EXECUTIVE INSIGHTS

Keys to Unlocking Merger Value: Cost Synergies

Introduction

In today's competitive deal environment, your organization cannot afford to dismiss cost synergies. Developing a robust sense of the potential savings achievable through economies of scale and the elimination of redundancies after a merger is essential to both a successful deal process and the realization of the total potential value following deal close. Compared with revenue synergies, cost synergies[1] are often more straightforward to identify, quantify and track, and delivering is largely within the control of the organization (rather than significantly subject to outside forces). It's not surprising, then, that companies are 10 times more likely to announce cost synergy targets than revenue synergy targets.[2]

In our experience, balancing top-down targets informed by the due diligence process and industry benchmarks, with a bottom-up investigative approach across a broad set of cost synergy categories, is a critical first step toward capturing savings opportunities.

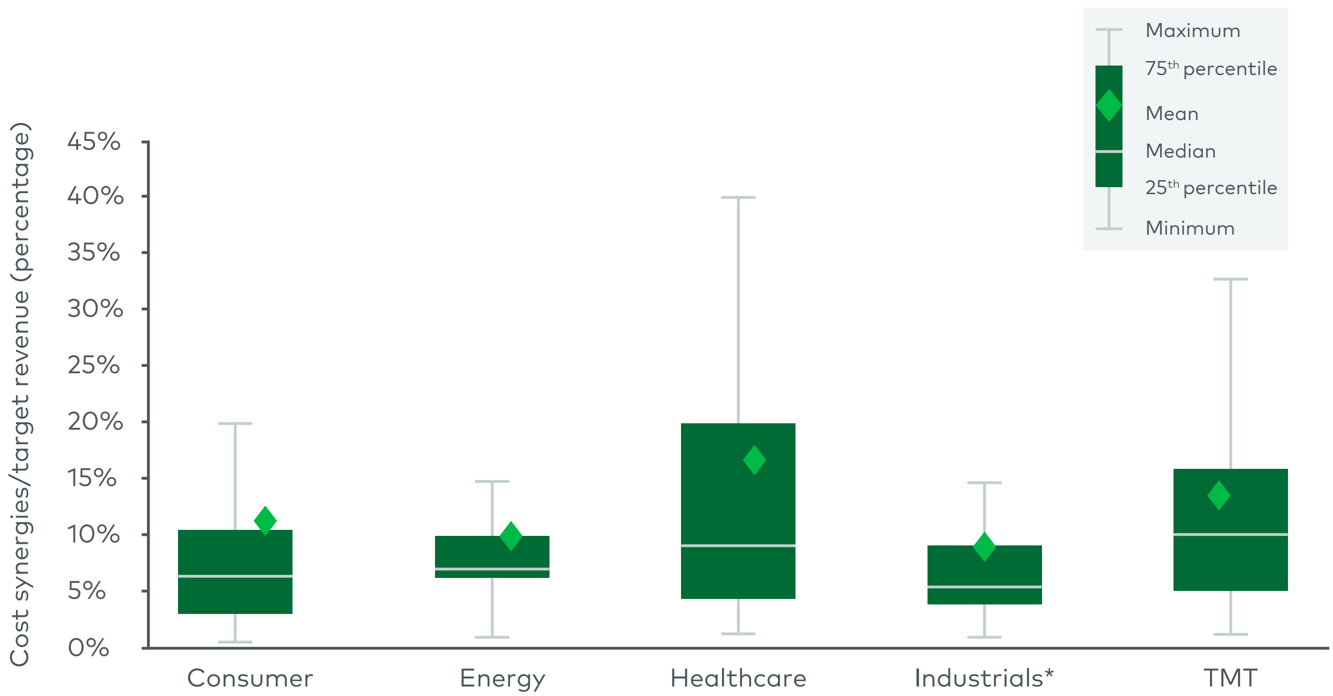
In this edition of L.E.K. Consulting's *Executive Insights*, we cover how to think about cost synergy potential and timing as well as the categories an organization can consider to ensure no stone is left unturned in the search for cost savings opportunities.

Typical cost synergies by industry

Many factors impact the magnitude of cost synergies. Industry plays a significant role, as shown in the chart below (see Figure 1), with healthcare and technology, media and telecommunications seeing larger anticipated savings than energy and environment or industrials. Just as potential value will vary by industry, the importance of major cost synergy categories differs by industry and the nature of the particular deal. To achieve maximum value, organizations should understand the full range of opportunities and then narrow the focus to effectively prioritize postmerger synergy planning and execution.

Figure 1

Cost synergy potential as a percentage of target revenue, by industry (1990-2023)



*Industrials includes Aerospace and Defense, Agribusiness, Automotive, Building and Construction, Chemicals, Energy and Environment, Industrial Digital, Industrial Distribution, Industrial Equipment and Technology, Industrial Services, Metals and Mining, Paper and Packaging
Note: TMT=technology, media and telecommunication
Source: L.E.K. Synergy Database

Sources of synergy

We typically evaluate the opportunity for synergies across the entire profit and loss statement of the newly combined organization. Approaching this on a function-by-function basis can be an effective way to develop synergy targets and initiatives, as the categories and typical timing to realize synergies can vary across the different parts of the new business (see Figure 2).

Figure 2

Realization expectations across cost synergy categories

	Cost synergy lever	Typical timing for focus and initial synergy realization			
		Immediate	First year	First two years	Two+ years
Sales and marketing	Commercial process optimization		✓		
	Cost of sales		✓		
	Marketing spend rationalization	✓			
	Aftersales service consolidation			✓	
	Business partner/channel partner renegotiation		✓		
Supply chain operations	Supply and demand planning process improvement			✓	
	Inventory optimization/segmentation (MTO vs. MTS)		✓		✓
	Transportation rate, cube, mode optimization for inbound/outbound		✓		
	Four-wall manufacturing efficiency		✓		✓
	Network optimization/site consolidation			✓	
	Four-wall distribution improvement and order allocation optimization			✓	
	Make vs. buy		✓		✓
	Co Man/supplier alignment			✓	
	Supporting function (e.g., EHS, QA, regulatory)		✓		
	Capex planning and deployment				✓
Operating cost	Direct spend		✓		
	Indirect spend		✓		
	Working capital (DPO)		✓		
	Procurement process enhancement			✓	
	Capex optimization	✓	✓		
	Tax advantages		✓		
R&D/product development	R&D process optimization		✓	✓	✓
	R&D footprint alignment		✓	✓	✓
	Product portfolio/product roadmap consolidation		✓	✓	✓
Back-office/shared/corporate costs	Corporate/overhead costs	✓			
	Functional management redundancies	✓			
	Back-office FTE/service redundancies	✓	✓		
	Office space/locations			✓	
	Systems/tools/IT license rationalization			✓	✓
	Compensation and benefits		✓		
	Third-party spending	✓			

Note: MTO=make to order, MTS=make to stock, EHS=environmental, health and safety, QA=quality assurance, DPO=days payable outstanding, FTE=full-time equivalent, IT=information technology
Source: L.E.K. research and analysis

Evaluating synergy opportunities

We endorse a pragmatic approach to quickly drive toward estimates for synergy targets and initiatives. These estimates can be further refined by interrogating each of the functional areas listed above with respect to the number of typical synergy drivers, including:

- **Assessing role/head count/full-time equivalent redundancy** and the potential reduction in a combined team that might be possible across the newly combined entity
- **Streamlining the organization** through levers like reduction in management layers and overlapping teams or capabilities
- **Aligning compensation and incentive packages** for management, sales, etc.
- **Realizing procurement scale benefits** for both direct and indirect spending
- **Improving processes** via streamlining, best practice sharing and other efficiency gains
- **Harmonizing and rationalizing systems**
- **Spending** on third-party service providers
- **Renegotiating business or channel partner agreements** to improve cost position or achieve other advantages (e.g., exclusivity)
- **Removing and reducing corporate costs**
- **Rationalizing the new entity's footprint** via rooftops/facilities consolidation
- **Realizing financial benefits** via working capital optimization, capex optimization (or avoidance) and tax advantages

Conclusion

Every acquisition carries the potential for cost savings or for resources that can be recaptured and/or redeployed to better serve the needs of the combined business. Using guideposts and frameworks as outlined here, we can help your team identify costs that can potentially be reduced or avoided, gain confidence that key opportunities are not being overlooked, and deploy a proven process[3] that delivers results.

For more information, please contact strategy@lekinsights.com.

Endnotes

[1]LEK.com, "Keys to Unlocking Merger Value — Revenue Synergies." https://www.lek.com/insights/all/us/ei/keys-unlocking-merger-value-revenue-synergies

[2]Based on public transactions with announced deal synergies between 2012 and 2022.

[3]LEK.com, "Achieving Synergies Post Merger." https://www.lek.com/insights/ei/achieving-synergies-post-merger

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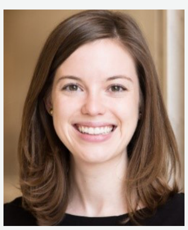

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