Identifying and Achieving Transaction Synergies and Impacts on the Acquisition Price

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There are no hard and fast rules of engagement in the world of transaction synergy analysis. Many business owners, investors and advisors have their own ways of looking at synergies, each of which are a product of perspective on the subject as well as individual and corporate experience. In this paper, we’ll cover some practical implications of transaction synergies, provide a conceptual framework with which to consider synergies, and evaluate some real world applications.

Practical Implications

The concept of synergies is one that acquirers and sellers alike have an interest in evaluating, for synergies can be a driver of transaction price, particularly if potential acquirers have disparate views on synergy value. This can lead to substantial bid modification by acquirers in an active and competitive sales process. Consequently, how synergies are identified, valued and split among parties can be a critical factor in assessing transaction value and formulating a competitive but reasonable bid.

Synergies are often situational – not only in how much they are worth, but what those synergies are, and how much an acquirer is willing to pay. Potential synergies also depend on why the deal is being considered in the first place.

Customer-centric deals
In customer-centric deals, like bolt on acquisitions intended to add to the customer base, there are a number of hard synergies at play, including cost savings. Because these hard synergies are more obvious and more easily achieved, there is often a greater willingness on the acquirer’s part to share these synergies with the seller.

Growth-centric deals
In growth-centric deals, like technology acquisitions, there are often fewer synergies at play. With a technology acquisition, the growth potential is inherent in the technology itself (and not necessarily a customer base or work force). Because the growth potential is often factored into the transaction multiple, there may be less willingness to share in any synergies.

Regardless of the type of acquisition being contemplated, the intent is often to get the deal done as quickly as possible at a price that is agreeable to both parties. The one primary and overarching goal, however, is to preserve the acquirer’s internal rate of return (IRR) discipline.

Essentially, buyers seek to gain a return on investment equal to or in excess of the appropriate cost of capital for the investment, often with some margin to provide an extra level of risk.

Transaction synergies are often a significant element of deal price. As several studies indicate, however, strategic M&A transactions sometimes fail to create their expected value. Often this is attributed to unrealized or misestimated synergies. How synergies are identified, valued and split among parties can be a critical factor to assessing transaction value and formulating a competitive but reasonable bid.

Included here is a discussion on the valuation and pricing of transaction synergies and real world implications of how synergies can be beneficial to both the buyer and the seller.
mitigation versus the inherent uncertainties that arise when attempting to forecast cash flows several years into the future. The appropriate cost of capital can be estimated from market analysis, or even purchase accounting evaluations of similar transactions. By spending the effort to develop a solid baseline for financial return, the buyer is in a position to better evaluate situations where it needs to pay for synergies.

Conceptual Framework

Having framework for identifying and evaluating synergies can be useful in the process of evaluating a target for acquisition. There are any number of ways to group and classify synergies. Generally speaking, we group synergies into three types:

- **Economies**: Synergies of scope and scale. They are the rewards of being either bigger or broader. Examples of these include both cost savings (e.g., eliminating duplicative corporate overhead, rationalized staffing, cost reduction through supplier consolidation, etc.) and revenue opportunities (e.g., cross selling and price premiums realized through greater market share [i.e., horizontally integrating the value chain]).

- **Opportunity**: Synergies of opportunity provide gains in efficiency, asset utilization and/or value capture. Examples may include a rationalization of the manufacturing or production process, or vertically integrating the supply chain.

- **Restructuring**: Synergies of restructuring result from opportunities to redeploy assets to more financially or strategically valuable initiatives. Examples here may include divesting non-core assets that are not key to the company’s long term strategy, or unlocking the value of assets through another transaction like a sale/lease back arrangement.

No matter how you define or group synergies, achieving them often depends on three things:

- Having a sharpened acquisition strategy
- Systematic identification and assessment
- Understanding market vs. unique synergies

Synergies need to be identified and assessed systematically – with planning and forethought as to how acquisition targets will integrate with the company and the synergistic potential present. Some synergies can be unique to a particular buyer or group of buyers, separate from what the general market may be able to achieve. The most valuable synergies are often more subtle and difficult to detect and tend to be very buyer-specific. Acquirers who recognize this without fooling themselves have an additional source of potential value they can use to improve their bid relative to competitors.

Part of a well-established acquisition plan is also having a model for synergies estimation. The key to synergies estimation and modeling is consistency. Irrespective of whether you’re working with a rough synergies model or one that is highly detailed and precise, consistent

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**An Example: Situationaly Specific Synergies**

Paychex recently evaluated a regional payroll processing company for potential acquisition, conducting a number of analyses in their due diligence process.

The first analysis preformed was a standalone DCF analysis, coupled with a traditional multiple analysis due to the common industry practice for businesses to trade on revenue multiples. In conjunction with the standalone analysis, Paychex performed a post-acquisition analysis, which incorporated:

- Hard synergy benefits arising from the conversion and migration of the portfolio to Paychex platforms (savings to facilities, overheads, etc.)
- Productivity benefits arising from greater service bureau efficiency
- Losses due to conversion risk (either client attrition or lack of fit between client’s business needs and Paychex platform capabilities)
- Integration and conversion costs
- Benefits from cross sell of a broader range of Paychex products into the acquired client base

The evaluation culminated in a post-transaction summary that addressed the IRR and transaction multiples for a narrow range of price to determine if a potential market-clearing price existed that made a bid “reasonable.” The bid was made and heavily negotiated, but ultimately an agreement could not be reached and the acquisition prospect did not proceed on the LOI. This disciplined focus on IRR allowed Paychex to walk away from a marginal deal.
application of that model is a factor in being successful over the long run in identifying, valuing and extracting synergies from transactions. This is because, over time and with repetition, a synergy model becomes institutionalized knowledge in the acquisition strategy, and the deals done in the past provide valuable context for deals being contemplated now and in the future. After enough repetitions it may become less about the results coming out of the model and more about creating analogous reference points. For example, this deal “looks just like” XYZ deal on which the company did well, or that deal “looks like” ABC deal on which the company did poorly.

So why do some companies seem to do better than others in identifying and capitalizing on synergistic opportunities?

It may sound trite, but knowing precisely how you can and want to grow through acquisition is a key factor in identifying targets that will help you accomplish growth goals and realize synergies. A big contributor to success or failure comes down to how well-honed a company’s acquisition strategy is. A well-developed acquisition strategy often selects a limited number of growth sectors on which to focus—providing a way to constrain and focus the M&A search process to identify actionable opportunities. The acquisition strategy also guides the integration strategy, giving a high degree of precision in forecasting how the integration will go.

Acquirers that are reactive to the transaction landscape can misestimate synergies more than acquirers that have a hardened acquisition strategy and are seeking specific opportunities.

In addition to the acquisition strategy, acquirers that have a pre-developed integration plan, and synergies estimation process conducted in accordance with this plan, often will see greater success. Acquired companies can continue to be operated standalone, partially integrated or fully integrated, and synergy estimates must be compatible with the level and timing of planned integration.

Substantive due diligence flows from the target search and integration planning. The due diligence process validates the going-in investment and answers the question of whether the companies can integrate effectively and deliver on the synergy model. A developed acquisition strategy, driven by a thorough due diligence procedure, may return a lower M&A close rate but a higher success rate by creating higher confidence in the ability to plan, invest, integrate and deliver.

As an acquirer or a potential acquisition target, a company that is positioned well within the marketplace may be able to take better advantage of the synergies in a transaction.

For Acquirers, being positioned to take advantage of synergies starts with the assessment and diligence process founded on a solid acquisition strategy. Having an operational approach to the inquiry and assessment helps instill confidence in company leaders and acquisition partners that the deal will close and the acquirer can deliver on the deal, the synergy plan and the business case.

For the Acquisition Target, being positioned well centers on 1) knowing what acquisition partners are looking for, 2) the quality of the portfolio, and 3) the ability to instill confidence. Having company systems in good working condition, where master data flows between systems, will increase the ease of conversion to other platforms and having uniform platforms for system data (i.e., having all customer data on one
system) demonstrates a greater sense of follow-through potential for the deal to close and for integration to flow according to plan.

Now let’s move to some real world applications of due diligence that lead to deal confidence as well as some market trends backed by recent research.

Real World Applications

In reality, much diligence is skewed toward validating fit and the ability to deliver on a plan. As with any business endeavor, a comprehensive due diligence and assessment is vitally important. In M&A transactions, the due diligence needed will vary by deal type but is always essential to identifying and realizing synergies.

In the M&A due diligence process it is important to examine many aspects of the target company:

- Management and Human Resources – meeting with the target company’s management team may provide a deeper insight into the company, as well as an understanding of the management team and employee’s intentions to remain with the company post-acquisition.
- Culture – understanding the target company’s culture is an important piece to developing an integration plan and knowing how the companies will fit together. This is an important people aspect that needs to be considered for successful integration. There are increasingly available technology tools to assist buyers with this kind of “fuzzy” due diligence.
- Finances / records / company data – an obvious step, a review of the target company’s finances and records will determine the stability and quality of earnings. Knowing where and how the company data is maintained is also another key piece to developing an integration plan.
- Technology – examining the company’s technology platform and offering is a twofold undertaking – first to integrate business processes and employees, and second from a compatibility and growth perspective for a technology acquisition.
- Customers – reviewing customer data, looking at attrition rates and customer loyalty, will help determine sustainability and potential customer willingness to migrate to a new platform or service offering. This is really an assessment of whether the target company customers are compatible with the business platform and service offering of the acquirer.
- Pricing consistency – pricing consistency is also important from an integration perspective. If there is too great of a gap between the target’s and the acquirer’s pricing strategies, customer attrition is likely to increase with the introduction of a higher pricing model.

The ultimate goals of conducting thorough and comprehensive due diligence is to evaluate and validate the “fit” of the target company. The fit is not just about the surface level items like IT conversion and financial reporting, but is more heavily based on the soft things – looking if the
people elements line up, compatibility of the cultures, characteristics of the customers and the portfolio of business. The examination and evaluation of the degree of fit helps gauge the degree to which you can ensure that the implementation of the integration plan will lead to success.

Beyond the due diligence and planning steps to evaluating an acquisition target, it is beneficial to have an understanding of the broader market trends. Research studies will tell both sides of M&A transaction synergy success. Some studies indicate many mergers and acquisitions destroy value for the acquirer. However, most studies are based only on public acquirers, which makes the data sample limited. These studies can often suffer from attribution problems as well, where the further you get out from a deal, the harder it is to attribute valuation outcomes to a particular transaction.

In 2006, approximately 20% of global M&A activity was initiated by private equity firms, and over one-quarter of the deals in 2007. The success of private equity firms over time indicates that, on average, their return expectations are generally met. This also presents a synergies conundrum as private equity firms can sometimes provide higher bids than strategic acquirers.

Even when contemplating private transactions, trends shown in the public transaction data offer good correlations for smaller transactions in the lower and middle markets.

However, with that backdrop, our primary focus is on new research being conducted specifically in the area of synergies. A recent study by the Boston Consulting Group (BCG) and Technische Universität München looks at how successful public M&A deals split synergies.

Let's start with some of the data. The BCG analysis is based on a sample of 365 public M&A deals with transaction values of more than $300 million that took place from 2000 to 2011, where industries with a sample population less than 3 were excluded. The following graphs reflect the value of announced synergies per year, illustrating the value of the announced synergies as a function of the sales of either the combined company (on the left) or just the target company (on the right).

The data demonstrates that the most globally consolidated industries tend to have the greatest synergies, though there are some interesting discrepancies in the amount of synergies announced in each industry.

### An Example: Due Diligence of a Target

Paychex recently completed a bolt on acquisition of a technology company. Key deal considerations were threefold:

- Technology alignment with Paychex tenets (architecture, functionality, roadmap, etc.)
- Scalable business
- Reasonable price

Paychex conducted a traditional assessment of contracts and financial information in evaluating the target. They conducted a 2-day deep dive on all aspects of business during due diligence, including:

- Technology assessment – based on responses to a customized diligence request on all aspects of the technology, team and roadmap
- Channel/sales assessment – assess who will sell the product into the Paychex base, how it will be sold and build out the go-to-market strategy
- People assessment – two days of discussions with management to develop a full picture of the organization, its likelihood of fit and retention, and its capabilities
- Service/support assessment – Identified ability to integrate areas like billing, as well as Paychex’s ability to further automate and drive productivity in areas like client support

The post-acquisition business case was finalized and compared to initial assumptions about the synergies of the deal. A final diligence review was held with the entire team and senior management to ensure alignment on the deal, objectives and execution plan (including post-acquisition organization). The deal was consummated and the integration team was briefed before hand-off.
Available synergies are typically paid for in some form or fashion. The research epiphany centers on the contradiction of reality and perception in the context of synergy strategy. As a buyer, the kneejerk reaction is often that if you can keep more of the synergies, you have a better shot of making the transaction a financial success and achieve higher rates of return. However, quite the opposite is true according to the BCG study.

By sharing synergies and “getting on the same page” with the seller pre-closing, the buyer’s chances of realizing synergies goes up dramatically. This is because both parties are coordinated to kick off the integration process and the seller’s agents tend to be more inclined to assist the buyer. Shared synergies results in a more collaborative, coordinated integration process post-close.

More importantly, the BCG study notes that the 31% median synergy value captured by sellers has trended upward over the last several year, indicating that sellers have grown more sophisticated in assessing the synergy potential of their assets and capturing that value in transactions.

There is a geographical pattern at play here as well. Sellers based in rapidly developing economies tend to experience a greater share of synergies as buyers have shown a willingness to accept lower returns for access to faster growing markets.

Looking at the data above, sellers of telecommunications companies, whose synergy potential is often low because of regulatory constraints, captured only 6 percent of the net present value of announced synergies in deals executed from 2000 through 2011, compared with a 51 percent share for health care companies over the same time frame.

Interestingly, the experience for the healthcare sector is largely driven by pharma deals where smaller targets with product pipelines are able to leverage the resources of the buyer, who is typically larger. This provides access to additional R&D resources to increase the probability of

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**A side note on Organic vs. Acquired Synergies**

Some sellers will try to fold their own acquisitions into the forecast and valuation of the company. In some sense, that’s akin to asking for synergy twice-removed.

Examples would include:

- a target currently “digesting” a large deal that has not yet closed, but valuing the company based on the combined worth
- embedding future acquisitions in a target company forecast (i.e., paying for corporate development effort)

While such an approach is potentially valid, the underlying market dynamics and financial assumptions must be reviewed and assessed for achievability.
success in gaining regulatory approval for new drugs as well as access to a larger, more sophisticated sales force to drive script volume post-approval.

Where you can potentially end up destroying value from the transaction is when the synergies are not estimated well. Overpaying for synergies has consequences broader than a simple wealth transfer from one ownership group to another on a specific deal. A failure to properly understand synergies creates a tremendous waste of management time and resources post-acquisition. This is because integration planning and processes will be disrupted and require modification. This can drain management resources and cause executives to lose focus on the core businesses for the sake of salvaging the synergies. There is also a danger in focusing on short-term synergy realization at the expense of long-term value creation from the deal. If the situation is dire enough, the simple wealth transfer could jeopardize both companies’ core valuations.

**Key Takeaways**

Synergies are a key ingredient in today’s M&A environment, where synergistic potential can drive deal price and the realization of those synergies can make or break the deal post-close. There may be obvious synergies that are easy to achieve, and other synergies that are more involved and dependent on the successful implementation of the integration plan. The primary drivers for success or failure in synergy realization are having a hardened acquisition strategy and synergies estimation model, and follow through on the integration plan. We leave you with a few important takeaways to keep in mind.

1. Synergy estimates must be compatible with the level and timing of planned integration

2. Sounds like common sense, but we often see a disconnect between the financial modelers of synergies and the strategic & operational planners, particularly in large corporate settings.

3. Know your company if you are looking to sell. Understanding what impact integration planning will have at the workflow and customer level is essential to avoiding costly delays or workflow interruptions post-acquisition

4. Develop a consistent acquisition strategy with a solid synergy estimation model
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