Where mergers go wrong

Most companies routinely overestimate the value of synergies they can capture from acquisitions. Lessons from the front lines can help.

It’s known as the winner’s curse. In mergers, it is typically not the buyer but the seller who captures most of the shareholder value created. On average, in fact, acquirers pay sellers all of the value created by the merger in the form of a premium that typically ranges from 10 to 35 percent of the target company’s preannouncement market value. But while the fact is well established, the reasons for it have been less clear.

Our exploration of postmerger integrations points to an explanation: the origins of the curse lie in the average acquirer materially overestimating the synergies that can be captured in a merger. Even a good faith acquisition effort can stumble over what appears to be a remarkably small margin for error in estimating synergy values.

No question, acquirers face an obvious challenge in coping with an acute lack of reliable information. They typically have little actual data about the target company, limited access to its managers, suppliers, channel partners, and customers, and insufficient experience to guide synergy estimation and benchmarks. Even highly experienced acquirers rarely capture their data systematically enough to improve their estimates for their next deal. And external transaction advisers—usually investment banks—are seldom involved in the kind of detailed, bottom-up estimation of synergies before the deal that are necessary for developing meaningful benchmarks. Fewer still get involved in the postmerger work, when premerger estimates come face to face with reality.

Lessons learned

To address this challenge, we have begun developing a detailed database of estimated and realized merger synergies, grounded in our experience in postmerger integration efforts across a range of industries, geographies, and deal types. We have accumulated data from 160 mergers so far, and combining it with industry and company knowledge we believe that there are practical steps executives can take to improve their odds of successfully capturing acquisition synergies.

For starters, they should probably cast a gimlet eye on estimates of top-line synergies, which we found to be rife with inflated estimates. They ought to also look hard at raising estimates of one-time costs and better anticipate common setbacks or dis-synergies likely to befall them. They might also vet pricing and market share assumptions, make better use of benchmarks to deliver cost savings, and get a better fix on how long it will take to capture synergies. When applied together, especially by savvy acquisition teams chosen for maximum expertise and ability to counter gaps in information, we believe acquirers can do more than merely avoid falling victim to the winner’s curse—they can 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, the conventional wisdom is right. The area of greatest estimation error is on the revenue side—a particularly unfortunate state of affairs, since the strategic rationale of entire classes of deals, such as those pursued to gain access to the target’s customers, channels, and geographies, is founded on these very synergies. Nearly 70 percent of the mergers in our database failed to achieve the revenue synergies estimated by the acquirer’s management (Exhibit 1).

Acknowledge synergy setbacks

Another regular—and large—contributor to revenue estimation error is that few acquirers explicitly account for the common revenue dis-synergies that befall merging companies. Sometimes these stem from simple disruption of business as usual, but often they are the direct result of cost reduction efforts. For example, in retail banking, one of the most important cost savings comes from consolidating branches. Some customers may leave, but the cost savings are expected to more than make up for the losses. When one large US bank acquired a competitor with substantial geographic overlap, however, it suffered unusually high losses among the target company’s customers, rendering the deal unprofitable and making the entire company vulnerable to takeover. Due diligence on the target’s customer base would have revealed that they were heavy branch users and thus especially likely to defect during an integration that closed more than 75 percent of the acquired company’s branches. This company’s customer loss experience may be at the high end, but according to our research, the average merging company will see 2 to 5 percent of their combined customers disappear.4

Most acquiring companies can do better, especially in industries that have undergone considerable consolidation. Data on the severity of customer loss experienced by merging parties in retail banking, for example, can be gleaned from a variety of sources: industry associations, regulatory filings, and press articles. Examples are numerous enough not only to identify helpful benchmarks (e.g., 8 percent of retail deposits at closing branches will be lost to competitors) but also underlying drivers of whether a deal will see losses above or below the benchmark (e.g., the number of customers who also bank with a competitor, the distance to the next-
closest remaining branch, or the presence of competitors to take over closing branches). In other industries, a search may yield only two or three good precedents and only limited data on those; even this can greatly improve management’s revenue estimates.

**Increase estimates of one-time costs**
Many deal teams neglect or underestimate the impact of one-time costs. For example, one chemicals manufacturer publicly committed itself to reducing annual costs by $210 million at a one-time cost of $250 million. Had it put as much due diligence into that one-time figure as the annual synergy target, it would have found a few relevant precedent transactions suggesting that it was unlikely to spend less than $450 million. In trying to fulfill their original commitment, the company ended up running over budget, under-delivering on promised synergies, and falling well short of revenue growth targets.

**Compare pro forma projections with market and competitive realities**
Many acquirers rely too heavily on assumptions about pricing and market share that are simply not consistent with overall market growth and competitive reality. Instead, acquirers must calibrate the assumptions in their pro-forma analysis with the realities of the market place. For example, one global financial concern estimated that a recent acquisition would net €1 billion in mostly top-line synergies within 5 years and 13 percent profit growth in the first year. With limited overall market growth, these goals could be achieved only by using cross-selling to increase market share without triggering a competitive response. Actual profit growth was a mere 2 percent.

**Apply outside-in benchmarks to cost synergies**
While managers in about 60 percent of mergers can be commended for delivering nearly all of their planned cost synergies, we find that about a quarter overestimate cost synergies by at least 25 percent (Exhibit 2). That can easily translate into a 5 to 10 percent valuation error.6

One route to overestimating cost synergies starts by failing to use the benchmarks that are available as outside-in sanity-checks. One European industrial company, for example, planned on cost savings of €110 million from selling, general, and administrative (SG&A) cost savings, even
though precedent transactions suggested that a range of €25 million to 90 million was more realistic, and the company neglected to conduct bottom-up analysis to justify the higher figure. Worse, this was an especially risky area in which to aim high, because cutting sales and marketing expense puts revenue growth at risk, and the net present value of pre-synergy revenue growth was roughly four times more valuable than all synergies combined.

**Synergies that are not captured within, say, the first full budget year after consolidation may never be captured, overtaken as they are by subsequent events.**

Temper expectations for synergy timing and sustainability

Deal teams often make simplistic and optimistic assumptions about how long it will take to capture synergies and sustain them. Important deal metrics such as near-term earnings and cash flow accretion can end up looking better than they deserve as a result, leading to a substantial overestimates of synergy net present value.

One company we worked with had budgeted headcount cost savings (including severance) as if they were spread out evenly over each quarter. In practice, however, managers tended to wait until the last month of the quarter before making reductions. As it happens, this example did not have a material impact on the net present value of the transaction, but it did cause the post-merger integration leaders to miss their projections for first-year synergies, thereby undermining the credibility of their process.

Neglecting to “phase out” certain synergies can be equally problematic. Companies often plan to reduce operating costs by squeezing production capacity and logistics across the merged organization. But if the merging companies are growing quickly on a standalone basis, sloppy incremental analysis will attribute benefits to the merger that would have been realized by the standalone companies. Indeed, one medical products company, growing at 10 to 15 percent a year, estimated that it would be using the full capacity of existing plants within three to four years without a merger. So many of the savings from closing or streamlining plants could not rightly be expected to last long, as the affected facilities would be quickly reopened. Many savings, while real, are not perpetual, and must be phased out. In general, we believe that it is overly optimistic to include the full amount of targeted annual synergies in the “continuing value” calculation of a net present value model.

Moreover, the problem isn’t just one of properly translating synergy timing into present values: bad timing can even affect whether synergies are captured at all. Persistent management attention matters in capturing synergies. We have found some evidence to suggest that synergies that are not captured within, say, the first full budget year after consolidation may never be captured, overtaken as they are by subsequent events. We have also observed that synergies are captured more quickly and efficiently when the transaction closes at the start of the two companies’ annual operational planning and budgeting process. One financial institution even learned that its plans to migrate IT systems had to be radically altered (i.e., move onto the acquirer’s platform rather than the target’s)
to accommodate the relatively narrow window of opportunity between peaks in the lending season.

**Forming effective deal teams**
Estimating synergies is difficult, but the practice is critical and needs more investment than it usually receives. Companies we’ve studied have used a variety of ways to improve their synergy estimates.

**Involve key line managers**
Involving line managers in problem solving and due diligence not only improves the quality of estimates but also builds support for postmerger integration initiatives. Synergy analysis also illuminates issues that will shape due diligence, deal structure, and negotiations.

For example, one client 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 looming investment needs at the acquirer’s main plant helped improve the estimates. He also used a due diligence interview with the target’s head of operations to learn that they had recently renegotiated their supply contracts and had not yet implemented an enterprise resource planning (ERP) system; both of these facts refined synergy estimates even more. All of this helped during negotiations and deal structuring (e.g., knowing that it was all right to promise that the target’s main European location would be retained, but to make no promises about their main US facility). Moreover, his involvement ensured that he was prepared to act quickly and decisively to capture savings once the deal closed.

Another company with substantial acquisition experience left synergy estimation up to the mergers and acquisitions department, and paid the price. Based on accurate but high-level financial analysis (total cost per customer served), they concluded that there was no value in integrating customer service operations. Line managers would probably have discovered during due diligence that the target’s smaller centers had much lower labor productivity but compensated for this with an innovative Web servicing program. Consolidating operations could have both improved labor productivity and brought the Web servicing program to the acquirer’s larger service center. But they missed the “unfreezing” time immediately following the merger announcement, and the acquirer 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. Some specific actions we have seen make a difference include: holding a formal post-integration debrief session with both 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 relative to plan for two years; and calculating after the fact what the net present value of the transaction turned out to be.

On the other hand, one must not overstate what can legitimately be learned from experience, since not all deals are alike. One bank balanced what it learned from one acquisition quite skillfully against the idiosyncrasies of its second major acquisition. The first had gone badly; the bank underestimated integration costs
by a factor of three. The second went better because executives leading the deal understood that they needed to get the cost (and deposit loss) estimates right. Instead of simply applying the loss data from the first merger, which did not involve nearly as much geographic overlap as the second, they involved a line manager who had been part of a recent branch closure program. By applying benchmarks carefully and involving line management, the bank avoided making the same estimation error twice.

What’s next?
Companies with access to reliable data can develop sound benchmarks for estimating realistic synergies. They can also find insight into the sources and patterns of error when estimating them.

One client had its head of operations take the lead in estimating the savings from rationalizing manufacturing capacity, distribution networks, and suppliers.

Once companies have a database in place, they can explore other strategic issues, such as whether some synergies are consistently embedded in the acquisition premium paid while others are captured by the acquirer, or whether the stimulating effect of a transaction is even necessary to improve the standalone performance of an acquirer. The former will obviously inform price-setting and negotiation strategies for acquiring companies, while the latter will lead companies to consider tactics other than an acquisition to accomplish the same ends. It’s important to recognize, however, that a well-designed post-merger integration effort can sometimes even do better.7

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