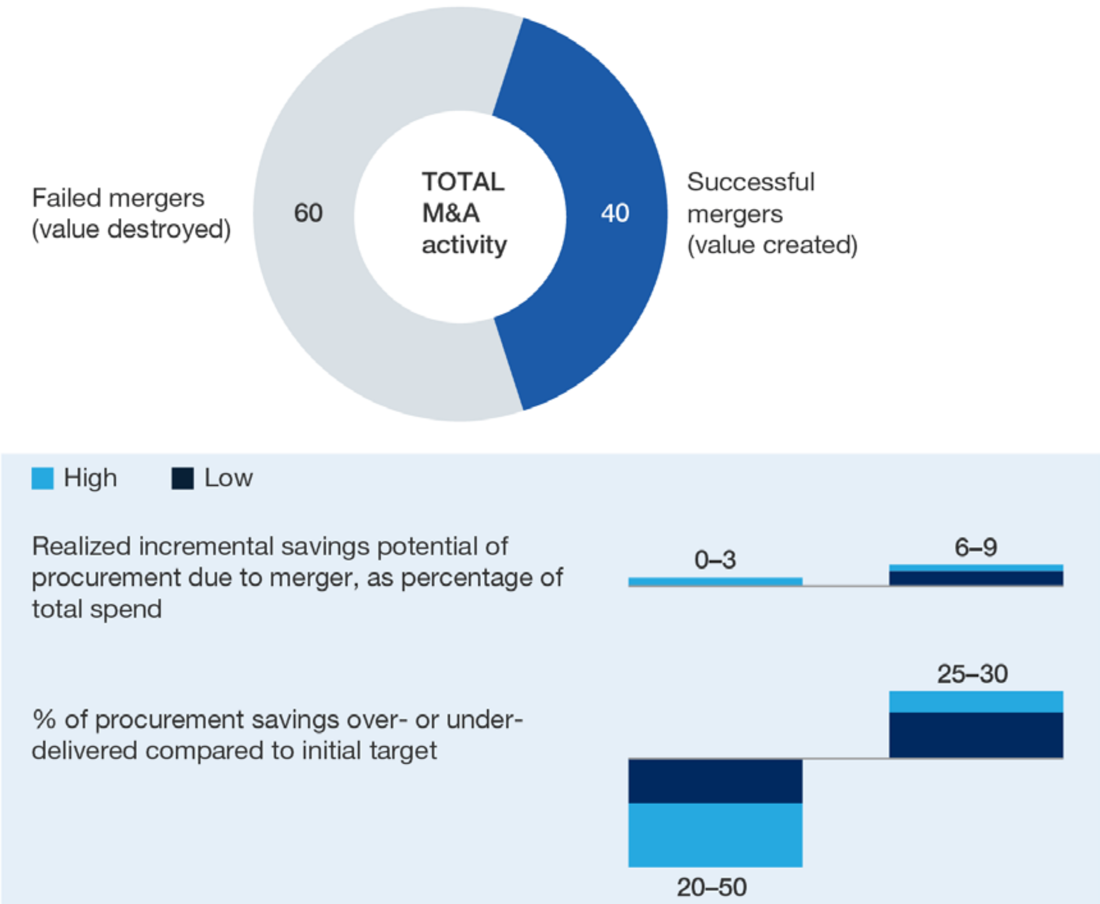
But which costs are the first priority for synergies? The reality is that external spend often represents the largest share of a company's cost of goods sold. Consequently, the procurement function represents a potential goldmine in mergers, and one that's relatively lower-pain as a source for cost reduction. Better to find savings from suppliers than from headcount reductions or complex operating-model changes.

Yet even today, procurement is often viewed only as a secondary source of savings—despite the fact that in our experience, it represents on average 25 to 40 percent of a merger's total cost-saving potential. Moreover, analysis of an Economist Intelligence Unit survey of 150 mergers shows that achievement of procurement synergies correlates strongly with a merger's overall success. Shortfalls in procurement synergies, on the other hand, seem to be a symptom of larger problems in a merger: a landmine to avoid (Exhibit).

Exhibit

Shortfalls in procurement synergies may indicate larger deal problems.

Merger performance, %



[1]Economist Intelligence Unit survey of 150 mergers.

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Avoiding the landmines

We've seen many companies across industries use procurement savings as an essential step in a successful merger integration. The impact these organizations have achieved illustrates multiple lessons—and a few surprises.

1. **Engage procurement early in the deal process.** Too often, procurement isn't brought in until after the target has been identified or the synergies have been estimated—or, in some cases, until after the deal has been finalized. This is a missed opportunity, since procurement experts can quickly estimate the synergies' full potential to inform the deal model and economics. Procurement's perspective is more likely to be truly comprehensive, encompassing the entire suite of options discussed later in this paper. Failing to take advantage of this

capability can lead companies to pass on attractive deals or pursue ones that offer too little upside.

2. **Avoid over-emphasizing business continuity.** In most mergers, management spends a disproportionate amount of time and effort on ensuring that suppliers will continue to supply product, financial transactions will continue to flow, and so forth. These issues are important as hygiene, but we would argue that they are truly table stakes. What differentiates a successful merger from an unsuccessful one is a company's ability to zero in on the biggest synergy initiatives and build confidence in management's ability to deliver impact.
3. **Build the right foundation: a combined spend baseline and taxonomy**. Mapping spend between two legacy organizations to a common taxonomy is difficult, but a must-have to ensure an apples-to-apples spend comparison. You need to know the starting point in order to estimate the opportunity from spend consolidation. It's surprising how many companies disregard this basic requirement, and then painfully realize after Day 1 that their definitions of spend in each category are different.
4. **When possible, launch value-capture initiatives before Day 1.** The traditional thinking is that synergy *identification* happens before Day 1, and synergy *execution* after Day 1. A few companies are successfully pushing those boundaries. A clean team can identify initiatives that can be executed prior to deal closing, such as policy changes that bring the two companies closer. In some cases, even supplier negotiations may be possible based on tiered pricing or three-way supplier non-disclosure agreements. Both tactics help accelerate value capture so that the cash register is already ringing when Day 1 starts.
5. **Use the merger as an opportunity to re-build**. Mergers are invaluable opportunities to transform the combined business: through upgrading talent, building capabilities, and designing nimble organization structures that better navigate the post-merger environment. But most companies still solve for business continuity over talent, such as by keeping low performers to get their institutional knowledge. It's a short-term benefit with a medium- to long-term cost, too often leading to a sub-optimal organization that is even more difficult to change later on.
6. **Involve business and functional stakeholders as you identify synergies.** Who you work with to identify synergies and capture value—and how—are just as important as what you actually do. Getting early buy-in from the C-suite, as well as involving leaders of business units and functions (manufacturing, commercial, IT) in major decisions clears procurement's path to execute its initiatives more collaboratively and effectively. In this fashion, mergers are prime opportunities for procurement to build credibility in the broader organization.

Prospecting for goldmines

As teams begin to identify synergies, here are the typical goldmines that you are likely to come across. Some are bigger than others, and some are easier to as well.

7. **Price alignment**: This is probably the simplest type of procurement synergy: the two companies pay a different price (or have different terms) for a similar product or service, and can move to the better of the two. For example, in one of the top mergers in healthcare, the two merging companies discovered that they were paying prices that were 30 percent apart for the same specifications on a crucial commodity. Capturing this opportunity by moving to a common supplier was relatively easy.

   But as easy and quick to capture as these synergies may be, in our experience they end up being a small source of impact. In most mergers, only a small percentage of the two companies' spend is on products and services with the same specs or service-level agreements (SLAs). And even a 5 to 10 percent difference in prices results in a fairly small opportunity.

   That said, there may be more opportunities than initially meet the eye. It's important to avoid looking for price alignment at the most detailed level, such as an individual SKU. Instead, teams should open their field of vision to similar products that aren't quite identical, looking at category- or supplier-level possibilities. But even with this extra step, the exercise still ends up being a fairly small (but easy) source of impact.

8. **Combined spend leverage**: This is the second most common source of impact, and also one of the bigger ones. The simple view is that leveraging combined scale with suppliers drives higher discounts. For example, one company was able to leverage the combined volumes for marketing-agency spend across two merging companies to deliver savings of almost 10 percent.

   But not every category offers the same possibilities, and indirects often offer more headroom than directs. For most traded or listed commodities (metals, basic chemicals, resins), suppliers are price takers and most of the costs are variable. Because variable costs increase with scale, being able to make a larger order won't leverage may not be a big savings source. On the flip side, this becomes more meaningful for categories that have higher variable costs or tiered pricing discounts (e.g., marketing services, temp labor).

9. **Clean-sheet based negotiations**: This source of synergy goes beyond leveraging scale, and asks a more fundamental question: how much should this product or service cost?

   The approach here is to create an outside-in view of a product's "should costs" (meaning its lowest possible cost under ideal production conditions), and use that to drive fact-based negotiations. Instead of old-school pounding-the-table negotiations to get suppliers to lower their prices, the parties can engage in an objective conversation on the gap between the product's current and potential cost structures. The supplier must then articulate factual reasons for their pricing, and may discover mutually beneficial opportunities. For example, one merged high-tech company used clean-sheet models to negotiate markups for temporary labor. A detailed, bottom-up view of statutory costs, taxes, recruiting costs, and overhead helped inform the development of new targets for temp agencies.

In our experience, this is one of the most powerful and biggest source of value. While companies can (and do) pursue this approach independently, a merger's high incentives and organizational momentum often become a trigger for change.

10. **Policy alignment for specs/SLAs**: Standardizing specs, both for directs and for indirects, can be a significant saving source: moving to a common travel policy, standardizing benefits, imposing uniform SLAs for various services, and the like. One company achieved real savings just by creating common standards for corrugated packaging.

    Most procurement professionals also know that changing what the company buys can be as or more important as the price it pays. However, they may underestimate the power of a merger to help push for these changes. Aggressive synergy targets, demand from business and function heads, and a quantified business case often create the right conditions to make these ideas real.

11. **Demand and compliance management**: Controlling how much the company buys can drive even more impact. Thoughtful limits not only reduce wasteful spend (for categories like temp labor that often go unchecked for demand management), they also help instill a return-on-investment culture and a mindset of budget stewardship.

    We generally see two extremes on this point, though: too relaxed or too strict. Few companies strike a good balance between control and individual ownership. It's important to keep that in mind, and take a nuanced view based on the nature of the category, the level of spend, the savings potential, and the practicality of implementation.

12. **Operating model changes (e.g., make vs. buy)**: This final savings source is one of more difficult levers to pull. A merger often opens up decisions on make versus buy, especially when one company buys a service that the other performs in-house. In some instances, the combined scale changes the economics of this decision. When applicable, this can be a big (though complex) driver of impact.

    One company helped identify potential from in-sourcing product sterilization, an option that was made possible by the scale the combined company achieved post-merger. Similarly, another company's combined volume for certain marketing projects allowed it to in-source them to an in-house agency.

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The potential value of procurement savings in mergers can be extraordinary, but it will take time and leadership commitment to transform your organization to capture this value. A company's ability to fully capitalize on all these goldmines depends heavily on its approach, and what it chooses to emphasize. Knowing the categories where leverage matters, utilizing advanced tools like clean-sheet cost models, and using the merger as a trigger to drive changes in demand and policy are some of the ways that lead to success■

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