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An approach to revenue synergies

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Part art, part science

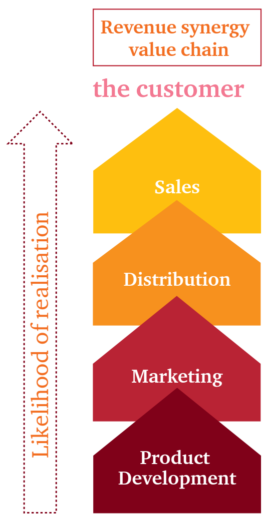
“Wholly uncertain. Unreliable. Risky.”

These are some words which have traditionally been associated with revenue synergy opportunities in transactions. Although delivery of these synergies is amongst the hallmarks of successful deals, they are considered to be incredibly hard to achieve with an endless number of uncontrollable internal and market factors to manage. It is largely for this reason that most deal-makers consider them to be ‘un-bankable’ and build acquisition and synergy models based around cost. Yet, almost every executive team has as part of their merger rationale ‘growth’ not just in bottom line from taking costs out but genuine revenue and earnings upside from combining acquired businesses.

Given therefore the importance of top line growth as opposed to purely cost synergies, generating a more robust approach on both identifying and developing a concrete plan to capture these revenue opportunities has become increasingly important. Through applying a structured approach, uncertainties can be made more certain and acquirers can inform their view of asset price, their willingness to confidently pay a premium and refine their integration strategy.

To bring more structure and discipline to this crucial source of value, PwC have identified eight levers that can be used to deliver revenue synergies (left):

Sources of revenue synergy

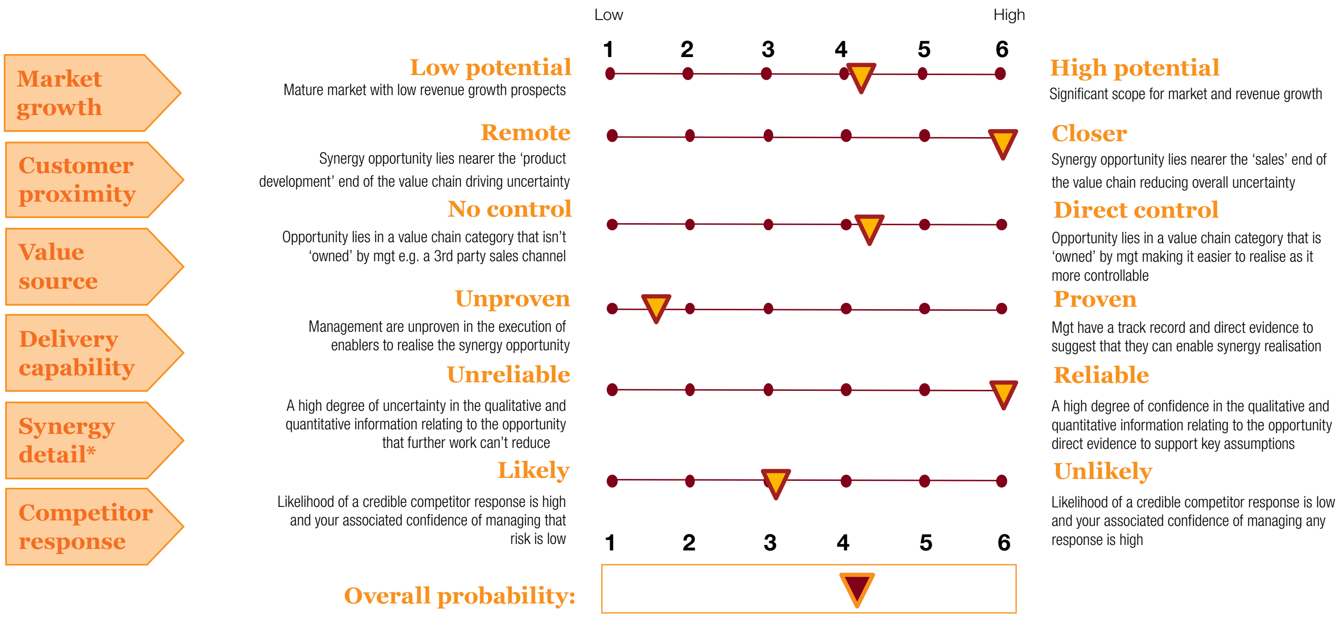


Levers	Examples
1. Cross selling	*Sell existing products to the new customer base*
2. Product bundling	*Offer customers complimentary product sets*
3. In-sourcing	*Substitute externally sourced products for equivalent products of the acquired business*
4. Margin improvement	*Use combined offering to drive premium pricing*
5. Distribution channels	*Sell existing product through newly acquired channels*
6. Market power	*Extend share of wallet through scale of presence*
7. Marketing ability	*Share expertise to enhance brand & product reach*
8. New product dev’t	*Use acquired IP to enhance existing product set*

By categorising the revenue synergy opportunities into this value chain, a buyer can gain an initial insight into the probability of its realisation. The closer the opportunity lies to the ultimate customer, the higher the likelihood of success. This insight can be further refined by assigning a 'lever' to each opportunity. For each of the eight, PwC have, through their experience, observed common features of success and challenges associated with realising the benefits. We have highlighted three of the eight below:

Lever	New product development	Product bundling	Margin improvement
Case Study example	A consortium that included **Apple** and Microsoft bought Nortel's patent portfolio in 2011 to for $4.5 billion to enable future innovation	**Telstra's** 50% investment in **Foxtel** has allowed them to bundle their product range and together generate stronger revenues	**Royal Bank of Scotland Group's** acquisition of **Coutts Private Bank** enabled the differentiation of customer segments and realise better margins
Common challenges in synergy realisation	• Lack of clarity on how to effectively leverage each other's product development capability • Product innovation is not institutionalised in the combined organisation • Product development units are physically dislocated • Insufficient organisational incentive to innovate	• Sales staff don't understand the true customer requirements • Branding the combined bundle can often be contentious • Depending on price elasticity, bundling products won't necessarily generate higher incremental revenue • Discounting bundled products can generate internal debate around which organisation should take a margin 'hit'	• Mis-alignement between the two organisation's customer databases • Cost savvy customers expect some of the margin improvement to be passed on, reducing the net benefit • Prestige associated with serving some customer segments over others can create tension amongst staff when asked to specialise
Key success factors in synergy realisation	• Physically co-locate the product development capability where possible • Have a direct link between the customer and product development • Optimise organisational aspects such as incentives, structures and information to enable the synergy	• Establish customer need and whether bundling increases customer's utility • Consider how best to brand the bundled product as this can be a key determinant of margin • Understand the role that each product plays in the bundle • Ensure balanced internal 'sacrifice' when discounting price	• Consider the alignment of customer data in order to understand how much remediation work would be required • Agree how much (if any) of the margin improvement benefit to pass on to customers • Clearly articulate to both staff and customers the benefits of the change

The extent to which a buyer can effectively mitigate the common challenges associated with each revenue synergy lever will determine an opportunity's achievability. Although deal risks are as varied as the companies and personalities involved, some risks are consistently relevant when assessing how to realise revenue and earnings benefits. Reviewing each opportunity against these risks will generate a refined assessment of success probability. With that structure in mind, the task of then establishing how best to realise these benefits becomes a more transparent and manageable task:



Market growth: Before assessing the elements that are within a buyer's control, it is crucial to survey the commercial landscape. A high level assessment of market conditions e.g. maturity and growth prospects will be a key informant to the probability of success.

Proximity to 'the customer': Each revenue and earnings enhancement opportunity can be mapped to one of the four typical value chain components. The further away an opportunity lies from 'the customer', the longer the likely lead time required to realise the synergy, the higher the risk and consequently the lower the probability of a successful outcome.

For example a cross selling opportunity to existing customers that you have a strong relationship with would be considered 'close'. This of course does not change the requirement to demonstrate genuine value for the customer associated with this new product or service nor the challenge associated with enabling a sales force to sell a potentially unfamiliar product or service. However challenge is relative measure. Conversely, a new product development opportunity that requires capability transfer and isn't directly aligned to an existing customer is considered 'remote'. The order of complexity and challenge to achieve this outcome is typically exponentially greater.

Control of value source: If control of a value chain area resides with a third party e.g. leveraging another company's website as your distribution channel, there is less control and oversight across the lifecycle which generates risk. The converse also applies e.g. where you control over how combined products are bundled, you can ensure that it is a complimentary pairing and track sales data to validate your assumptions. Although there are ways to mitigate the risk of indirect control of the value source, opportunities with lower complexity, have a demonstrated higher probability of success.

Proven delivery capability: Great opportunities can remain unrealised without the experienced people to turn them into reality. Although success and experienced people are not mutually exclusive, there is a lower associated risk when an opportunity is delivered by individuals with a track record. The 'experience curve' is a well trodden path and there is extensive research to demonstrate that serial acquirers tend to embed an enduring integration capability. Having a structured, tried and tested approach to capturing revenue synergies is just part of this body of expertise.

Synergy detail reliability: The template on the next page can be used to outline the underlying detail that forms the basis of a synergy opportunity:

Revenue synergy initiative – Example

Synergy source:	Cross selling

Description

- Sell Target's Category A products in all of our stores

Synergy rationale and basis of calculation

- Market research suggests that 40% of our customers also buy Category A which we currently do not sell
- Base case assumes we capture X% of these sales versus 100% in the stretch case
- Acquirer opportunity is $1.0>1.8m of retail margin; Target opportunity is to capture $2.5>4.5m of wholesale margin

Acquirer

EBITDA $m	Yr 1	Yr 2	Yr 3
Synergy base	0.4	0.9	1.0
Synergy stretch	0.6	1.1	1.8
One off costs	0.7	0.3	0.3

Target

EBITDA $m	Yr 1	Yr 2	Yr 3
Synergy base	0.2	1.8	2.5
Synergy stretch	0.5	2.5	4.5
One off costs	1.6	0.3	0.3

Assumptions

- Customers will pay the average retail price of Category A products
- No change to branding of goods and no product bundling
- Target's production function has capacity to meet demand with existing resource
- No additional sales force incentives are required to realise synergy

Dependencies

- IT systems in stores will need to be able to scan, recognise and report sales of Target's Category A products
- Production function will need to produce 200% more of Cat. A product
- Need to recruit 1FTE in X function to support new sales

Issues and risks

- Target's products are more complex so we will incur some training costs
- Individual X in the Target holds key relationships which underpin the synergy – recommend retaining for min. of 6 months
- IT will need to implement the changes along side the existing Program Y

One off costs and integration implications

- Training our staff on Target products will cost $0.1m/store – Yr 1 cost of $1.5m & $0.4 on-going and retention is required for Individual X who is a key enabler of this synergy
- IT hypothesis is to leave IT systems unchanged in both businesses i.e. co-exist, in order to reduce business disruption. Cost will be focussed on enabling the two systems to communicate with each other ($0.8m in Yr 1 and $0.2m in Yrs 2 & 3)

It is here that the Digital aspects of an opportunity can also be highlighted as digital can have deep implications for the delivery of revenue opportunities. For example, the quality of digital assets acquired e.g. customer databases require careful assessment. If there is deep customer information, effective segmentation and high levels of customer engagement, it is more probable that an opportunity will be realised.

Although there are multiple elements to consider in this section, by articulating an opportunity's causal details, it can help to establish its credibility and reliability.

Competitor response: It is inevitable that if success is achieved through the realisation of revenue synergies, it will try to be emulated by competitors. It is the credibility of your response to that emulation that will inform overall risk. Equally the lower barriers to entry generated through the pace of digital change, increases the risk of non-traditional rivals competing. There is no such thing as a future proofed opportunity however the extent to which it is at least 'short-term' proof is a key determinant of success.

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Filtering the opportunity through PwC's framework will help to:

Establish a synergy range

An early assessment of synergy base and stretch helps articulate the benefit range to enable communication to various stakeholders (the market, banks and internal)

Drive transparency

Stakeholders can very quickly assess the reasonability of assumptions and gain confidence in the general rigour applied to the opportunity

Highlight complexity

Articulating the interdependencies, phasing assumptions and potential issues helps to bring out the complexity involved in realising opportunities

Inform integration approach

Prior knowledge of synergy realisation requirements will help frame the integration approach. e.g. if the acquisition rationale is driven by the development of an exciting new product in the Target, retention of the individuals involved in its development should be a key element of the integration strategy

Allocate resource

Once the likelihood of success and the potential benefit is quantified, it can be used to inform which opportunities should be prioritised with resource, time and money

In the post GFC world, deal makers can do more to develop a refined view of these opportunities. The application of a structured approach can make the process of revenue synergy identification, validation and delivery more scientific. This journey of making the uncertain more certain will help to reduce risk, determine how aggressive or conservative a buyer can be, indicate optimal integration strategies and be a key informant of price.

PwC's M&A Integration team

Simon Mezger
Partner

simon.mezger@au.pwc.com
Tel: +61 (3) 8603 0161 | Mob: +61 412 116 398

Simon has over 23 years work experience in management consulting, private equity (PE), treasury and operations. He has completed over 30 buy and sell side strategic & commercial due diligences which have included revenue synergy identification, verification and oversight of delivery. Simon has also led over a dozen mergers and several carve outs.

Donna Watt
Partner

donna.watt@au.pwc.com
Tel: +61 (3) 8603 3136 | Mob: +61 421 141 350

Donna has extensive end to end transformation and integration experience. She has been program director for a ($0.5bn) hostile takeover for a third party logistics provider and the demerger of the transport and logistics function for a large global resources company. She also led the $1bn acquisition of a gas business by a large listed utility and the $0.75bn integration for a large global paper company.

Ajay Rawal
Partner

ajay.rawal@au.pwc.com
Tel: +61 (2) 8266 2848 | Mob: +61 405 112 840

Ajay leads PwC's M&A Integration practice for Asia Pacific. He has over 20 years experience working with senior executives across the full M&A lifecycle and advises on both in terms of standalone value and attributing value to synergies and operational improvement . He has advised on multiple re-deal synergy and commercial engagements across most industry sectors, as well as over 70 post-deal integration, separation and demerger assignments.

Mike Sum
Director

mike.sum@au.pwc.com
Tel: +61 (3) 8603 5924 | Mob: +61 420 314 505

Mike has worked on over 100 synergy and merger integration projects in a range of industries across Europe and Australia. His experience includes leading a review of potential synergies for two building products players, managing the end-to-end integration including benefit identification for two tool hire firms & helping BHP Billiton develop their synergy case for its $147bn hostile bid for Rio Tinto.

Richard Blundell
Director

richard.blundell@au.pwc.com
Tel: +61 (3) 8603 0086 | Mob: +61 415 881 841

Richard has led over 50 strategy and operations engagements related to M&A in Australia and Europe. His experience has enabled him to develop methodologies for identifying and assessing the value opportunities in cost synergies and revenue growth that come from deals.

Kushal Chadha
Director

kushal.chadha@au.pwc.com
Tel: +61 (3) 8603 5285 | Mob: +61 421 440 834

Kushal has over 10 years of experience in leading synergy identification, merger integration and separation engagements. He has worked on over 60 transactions and transformation projects across a wide range of industries. Recent experience includes pre-deal advisory for the Foster's demerger including synergy analysis and advising on Dulux's acquisition of Alesco (focussing on synergy identification).

Alan Glenville
Manager

alan.glenville@au.pwc.com
Tel: +61 (3) 8603 0417 | Mob: +61 459 772 680

Alan has undertaken a number of pre-deal reviews in order to identify and grade synergy opportunities. The most recent example was helping two FTSE 100 Retail companies identify $0.5bn of revenue and cost opportunities. Alan has also managed numerous due diligence engagements and integrations to highlight and deliver synergies e.g. Deutsche Bank's acquisition of ABN Amro.

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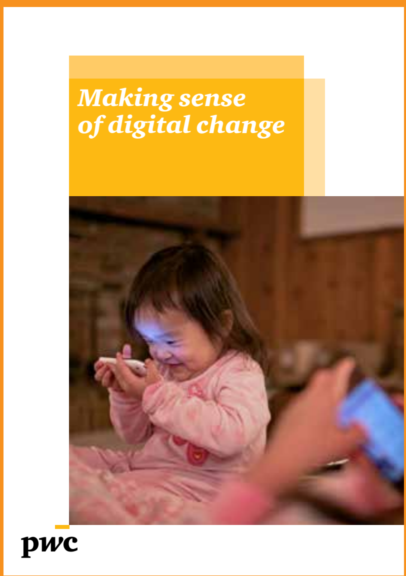

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