The Deal Pipeline

Accelerating nonpersonnel-related savings in mergers

by Brad Birdwell, Third Law Sourcing | Published April 23, 2012 at 1:25 PM



We have all seen it. Company A acquires Company B. Company A identifies transaction synergies and overlapping functions, and commits to eliminate a significant percentage of the combined personnel. And shortly after the deal is completed, the organizational decisions are made, and the workforce reductions begin. Company A had little time to fully evaluate individual capabilities and contributions, and it is inevitable that some institutional knowledge will be lost.

The M&A environment creates tremendous pressure on leadership to deliver on promised synergies as quickly as possible, and workforce redundancies are often regarded as low-hanging fruit. There is never enough time to handpick the best apples from each "branch" of the companies. Full-scale evaluation of combined personnel is generally not feasible before an acquisition closes, especially in situations where the acquirer and the acquired are direct competitors and confidentiality precludes disclosure.

Of course, some head count reductions need to be made quickly after two firms merge, to ensure the near-term viability of the combined entity. In general, the quicker these decisions are made, the better it is for the remaining members of the team. However, when workforce reductions are accelerated to capture committed savings, unnecessary risk is introduced.

Best-in-class companies have begun to utilize a different approach to extract the maximum value out of acquisitions and accelerate nonpersonnel-related savings to "buy time" for deeper dives into key areas of the organization. Quick wins can be found within vendor integration and renegotiation -- including indirect spend areas such as telecommunications, information technology, business process outsourcing and professional services. While the magnitude of such spend may be relatively small, the savings are significant -- cost reductions of 10% to 25% of the combined spend are typical, and companies can identify and realize savings in these categories much more quickly than within other areas.

Due diligence activities typically include assessing the capabilities of an acquisition candidate and identifying potential issues and liabilities. Organizations that are frequent acquirers may even use the due diligence period to scope out potential operational synergies (for example, redundant facilities and duplicate personnel) and develop cost reduction targets. In some cases, these companies also look at overlapping vendors and potential pricing improvements in key spending categories, although such assessments are usually based on sweeping assumptions and

lack the detail required to make them actionable. The most common scenario goes something like this: An executive makes a 50,000-foot assessment of potential vendor-related cost savings without the benefit of strategic tools such as pricing benchmarks or a full understanding of vendor pricing practices. Most often, potential savings on indirect costs such as information technology and professional services are not even included in public savings commitments. Instead, such announced cost reductions are based on the aforementioned operational overlaps.

Once the deal closes, actual pricing renegotiations on indirect spend -- and even some key cost areas -- are often addressed on an ad hoc basis, either as products and services are integrated, or when agreements come up for renewal. By this time, the sharp focus on savings by the integration team may have been replaced by the day-to-day responsibility of each business unit to manage their associated costs. These managers, regardless of their best intentions, often lack the tools and resources required to drive an optimal deal. Additionally, the negotiation position is weaker because there is greater leverage in the potential future growth of volumes than there is once that volume has already been realized and received by the vendors. In any case, the savings occur long after the deal has closed and savings obligations have been achieved.

So, how do you get a head start?

The "clean room" concept is not new in the context of M&A transactions. Attorneys frequently use them to facilitate the exchange of confidential legal and contract information during the due diligence process. Virtually every transaction utilizes a clean room at some point in the diligence process, but most do not address spend analytics and preliminary sourcing activity.

Savings are increased and accelerated by an early focus on pricing renegotiations and vendor aggregation savings. Third parties can be leveraged as part of the clean room and subsequent integration to bring benchmarks, expertise and additional resources to bear. Ideally, the merging organizations would share vendor contract details with each other prior to closing, allowing the combined organization to begin implementing these opportunities as soon as the deal closes.

However, for a variety of reasons, direct sharing of confidential supplier and spend data is not always possible. It is untenable to share such confidential information when any level of transaction uncertainty exists, such as those involving direct competitors or transactions requiring the approvals of shareholders, antitrust authorities or regulatory bodies. In this case a "virtual clean room" can be established for the acceleration of vendor savings opportunities. In a virtual clean room, a nonpartisan external consulting firm that specializes in enterprise sourcing and vendor negotiations is engaged. The third party confidentially reviews the historical spending, invoices, accounts payable data and vendor agreements of each company, and even conducts brief interviews with the diligence team when necessary. The consultants collect and maintain each party's data and are responsible for ensuring the security and confidentiality of the data from each party.

Virtual or not, clean-room activities start with the analysis of supplier pricing within each spend category, based on the volumes and vendors of the combined company. Unlike traditional sourcing, the focus is on the quick implementation of savings without the change management required by bona fide sourcing and implementation of new suppliers. Value is created through

the leverage of benchmark pricing and increased volumes, which incent incumbent vendor price reductions, as well as the aggregation of vendors selling similar products and services.

In securing incumbent vendor reductions, pricing for products and services should be consistent with current market pricing for the total spend of the combined company. Low-hanging fruit often exists, where both entities received the same goods from the same suppliers, with one of the deals being more favorable. In any case, pricing can be improved by leveraging the increased volumes and projected post-integration growth.

Low-hanging fruit can obviously be found within redundant products and services, but there are far more opportunities when viewing the spend holistically. Multiple incumbent vendors may provide the same goods, allowing for significant vendor aggregation across the combined volumes. When the purchased items are bona fide commodities, there are very low switching costs, and the company can quickly consolidate vendors to receive greater enterprise discounts. Additionally, analysis of the product and service mix will identify which of your current vendors can also serve other areas of your business, yielding further aggregation opportunities.

Once closing is a certainty, the engagement team details the savings opportunities and provides the road map for implementation. The output includes: (1) a normalized pro forma view of the combined company's spend data by business unit, spend category and product/service; (2) target savings by category and vendor, prioritized based upon the size of savings, timing of realization and level of effort; and (3) methodology for implementing each opportunity, including resource requirements and any additional analysis required.

At this point, the company's integration team becomes part of the effort, working with the third-party consultant to accelerate implementation. Targeting low-hanging incumbent pricing opportunities is less disruptive than the introduction of new vendors or goods, and thus is well suited to consultant resources. This allows the company team to keep its primary focus on operational integration, while the third party facilitates the vendor discussions. Vendor discussions can begin as soon as the deal is certain, and implementation can start as soon as it is official. Legal resources should be assigned to the team to ensure revised agreements can be buttoned up quickly, allowing savings to begin within weeks of the closing.

Implementation and savings realization can happen within the first couple of months of initiation of due diligence. Even in deals that close quickly, this provides significant breathing room for more difficult synergy decisions. It is reasonable to expect the merger of two $1 billion firms to create $10 million to $20 million of indirect spending cost synergies with their incumbent vendors. And each $1 million in accelerated annual savings can buy six months of time for 30 to 40 employees. With thoughtful planning and solid execution, a significant portion of these savings can be achieved within weeks of closing the deal, creating more time to fully evaluate the combined organization's talent pool.

The Challenges of Traditional M&A Financing

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