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### 2009 International Mergers & Acquisitions executing deals in the economic downturn



## ■ High performance mergers

BY TOM FLAHERTY AND EARL SIMPKINS

After a flurry of sustained transaction activity in the utility sector in the mid- to late-1990s, the pace of consolidation has slowed considerably. However, the rationale for combinations has not changed, only the circumstances under which transactions are considered and executed. Massive capital spending requirements, elevating industry directional uncertainties, heightening risks to decision-making and accelerating needs for financial flexibility are colliding to again position mergers as an effective means to achieve desired ends.

Where transactions have recently occurred, they are purposefully strategic in intent, yet equally focused on value creation opportunities from an economic standpoint. Particularly in today's environment, financial and regulatory attention is focused on measuring the production of sustainable value. Consequently, to realise the level of enhanced market positioning that transactions offer, companies will need to expand the sources of value in play and their rigour of execution to ensure they satisfy the market's expectations and fully deliver on promised outcomes. Successful transaction execution and value delivery will allow companies to demonstrate to stakeholders their performance capabilities and obtain the vote of confidence to continue to pursue the next stage of growth.

Two key elements will enable companies to successfully identify and capture the value potential in future transactions: reframing synergies development and reinforcing synergies preservation. Each element is critically important to establishing the right 'execution tone' for a transaction, and ultimately, enabling and sustaining synergies.

To ensure all potential value is captured, utilities will look more broadly to synergies sources that contribute to long-term value,

including redefining business models and rethinking how the combined enterprise positions itself as a market competitor. Beyond 'lifting the game' with respect to value creation, focusing more aggressively on value preservation will ensure that the full level of synergies are captured and sustained. Synergies preservation thus includes an enhanced focus on: planning and governance; tracking and performance management, and; cultural transformation as collective ingredients to creating the right environment for sustaining and enhancing the level of value realised.

### **Reframing synergies development**

Reframing synergies development requires leveraging beyond traditional synergies categories that arise from overlap and economies of scale to additional sources of value such as operating model choices, broader balance sheet contribution, extended adoption of leading practices and deployment of increased cash flows, all of which can contribute to the value and benefit of the deal.

Operating model choices impact the level of synergies available and help guide the organisation toward broader consideration of potential operational synergies. What seem to be simple and insignificant decisions around the role, boundaries and scale of the corporate centre have a direct impact on the synergies unlocked through a deal. Companies will bring early focus to resolving differences in fundamental business alignment and use the due diligence and integration periods for assessing how the operating model, i.e., the overall business element roles and relationships, organisational architecture, process configurations and, capabilities hierarchies are designed to provide for effective governance,

operations execution and performance management.

Once philosophical decisions are made around the degree of management control required to manage the business, the operating model to perform functions and support the organisation can be established based on desired performance outcomes. This operating model can then provide the framework to increase synergies and further leverage the transaction as the catalytic event to streamline operations.

In addition to operating model choices, how processes and activities are evaluated and assumed to be aligned within the business units and functional areas during the integration phase also has implications on synergies identification. A broader level of 'process' integration leads to expanded levels of synergies as a result of deeper alignment of end-to-end activities and the reshaping of the fundamental delivery and performance model. In addition, extending the focus beyond standardisation of performance to simplification of design will enable the business to further streamline and reprioritise its execution model.

With this sharpened focus on operations as a means to deliver enhanced value, the next wave of transactions can carefully think through the impact that operating design decisions and other structural assumptions have on the level of synergies available. These transactions will also focus on changing the purpose and shape of due diligence to develop increased insight into how their partner company approaches performance execution and establishing priorities.

Operating model and process choices provide a baseline for assessing synergies. Once those decisions or assumptions have been made, the balance of the synergies analysis can take shape. Several options exist to extend the categories of synergies available, including working capital and cash flow productivity opportunities that typically are not directly considered.

With pressure on cash flow generation and the need to preserve balance sheet flexibility, future transactions will bring additional focus to the consideration of working capital as a core synergies area. The components of working capital (accounts receivable, accounts payable, inventory) and the related operating practices underlying their management will be carefully scrutinised as sources of potential future savings. Managing the balance sheet to produce additional cash which could fund a portion of the deal, future projects, or offset some of the costs-to-achieve in year one will be an area of increasing interest for acquirers and merging partners.

Cash flow productivity reflects reinvesting the cash savings generated from the transaction at an imputed weighted average cost of capital (WACC), rather than simply assuming those cash flows will offset short-term borrowings. Assuming the savings are put to good use (projects that earn at or above the WACC), additional benefits can be obtained through the utilisation of the synergies for high return projects.

Future transactions will look to sources of value beyond traditional merger synergies and focus on areas that are complementary to the strategic, financial and operational imperatives of the business. As additional sources of value are sought, identifying potential areas of business redesign, performance enhancement, leading practice adoption and,

changes to financial management philosophies will enter more predominantly into synergies capture thinking.

### **Reinforcing synergies preservation**

While the identification of synergies is often critical to the go / no-go decisions around a potential deal, companies also need to consider the mechanisms, practices and processes in place to ensure that the value created by the merger is actually delivered.

Much research suggests that nearly half of all industrial sector mergers result in below-market performance. While the success rate of the utilities sector in contrast is much more positive in achieving planned outcomes, mounting financial pressure to achieve value targets and regulatory pressure to restrain cost growth suggests that synergies preservation will become a more significant topic. Several factors can significantly improve planned outcomes including more rigorous planning and governance processes, implementing a robust performance management system and focusing on institutionalising behaviours to continuously identify improvement opportunities.

The traditional emphasis on providing the right structure and approach for the integration is important, yet it is a tablestake expectation. Given the additional value at risk to transaction participants, an extended focus on synergies sustainability will be a key component of integration execution to ensure business changes are embedded and objectives are realised. This can be supported through focused planning processes that: highlight the critical elements of execution; emphasise continuous measurement against established milestones and outcomes, and; incentivise transaction success as a shared goal among senior executives.

Heightened performance management discipline thus will be an imperative function of future transactions. As synergies expectations expand, the intricacies of tracking and managing performance become more complex. Specifically, appropriate tracking mechanisms are required to ensure that merger synergies are tracked separately from business changes that may occur within the course of ongoing operations. The ability to distinguish discrete merger impacts from other parallel changes in business operations will separate those companies that convincingly deliver specified outcomes versus those who may have simply been lucky at achieving a similar result through other means. Performance targets will also need to raise the ante on challenging the organisation to achieve savings above and beyond those quantified as part of the initial due diligence work. These performance targets should relate to the anticipated outcomes of the transaction and measured in a way that provides a direct line of sight from the highest level performance objectives to tactical level functional actions. A persistent focus on performance management and synergies tracking will ensure that expected synergies can be fully realised and are not left to chance.

Mergers are often justified on the basis of synergies; however, in some cases, synergies fail to materialise because of cultural resistance and a lack of focus on the level of change management required to successfully achieve synergies throughout the business. Consequently, with enhanced planning, governance and performance management, come additional responsibilities of the organisation to successfully deliver on commitments. Ultimately

the long-term realisation of many synergies will be based on the ability of all levels within the company (the executive management team, the transition leadership team, the integration teams, and ultimately the rest of the organisation) to effectively implement the required organisation, process and technology changes required to achieve the synergies.

In addition to the mechanical elements required to achieve the synergies, executives and integration managers must focus on the cultural transformation required to sustain and embed a mindset throughout the organisation that is focused on synergies attainment and capabilities enhancement. A lack of focus on sustaining synergies attainment over time is a major source of lost value and often results in the initiation of additional post-close improvement or 'second wave' programs several years after the merger. Accepting cultural resistance to change, allowing old practices to creep back into the business, or allowing formal commitments to digress all impede synergies attainment. While these factors may seem insignificant or appear to be issues that

can easily be avoided, these behaviours are real and can quickly kill momentum and preclude the capture of identified synergies. Cultural change requires purposeful and visible leadership from the top of the organisation and will be an important planning and success factor in future transactions.

With transactions taking on a more strategic role and the sources of synergies expanding, a focus on synergies development is important to ensure all potential sources of value are evaluated. By applying targeted foresight to focus on aggressive synergies development and relentless integration execution, companies can avoid the perils of not attaining financial commitments. The ability to deliver on commitments to market and regulatory stakeholders is thus a fundamental element of a company securing its continued 'right to grow'.

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