McKinsey&Company

Perspectives on merger integration
June 2010

Opening the aperture 1:

A McKinsey perspective on value creation and synergies

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Almost 50 percent of the time, due diligence conducted before a merger fails to provide an adequate roadmap to capturing synergies and creating value. Typically compiled in haste, and concentrated on determining fair market value, this outside view often ignores critical sources of additional value offered by synergies between merging companies.

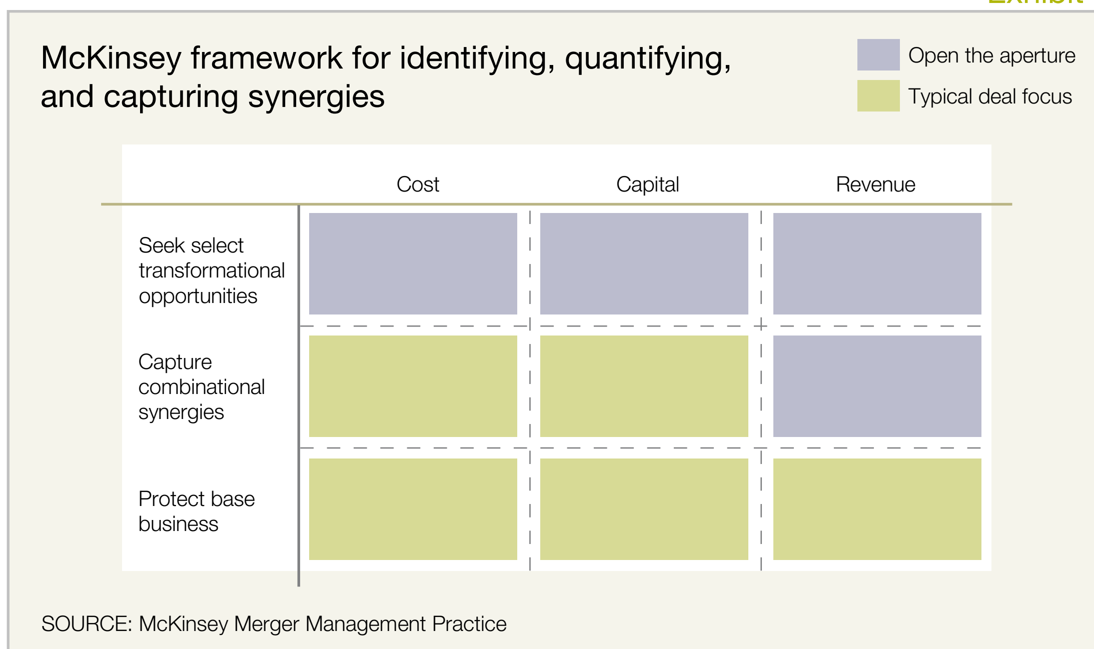
Traditionally, companies merged to achieve scale within an industry or reduce costs. Today many companies turn to mergers for new capabilities or access to adjacent businesses with which they may have limited experience. They need to open the aperture, looking beyond the traditional sources to achieve maximum value. They need to answer the question, "Now that we own this asset, what are all the ways we could create value with it?"

Identifying and quantifying synergies requires a systematic approach. McKinsey has developed a framework to guide the effort. This framework can help companies locate value creation opportunities that exceed due diligence estimates by 30-150 percent.

Overview of the framework

Putting new emphasis on transformation and revenue, the framework opens the aperture so companies consider the full range of opportunities to derive maximum value from any merger.

Exhibit 1



SOURCE: McKinsey Merger Management Practice

Layers of value creation

The framework defines three layers of value creation:

- **Protect the base business:** efforts to preserve pre-merger value and maintain the core business
- **Capture combinational synergies:** traditional value creation efforts to achieve economies of scale and enhanced efficiency
- **Seek select transformational synergies:** often ignored, often capability-based opportunities to create value by radically transforming targeted functions, processes, or business units.

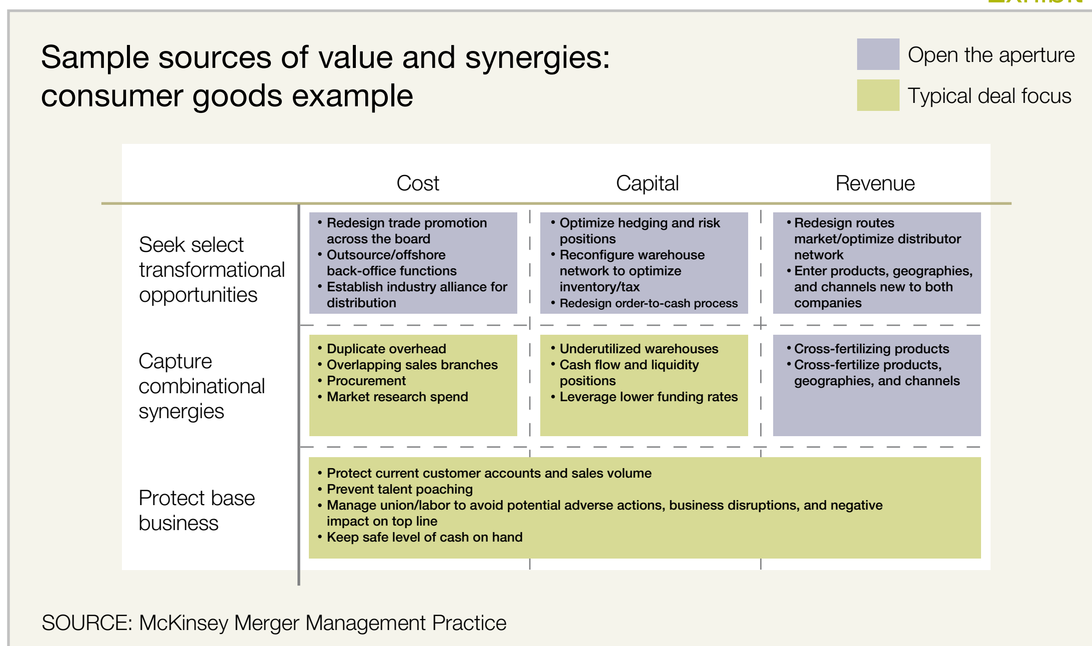
Levers of value creation

Within each layer of value creation, companies can pull three levers to realize value:

- **Cost:** capture cost savings by eliminating redundancies and improving efficiencies
- **Capital:** improve the balance sheet by reducing such things as working capital, fixed assets, and borrowing or funding costs
- **Revenue:** enhance revenue growth by acquiring or building new capabilities (e.g., cross-fertilizing product portfolios, geographies, customer segments, and channels).

Of course, cost, capital, and revenue opportunities differ by value creation layer. But mapping the full range of opportunities reveals the entire landscape of synergies that a merger might tap to create value. (See the sidebar on the four types of synergy targets.)

Exhibit 2



SOURCE: McKinsey Merger Management Practice

Protect the base business

This is not as straightforward as it sounds. McKinsey research has found that acquirers typically see sales decline eight percent in the quarter after announcing the deal.

Companies with significant merger experience avoid this pitfall by concentrating on:

- Keeping the business running, including maintaining accountability for current-year results and making the investments required to sustain quality
- Separating integration efforts from running the business, with integration managed by an integration office staffed with high-caliber people
- Shortening the post-announcement, pre-close period and announcing the new management team as early as possible
- Retaining customers and important talent through shared aspirations, clear communication, and appropriate incentives.

But their zeal to achieve due diligence targets often makes even experienced companies myopic. They overinvest executive attention and integration talent in that effort, failing to protect the base business or organize clean teams that could scope the full landscape of value creation opportunities so the combined company could begin to profit on day #1.

Capture combinational synergies

Most efforts to capture combinational synergies focus, at least initially, on cost and capital. These efforts typically exceed "expected" short-term estimates. But because they rely on across-the-board rules of thumb and ratios, they often underestimate savings, leaving money on the table. One company met its due diligence targets six months ahead of schedule. But a new business unit head who arrived at that point found 20 percent more than originally estimated by taking a clean-sheet approach.

Meanwhile, a company focused only on cost and capital is overlooking the growth opportunities represented by revenue synergies. Historically, many companies shied away from the uncertainty and risk associated with these synergies early in merger planning. But when less of a merger's value lies in cost or scale, revenue synergies loom larger in value creation and need immediate attention. In many industries a one percent increase in revenue growth creates more value than a one percent increase in EBIT. Failure to consider revenue synergies from the start may delay realization of any value from them by a year or more.

Companies that avoid this pitfall often organize cross-functional teams to define ways to meet synergy targets and develop realistic plans for achieving the targets.

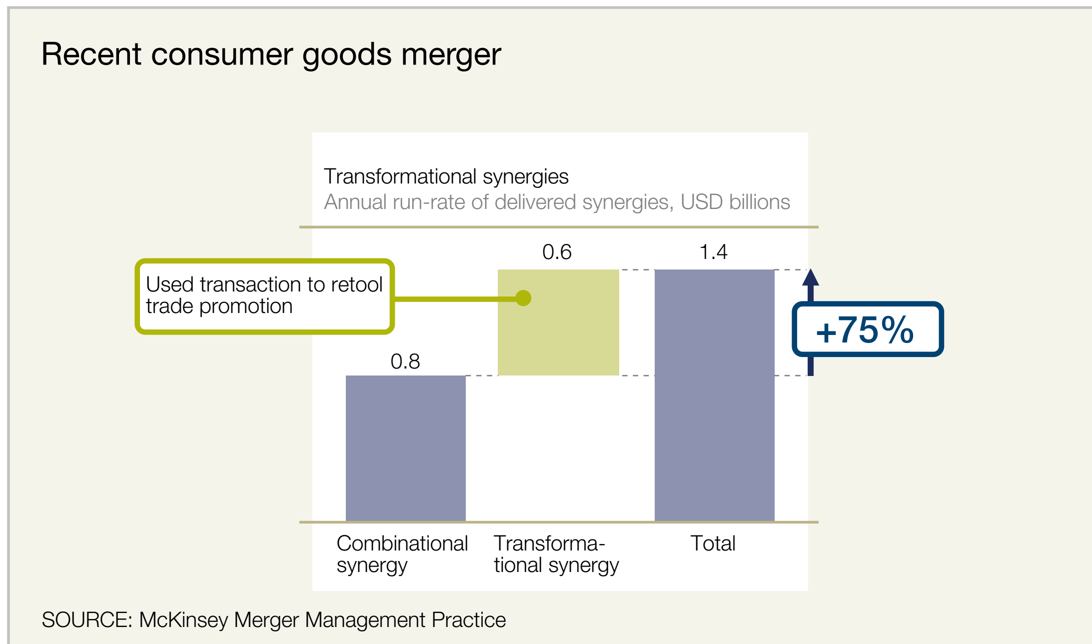
Four types of synergy targets

1. Targets announced publicly
2. Targets requiring minimum achievement above announced targets
3. Targets set top-down and bottom-up to exceed minimum achievement targets
4. Aspirational targets

Seek select transformational opportunities

Transformational synergies represent huge potential for breakthrough performance. But because transformation involves complexity that often exceeds management's capacity, it can bring the business to a grinding halt. Management needs to focus selectively – on a handful of targeted functions, processes, capabilities, or business units that make breakthrough performance possible and financially worthwhile.

Exhibit 3



Consider the recent merger of two major consumer goods companies. Recognizing the superiority of the target's innovative approach to distribution management, the acquirer assigned its top integration team the task of figuring out how to incorporate that approach into its own entrenched distribution practices. Their success boosted the value of the deal 75 percent.

Such success typically requires creating a team dedicated to locating breakthrough opportunities, setting bold goals for value creation, and providing incentives with real upside for breakthrough performance. Capturing transformational synergies requires disproportionate senior executive time. The CEO in the consumer goods merger met twice as often and twice as long with the breakthrough team lead than with the leads of the other 12 integration teams. The breakthrough team delivered more than 40 percent of the total synergies.

Companies contemplating transformational synergies must assess their readiness to capture each opportunity:

- Will we have the capabilities and financial means required for success?
- Do we have enough appetite for risk and full executive commitment?
- Can we stay the course until we realize value?
- Are we willing to break some glass to capture the opportunities?

With economic recovery looming, interest in mergers is reawakening as companies seek new ways to benefit from the upturn. The McKinsey framework for identifying and quantifying synergies can help ensure they weigh and balance all their options for realizing value from a merger.