Developing the *Full Cost* of an M&A

by Jack Prouty

One of the true'isms of business is that you cannot manage what you don't know. This is particularly true in mergers and acquisitions. Years ago a study was conducted with senior executives and they were asked the question of whether or not their deal had been successful. Eighty-four percent (84%) said yes. Yet when the actual results were analyzed (i.e., within two years after the deal had they created shareholder value or not), only 30% of these M&As had actually resulted in an increase of shareholder value.

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Simply put, companies should treat M&As like they would any major capital investment: what is the five-year (or 10-year) discount cash flow ROI on this M&A investment?

Too many companies rely on subjective assessments of M&A success, rather than objective measures. Our goal within the M&A Leadership Council is to promote best practices and the creation of in-house M&A competencies. One factor to becoming good at M&As is to first understand the fully burdened cost of the acquisition and integration; then focus on taking those planning and integration actions which will lead to business benefits greater than this fully burdened M&A cost. Simply put, companies should treat M&As like they would any major capital investment: what is the five-year (or 10-year) discounted cash flow ROI in this M&A investment? It starts first with capturing all of the associated costs (both acquisition and integration costs) of the M&A and then measuring that against the incremental financial benefits achieved to determine whether the business value is actually increased or destroyed in the transaction.

Acquisition Costs

A first step, which many companies do not complete, is the systematic capturing and reporting of front-end acquisition costs. These can be grouped under the heading of sunk costs, in that the costs invested in doing the transaction don't actually deliver bottom-line benefits. They only provide potential benefits. It is only in the integration effort of the combined companies that business value is realized.

In Template 1 below are listed the various acquisition costs a company might typically incur just in "Doing the Deal" before focusing on "Making the Deal Work." In the acquisition of a company with a $100 million dollar valuation, a typical acquisition cost of 1-5% will be incurred. This does not include any premium that might be paid above the market value of the business. Again, these are hard dollar costs with no value delivered until after the integration of the businesses. The question is: have you fully identified and captured the true acquisition cost of the deal? This template will help you do so, and in the appendix are provided some actual client examples of the acquisition costs they incurred in doing their transactions.

The question is: *Have you fully identified and captured the true acquisition costs of the deal?*

Template 1

Typical Acquisition Cost Buckets

- ☐ Investment Banking Fees
- ☐ Banking/Financing Fees
- ☐ Legal Fees
- ☐ Printing Expense
- ☐ Roadshow Expense
- ☐ Accounting/Tax Services
- ☐ Due Diligence Expense
- ☐ Compensation/Benefits Consultants
- ☐ Employment Contracts
- ☐ Integration Consultants
- ☐ Other??

Integration Costs

The next costs to identify and track are all the integration costs. Again, like the acquisition costs above, most of these are the sunk costs of doing the M&A. These costs, in most cases, are one-time, non-operating costs which have no return on investment associated with them. The more spent in these areas, the higher are raised the break-even cost of the M&A.

Below, Template 2 shows the various integration costs that can be seen in companies engaged in M&A activities. Because there are so many variables involved (e.g. the need for a new

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Template 2

Typical Transition & Integration Cost Buckets

- ☐ SEC/Regulatory Filings
- ☐ Facility Closing Costs
- ☐ Severance Pay
- ☐ Retention Bonuses
- ☐ Transition Staff Salaries
- ☐ Re-signing (facilities, brochures, etc.)
- ☐ Staff Relocation and Moving Costs
- ☐ Advertising and Promotions
- ☐ Fixed Asset Write-Offs (furniture, equipment, etc.)
- ☐ Contract Write-Offs
- ☐ Process Manuals, Documentation and Staff Training
- ☐ Marketing Collateral
- ☐ Interim Staffing/Outside Services
- ☐ Professional Services/Integration Consulting
- ☐ Pension Elimination Costs
- ☐ Travel and Meeting Costs
- ☐ Legal Fees (e.g. contract and labor issues)
- ☐ Training
- ☐ Marketing Material/Brochures
- ☐ Systems Conversion/Integration
- ☐ Interim Systems and Reporting Costs
- ☐ Internal/External Communications
- ☐ Outplacement Fees
- ☐ Transition Service Agreement Costs

headquarters for the combined business; level of IT investment required to integrate the companies on common systems and platform; or increased operating costs to bring the acquisition up to compliance and/or acquirer's standards) an average percentage of integration costs can't be stated; however, a typical company will incur 5-10% in normal integration costs. Again, it is important to identify, capture and segregate these one-time costs from the normal course of business operations.

During the integration activities, the metrics must be set up for measuring business benefits (or value erosion) against this break-even point

To a large degree these costs are unavoidable, but manageable. The real question is, are these costs being identified and captured so that the fully burdened costs of this transaction (both the acquisition and integration costs) are understood?

In the appendix are provided examples of the actual integration costs incurred by a client on an acquisition.

Fully Burdened Cost of the M&A

If all of the acquisition costs and the integration costs are completely captured, there is now a fully developed picture of the true cost of this acquisition:

- **The price paid for the company (which may include a premium paid above the actual market value of the business)**
- **The acquisition costs**
- **The integration costs**

The total of these elements now provides a break-even point for the deal.

During the integration activities, the metrics must be set up for measuring business benefits (or value erosion) against this break-even point. The way to identify and capture these is to take baseline measurements of key performance metrics and a combined financial pro forma upon closing of the transaction, then conduct monthly financial analysis to determine gains or losses against this baseline.

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Following is a representative business case analysis, taken from an actual M&A integration project, used for identifying and then tracking the expected costs and benefits of the M&A integration. The Appendix contains actual M&A acquisition and integration costs details for two representative M&As.

Client Example: Business Case Analysis

EXAMPLE - For Discussion Purposes Only

	Category	Value Driver	Buyer				Target				Combined		
				Cash Flow		BEV		Cash Flow		BEV	Cash Flow		BEV
Revenue				One-Time	On-Going	Impact		One-Time	On-Going	Impact	One-Time	On-Going	Impact
Loss of Customers	Loss Avoidance	% Revenue Loss	-5.0%		(7)	(67)	-5.0%		(8)	(81)	-	(15)	(148)
Slowdown of Growth Rate	Loss Avoidance	% Loss of Growth	-50.0%		(12)	(115)	-50.0%		(32)	(315)	-	(43)	(430)
Cross Selling Products	Synergy	% Revenue Growth	2.0%		2.7	27	2.0%		3.3	33	-	6	59
COGS													
Purchasing Efficiencies	Synergy	% of COGS	0.5%		1	15	0.5%		1	10	-	3	25
Distribution Efficiencies	Synergy	% of COGS	0.2%		1	6	20.0%		0	4	-	1	10
Manufacturing Efficiencies	Synergy	% of COGS	0.5%		1	15	0.5%		1	10	-	3	25
Capture of All Synergies	Loss Avoidance	Years to capture	6.0	(5)		(5)					(5)	-	(5)
SG&A													
Headcount Savings	Synergy	% of SGA	1.0%		0	2	1.0%		0	1	-	0	3
Employee Turnover	Loss Avoidance	% Turnover above Industry Average	10%				10%						
Replacement Costs	Loss Avoidance	$ Cost to Replace	$39,000	(1)		(1)	$39,000	(1)		(1)	(2)	-	(2)
R&D	Synergy	% of SGA	1.0%		0	2	1.0%		0	1	-	0	3
Net Working Capital													
A/R to Best of Buyer or Target	Synergy	Lower Days						4	0	4	4	0	4
A/P to Best of Buyer or Target	Synergy	Higher Days		2	0	2					2	0	2
Potential A/R Collection	Loss Avoidance	% of AR	2%	(1)		(1)	2%	(1)		(1)			(2)
Issues (Increase in Bad Debt)											(2)	-	
Risk of obsolete inventories	Loss Avoidance	% of Inventories	5%	-		-	5%	-		-	-	-	-
Tangible and Intangible Intellectual Property (incl. Obsolete Assets -TBD													
Total Loss Avoidance				(8)	(18)	(182)		(2)	(40)	(396)	(10)	(58)	(578)
Total Potential Synergies				2	7	67		4	6	64	5	13	131
Value @ Risk Range												(71)	(710)

Worst Case	238	1,642
Combined Companies - Base	296	2,220
Combined Companies - w/Synergies (based on deal	306	
Best Case	309	2,351

BEV = Business Enterprise
Cash Flow = EBITDA or Cash

Appendix - Part A

ILLUSTRATIVE BUSINESS CASE #1:

Health Care Company

Illustrative Business Case #1
Actual Client Example

Fully Burdened Cost Snapshot

PURCHASE PRICE:
$400 million ($250 million of this is in buildings and real estate)

ACQUISITION COSTS:
$5.1 million (not including goodwill premium)

INTEGRATION/TRANSITION COSTS:
$22.2 million

SYNERGIES:
40% increase in stock price
$34.25 million in annual cost savings

Illustrative Business Case #1
Acquisition Costs

☐ Investment Banker Fees	$2,000,000
☐ Legal Fees	1,600,000
☐ Registration & Licensing Fees	250,000
☐ Due Diligence Fees	100,000
☐ Hart Scott Rodino Filing	50,000
☐ SEC Filing	25,000
☐ Accounting Fees	60,000
☐ Financing Costs	862,500
☐ Tax Advice	100,000
☐ Travel Costs (Roadshow, DD, etc)	55,000
Total Costs	**$5,102,500**

Illustrative Business Case #1
Actual Client Example (cont'd)

Health Care Company

Illustrative Business Case #1
Integration Costs

☐ Severance/Transition Staff Costs	$3,900,000
☐ Change in Signage	3,000,000
☐ Marketing Collateral	1,150,000
☐ Corp Name Change/Branding	2,454,000
☐ Transition Service Agreement	3,275,000
☐ Other Department Transitions	2,275,000
☐ Integration Consultants	450,000
☐ Officer Moves	1,627,500
☐ Office Relocation	1,625,000
☐ T&E Costs for Integration Teams	846,000
☐ IT Costs	987,000
☐ Misc Costs	625,000
Total Costs	**$22,214,500**

Illustrative Business Case #1
Expected Synergies

☐ Corp/Field Staff Reductions	$18,000,000
☐ Facility Consolidation	5,000,000
☐ Marketing & Advertising	2,000,000
☐ Professional/Contracted Svcs	750,000
☐ Insurance	1,000,000
☐ Audit & Tax	1,000,000
☐ Purchasing (supplies, etc.)	3,500,000
☐ Other G&A/Back Office Ops	3,000,000
Total Business Benefits (annually)	**$34,250,000**

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Appendix - Part B

ILLUSTRATIVE BUSINESS CASE #2:

Consumer Products Supply Company

Illustrative Business Case #2
Actual Client Example

Fully Burdened Cost Snapshot

PURCHASE PRICE:
$1 billion

ACCUSITION COSTS:
$14.9 million

INTEGRATION/TRANSITION COSTS:
$15.6 million

SYNERGIES:
$111 million in annual business benefits

Illustrative Business Case #2
Acquisition Costs

☐ Investment Banker Fees	$10,900,000
☐ Legal Fees	500,000
☐ Banking Fees	1,200,000
☐ Printing Expenses	500,000
☐ Banking Research Expense	100,000
☐ Roadshow Expense	150,000
☐ Accounting Fees	300,000
☐ Due Diligence Expense	100,000
☐ Integration Consultant	500,000
☐ Comp/Benefits Consultant	250,000
☐ Other	400,000
Total Costs	**$14,900,000**

Illustrative Business Case #2
Actual Client Example (cont'd)

Consumer Products Supply Company

Illustrative Business Case #2
Integration Costs

☐ Severance/Retention	$5,000,000
☐ Incremental Integration Labor Exp	250,000
☐ Marketing/Communications	500,000
☐ Travel Costs	500,000
☐ Transition Services/Outsourcing	500,000
☐ R&D Costs	600,000
☐ Replacement/Recruiting	250,000
☐ Relocation Costs	250,000
☐ Contract Labor	1,000,000
☐ Facility Costs	1,000,000
☐ Contracts (oper leases, maintenance)	500,000
☐ Service Contracts	500,000
☐ Integration Consultants	500,000
☐ Shared Service Organization	500,000
☐ Training	1,000,000
☐ Svc Inventory/Spare Pts Adjstmt	500,000
☐ IT Costs	2,000,000
Total Costs	**$22,214,500**

Illustrative Business Case #2
Expected Synergies

☐ Staff Reductions (839 FTEs)	$63,000,000
☐ Facility Consolidation	19,000,000
☐ Marketing & Advertising	7,000,000
☐ Outside Services	11,000,000
☐ Insurance	6,000,000
☐ Audit & Tax	1,000,000
☐ Other G&A and Misc	4,000,000
Total Business Benefits (annually)	**$111,000,000**

(Note only 4-6 million in Year 1 and $56 million in Year 2)

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Jack Prouty is the President of the M&A Leadership Council, Managing Partner of Prouty, Montgomery + Partners (PM+P) and a subject matter expert in the field of mergers and integrations. He has over thirty years of line management and consulting experience working with Fortune 1000 companies on effectively integrating acquired companies, repositioning/ transforming their businesses for improved market success and conducting large scale change programs for bottom-line benefits. Jack's work has focused on assisting executives of major companies across the life cycle of transactions: acquisitions, mergers, consolidations, joint ventures, divestitures, and roll-ups. The emphasis is on addressing the strategy, people, process and technology areas so the value of the deal is realized. While he has a depth of industry and functional knowledge and experiences, Jack's role is to bring to clients his specialized expertise in what it takes to effectively execute a successful integration.

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