

Spend Analysis and Strategic Sourcing: A Critical Component of Merger & Acquisition Synergies

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From November 2004 to January 2005, Merger & Acquisition (M&A) deals totaled an astounding \$357 billion.¹ The spurt in M&A activity is directly correlated to the low price premiums for target companies, which may make executing an M&A deal appear more cost effective. However, even with the low premium paid for the acquisition, the merged firm still has to increase its rate of profitability through synergies from economies of scale to ensure a meaningful return on its investment. Unfortunately, growth in profitability is not the norm, because fewer than half of all mergers actually leverage the synergies, or add value for their shareholders.² This leaves many CEO's and shareholders scratching their heads and wondering why the stock price never realized its target.

Fortunately, there is a tool that will greatly increase the odds of realizing merger economies. Spend Analysis is a valuable tool that can be used to assess synergistic opportunities early on during merger integration, and then be used again, post-merger, to validate which economies have been realized and to identify which areas need to be improved upon.

How Does Spend Analysis Fit into M&A?

Spend analysis is the process of understanding the intricate details of a firm's spending characteristics, such as the associated spend by business unit or cost center, the key suppliers, and the products and services that companies purchase to run their daily operations. Such granular data enables the management team to analyze actual versus planned expenditures and focus on high spending business units, where cost-reduction opportunities can be realized efficiently. At the commodity level, the management team can use the detailed spend information to standardize product specifications; negotiate aggressive pricing; curtail maverick spend; and reduce total spend per commodity category. In addition, the management team can present the results of spend analysis to suppliers in order to show their annual aggregate spend and make a case for why the merged entity deserves preferential treatment.

Spend analysis also considers the diversification of a company's supplier portfolio, and allows the merged entity to make its relationship with suppliers more synergistic and less transactional. An optimized supplier base provides the merged firm with the ability to effectively manage changes in demand patterns and align new product initiatives with its core suppliers. This process enables the company to mitigate risks associated with merging the procurement functions of two corporate entities, by limiting the number of suppliers and by integrating quality and service guarantees via a thorough strategic sourcing effort.

For example, after Hewlett-Packard (HP) and Compaq Computer Corporation announced their merger, the new HP pursued a variety of supply chain programs, such as risk management, spend analysis, and e-procurement. These initiatives helped HP reduce its supply chain cost as a percentage of revenue by 22%. Spend analysis alone accounted for more than \$1 billion in savings for the two year period after the merger. Spend analysis also helped HP standardize seemingly minor products, such as power cords. Originally, HP purchased about 100 million power cords of varying lengths per year. After the spend assessment, HP was able to reduce the variety of cords, cut its number of power cord suppliers by 62%, and reduce its power cord spend by 20%. In addition, spend analysis enabled HP to reduce its number of direct material suppliers by 53% - from 1,500 to 720 - and allowed the new HP to own supplier relationships it had previously outsourced.³

The information available through spend analysis plays a powerful role when evaluating synergies and cost savings opportunities for the combined entities. Specifically, spend analysis, followed by a strategic sourcing effort across the merged companies, can help identify and create significant cost savings by leveraging the following factors:

- Economies of scale
- Demand management
- Procurement best practices

Identifying M&A Synergies

M&A synergy considerations using spend analysis allow the concerned parties to better evaluate the potential benefits of the merged entities. A detailed spend assessment helps determine potential merger benefits, by pinpointing specific cost reduction opportunities available to the combined companies. It also provides the information necessary for evaluating various cost savings opportunity scenarios, such as supplier base consolidation, demand management, application of industry benchmarks and best practices, and consolidated purchasing power.

Spend analysis helps the acquiring firm gain concrete intelligence about specific opportunities for ROI after the completion of the M&A deal. If the target firm has a highly fragmented supplier base in key purchasing areas, this fact could signal a greater future opportunity than a similar target company with a highly concentrated supplier base. This kind of information is actually a key and potentially hidden piece of market intelligence, that in some cases helps the acquiring firm uncover areas that were not accounted for in the valuation of the target firms. Such firms could be considered “undervalued” since they have higher potential returns from synergies than other similarly valued firms.

Successful merger integration planning also requires outlining organizational mechanics of “how” synergies will be attained, such as how to combine two procurement functions, or how to address the cultural turmoil associated with integrating the supply chain of two independent entities. Spend analysis provides the integration team with the necessary facts to rationalize the supply base and implement organizational change. By evaluating the differences and similarities in purchasing behaviors and patterns between the two parties, the integration team is armed with the information necessary to identify and focus on areas where purchasing should be streamlined and spending can be effectively reduced. In the HP-Compaq transaction, Compaq’s strengths included a centralized purchasing operation and a team skilled at aggregating demand and leveraging purchases with suppliers. HP was more decentralized, but was experienced at involving buyers in new product development. The new, post-merger HP effectively deployed best-in-class procurement practices to leverage the purchasing expertise that resided in both organizations, and realized savings in excess of \$1.2 billion.⁴

Lastly, unlike many of the “sunk” costs associated with executing an M&A deal, an investment in spend management execution results in high, positive ROI. In most instances, effective spend management efforts conducted post-M&A result in 7-10 times the project investment. This financial impact is yet another M&A synergy resulting from spend management efforts that are not leveraged by acquiring companies.

Continuing Benefits of Spend Management Post M&A

Spend analysis can be applied post-M&A to unlock cost-saving opportunities and gauge the synergies realized from the M&A. If spend analysis and strategic sourcing have been conducted as part of the integration, post-M&A spend analysis can be used to realize and monitor ongoing cost savings resulting from the effort. If spend management was not performed, post-M&A spend analysis can be used to bridge the inherent differences between two combined entities to create a robust long-term procurement strategy that highlights opportunities for future cost reduction.

By performing a comprehensive spend analysis after integration, the merged entity is able to assess exactly how much it is spending in each area with each supplier, and can project how much should be spent going forward. The company is able to slice the information as required to monitor actual spend and realized hard dollar savings. Spend analysis can also provide pertinent details that support a business case for selective or complete consolidation of the procurement functions. If a particular product is only purchased by one of the business units and is a critical operational component for that unit, it might make sense to have that unit procure that product on its own. If certain purchases are being made by multiple business units across the merged entity, then it makes sense to consider consolidation of the procurement. Spend analysis results will provide the necessary data to make these types of decisions.

Consider Spend Management in Your Next Integration Efforts

Disparate enterprise financial systems, operational differences, and contrasting procurement strategies make it difficult for merged companies to achieve savings from purchasing synergies. The result is lost opportunities for reducing redundant spend that can be achieved through economies of scale or demand management. More importantly, the merged entity is unable to leverage the purchases across divisions or geographic locations in order to enhance its buying power with suppliers. Spend management addresses these issues by capturing the relevant data; identifying opportunity areas for cost savings; and maximizing the potential synergies that are expected from a successful deal. On average, a 15-25% reduction in purchased expense can be realized without jeopardizing quality and service levels from suppliers. These cost savings impact the bottom line directly, demonstrating the financial benefits of the merger synergies in less than a year after the integration. Spend management is a powerful tool that is often overlooked during M&A activities. Perhaps it is time to consider it a prime tool for M&A integration efforts.

¹ "The Urge to Merge," *Fortune*, February 21, 2005.

² KPMG, *Unlocking Shareholder Value: The Keys to Success*, 1999.

³ James Carbone, "Hewlett-Packard wins for the 2nd time," *Purchasing*, September 2, 2004

⁴ James Carbone, "Hewlett-Packard wins for the 2nd time," *Purchasing*, September 2, 2004.