



National Audit Office

Reorganising central government

Synergy reporting for Mergers  
and Acquisitions

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## National Audit Office Foreword

### Drawing parallels with the private sector

The quality of information on the costs, and benefits, of reorganising central government is poor. A key reason is that departments and arm's length bodies are not normally required to report and disclose publicly the costs and benefits of their reorganisations (paragraphs 2.11-2.14 of **Reorganising central government**). This contrasts with the position in the private sector, where rules set by the Panel on Takeovers and Mergers require greater accuracy and transparency in identifying and disclosing this information.

We commissioned PricewaterhouseCoopers to produce the paper *Synergy Reporting for Mergers and Acquisitions*, which provides details on disclosure requirements and accountabilities for private sector mergers and acquisitions, in particular on costs and benefits (described in the paper as 'synergies'), and suggests possible areas of learning for the public sector. The paper makes the following key points about the private sector.

- Boards of Directors have a duty to ensure that due diligence is carried out on target organisations before recommending an offer for an acquisition or merger to shareholders.
- The Takeover Panel, comprising senior financial market professionals, supervises and regulates mergers and takeovers involving public limited companies on a statutory basis. It sets consistent, objective and transparent reporting standards for information provided to shareholders.
- Reporting Accountants formally review and report on the expected costs and benefits of mergers and acquisitions, as set out in bid prospectuses that are sent to shareholders. There should be a baseline against which to track and measure delivery. Prudence should be exercised, with contingencies made to reflect uncertainties and risks in estimates.
- Management of publicly quoted companies provide quarterly market updates on overall business performance and also on delivery of merger benefits. Analysts from investment banks report quarterly on progress in delivering these benefits. While these analyses are not publicly available, specialist financial media report their main points.

While private sector mergers and acquisitions do not always succeed (paragraph 3.1 of the National Audit Office report), there are lessons for central government on the importance of understanding the risks and opportunities of reorganisations, having rigorous and consistent standards for data on costs and benefits, and reporting transparently to Boards, Parliament and taxpayers, who are effectively the shareholders in the public sector. These lessons inform our report's recommendations.

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# Synergy reporting for Mergers and Acquisitions

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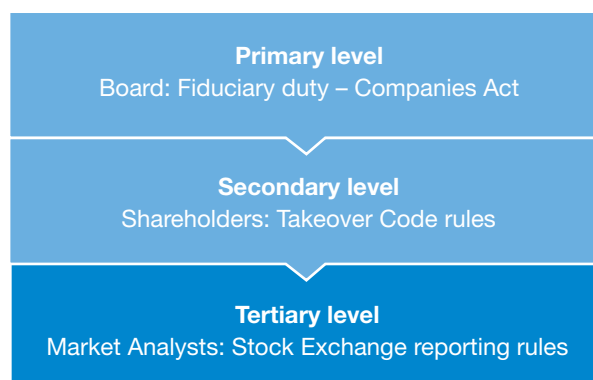
## Summary

Private sector organisations, both publicly listed and privately controlled, routinely undertake Mergers and Acquisitions (M&A) in order to realise their strategic ambitions such as inorganic revenue growth and economies of scale on costs.

The rationale for this activity is to increase shareholder returns and enterprise value, trading off the transaction risk today against the future enhanced revenues and lower costs yielded. Often, the value of the future benefits (“synergies”) is considered in determining the transaction valuation. Therefore there is a need for robust determination and objective reporting of these benefits to reassure investors, and other stakeholders, in any transaction prospectus.

In this paper we explore how M&A processes are governed, the role of the Takeover Panel in protecting shareholders through the Takeover Code, and the process for developing and reviewing synergies that arise, before concluding on some possible learnings for machinery of government changes.

## How M&A processes are governed



Successful M&A is a function of effective execution and accountability of management teams, incentivised to deliver the benefits of the transaction over a clear timetable. Depending on the structure of the business, there will be multiple levels of accountability, which require a high degree of information.

The Boards of both parties in a transaction have a fiduciary responsibility to protect the going concern of the merged businesses on behalf of creditors, shareholders and employees. No M&A transaction can be conducted without their approval, with due diligence undertaken to mitigate against excessive financial and business risk. Privately owned firms often have professional investors who have a high level of information and access to financial advice, and are in a position to better scrutinise and influence Board actions.

Where a firm is publicly listed there could be thousands of shareholders of varying types, from small UK investors, UK investment funds and international private investors and corporate funds, all of whom have varying access to company and market information. Where a UK plc is subject to a non-cash competitive takeover bid, then The Takeover Panel applies rules in order to protect shareholders – through ensuring a consistent, robust and objective process of information reporting around the financial terms of the deal, including synergies, to maintain transparency.

For publicly traded shares, Investment Bank analysts' reports are produced which make investment recommendations. These have an impact on the prevailing share price through encouraging shareholder transactions. They are generally written on a quarterly basis and also reflect the formal public reporting cycle of plcs (half-yearly and annual reporting). Post-transaction, analysts expect detailed updates on the successful delivery of synergies. In addition to analyst reports, the specialist financial media (Financial Times, Thomson-Reuters, Bloomberg etc), will cover the main points, and comment on synergy delivery. Similarly, plc companies may put their quarterly/half yearly financial reports on their websites so the general public can review them.

## What is the role of the Takeover Panel?

The Panel on Takeovers and Mergers (the "Panel" – [www.thetakeoverpanel.org.uk/](http://www.thetakeoverpanel.org.uk/)) is an independent body, whose main functions are to issue and administer the City Code on Takeovers and Mergers (the "Code") and to supervise and regulate takeovers and other matters to which the Code applies. Its central objective is to ensure fair treatment for all shareholders in takeover bids. The Panel has been designated as the supervisory authority to carry out certain regulatory functions in relation to takeovers under the EC Directive on Takeover Bids (2004/25/EC). Its statutory functions are set out in and under Chapter 1 of Part 28 of the Companies Act 2006. It is comprised of senior financial market participants and City professionals.

The Code has been developed to reflect the collective opinion of those professionally involved in the field of takeovers as to appropriate business standards and as to how fairness to shareholders and an orderly framework for takeovers can be achieved.

### The key rules are:

- When a person or group acquires interests in shares carrying 30% or more of the voting rights of a company, they must make a cash offer to all other shareholders at the highest price paid in the 12 months before the offer was announced (30% of the voting rights of a company is treated by the Code as the level at which effective control is obtained).
- When interests in shares carrying 10% or more of the voting rights of a class have been acquired by an offeror in the offer period and the previous 12 months, the offer must include a cash alternative for all shareholders of that class at the highest price paid by the offeror in that period. Further, if an offeror acquires for cash any interest in shares during the offer period, a cash alternative must be made available at that price at least.
- If the offeror acquires an interest in shares in a target company at a price higher than the value of the offer, the offer must be increased accordingly.
- The target company must appoint a competent independent adviser whose advice on the offer must be made known to all the shareholders, together with the opinion of the board.
- Favourable deals for selected shareholders are banned.
- All shareholders must be given the same information.
- Those issuing takeover circulars must include statements taking responsibility for the contents.
- Profit forecasts and asset valuations must be made to specified standards and must be reported on by professional advisers (including synergies in certain circumstances).
- Misleading, inaccurate or unsubstantiated statements made in documents or to the media must be publicly corrected immediately.
- Actions during the course of an offer by the target company which might frustrate the offer are generally prohibited unless shareholders approve these plans.
- Stringent requirements are laid down for the disclosure of dealings in relevant securities during an offer.
- Employees of both the offeror and the offeree must be informed about an offer.

## How does The Code work in practice for reporting synergies?

The Code offers protection to shareholders by making sure that all bidders for the target plc in question are obliged to support consistent, objective and transparent reporting standards based on equal levels of data and information access. Prior to any bid being approved by shareholders, a formal takeover offer has to be made, with prospectuses detailing the proposed structure and benefits from the transaction. These are available in the public domain.

The application of the Code is precise and detailed, and needs careful consideration by any UK public company's management team and their financial advisors when they propose to undertake a merger. Where it does apply, it is important that any synergies that are to be publicly announced are assessed with a high degree of rigour.

A report is required from a Financial Adviser and Reporting Accountant on whether the synergy estimate has been made with "due care and consideration" if:

- there is equity being issued as part of the consideration for the target of the bid;

And then either if:

- the offer has not been recommended by the Board of Directors of the target;

Or

- there is a counter bid and the original bidder repeats their estimate.

## Approach to estimating and delivering synergies

The estimated synergies and their associated implementation costs are both an important component of the transaction value as well as forming the initial baseline against which the subsequent realisation of benefits will be measured.

The baseline for the synergy case is developed in an iterative fashion, starting with high-level estimates based on limited access to the target prior to agreeing a transaction. This will then be updated once full access is obtained, either after signing or closing of the transaction. The actual baseline used for developing synergy values is typically either the current year budget for the merged business, or pro-forma last year actual. Care needs to be taken to factor in inflation into values.

Where synergies are disclosed in a shareholder prospectus or circular, then a high degree of support to justify the expected benefits is required and an appropriate degree of prudence must be exercised, resulting in contingencies being made within the estimates to reflect uncertainties and risks. The quality and extent of support needed if revenue synergies are to be published is particularly high.

Thereafter the actual synergies and associated implementation costs will be tracked and reported against the baseline, on an annual recurring basis, in order to ensure that management are focussed on delivering the anticipated synergies and minimising the associated implementation costs.

### Approach to estimating and delivering synergies



## How the Reporting Accountants classify and quantify synergies

In the majority of transactions 3 types of synergy arise; cost, revenue and financial, against which the costs of implementation must be set.

**Cost synergies** arise either from any reduction of overheads that become duplicated as part of the transaction or from application of better productivity ratios, and should be based on actual cost bases. Typically cost synergies come from sales and marketing functions, manufacturing, procurement, research and development (R&D) and back-office or general and administrative (G&A) functions, and are split into staff and non-staff buckets. They should exclude any previously announced internal cost reduction programmes, as these are already factored into the market value of the business, and cannot be double counted.

**Revenue synergies** arise from any benefits to commercial terms that arise through the merger. This could include selling more products to a shared customer base or cross-selling products. They are typically harder to quantify given the range of factors that could impede delivery which are beyond management's control, such as macroeconomic conditions. Therefore, they should be subject to a higher level of contingency.

**Financial synergies** apply where there is financial structuring or taxation benefit achieved through the merger. This could imply a lower cost of capital, a better use of capital employed, or rationalising of the legal entity structure to yield potential taxation benefits.

**Implementation costs** are typically redundancy or closure costs, or investment in simplifying IT. Depending on the speed of synergy delivery, implementation costs are usually incurred in the first year of synergy delivery. Synergy costs are split into two categories, cash and non-cash.

## Key output of a Reporting Accountant

The Reporting Accountant conducts an initial high level review of documentation and discussions with management, followed up by a more detailed review of synergy documentation and supporting evidence.

### There are 6 key factors to be considered:

- 1 Appropriateness of the basis of belief
- 2 Reasonableness and completeness of the principal assumptions (e.g. consistency with the underlying facts, integration and future business plans)
- 3 Accuracy of calculations
- 4 Appropriateness of base figures used
- 5 Appropriateness of sources of information used to determine the estimates
- 6 Appropriateness of principal judgements made

The typical output is a "due care and consideration report". This report typically covers the following checklist:

#### Non-Financial Information

- Dependencies / Pre-requisites
- Assessment of resource requirements

#### Supporting Information for Financials

- Key actions required to achieve synergy (i.e. action plan)

#### Financials

- Costs of implementation
- Impact on revenue (positive or negative)
- New recurring costs
- Cost savings
- Costs avoided
- Balance Sheet / Net Asset impact
- Impact on Headcount
- Cash vs. non-cash write-offs

## Other benefits of a robust synergy analysis

Synergy reporting is not just good corporate governance and good commercial practice, but also enables bidders to identify benefits early in order to be competitive in the valuing of their bid. It provides comfort for deal valuation purposes and enhances value to shareholders. In addition, a robust synergy case enhances real delivery in practice by establishing a clear platform.

## How does the financial market view synergy plans?

Cost synergies are, for the most part, taken at face value and given credit by the market almost immediately. It is significantly easier to report on a synergy case which is developed from the actual cost base of the merged businesses, which is possible to validate, rather than a budgeted cost base. Revenue synergies are regarded sceptically and credit is not given until they are delivered – tracking and reporting is the key to measuring success in the first few years. The critical success factor for synergy delivery in UK plc mergers is above all having the right leadership team and the right process in place to fully execute synergy delivery plans. Why is this important? Experience shows that effective execution is critical:

- 75% of mergers and acquisitions disappoint, fail outright or fail to match the companies' previous organic performance (Financial Times, 2004).
- In 2005, a PwC survey of 100 senior executives from top FTSE companies found that post deal integration is the most important factor in their minds when they consider M&A, after the value for money of the deal.

## Synergy reviews on other non-Code transactions

Good practice dictates that private reporting on merger benefits should be conducted to the same standards as under the Takeover Code, but there is some greater flexibility around reporting standards. Preferred investors are often better equipped with market information, and are more prepared to take a greater degree of risk in entering into the transaction, at a faster pace, which means that data standards do not necessarily have to be as high as in public transactions. However, there is still a need for detailed refinement given the impact of synergies on transaction valuation by the acquirer.

## Application to the governance of Machinery of Government changes

Most Machinery of Government (MoG) changes are in fact a merger of some kind (e.g. the merger of departments, or the creation of new arms length bodies from other institutions). Taxpayers are analogous to shareholders, and it is reasonable to expect that the same standard of reporting for private sector transactions should also be applied to the public sector. Such statutory standards do not currently exist.

Best practice in the public sector would be for all significant MoG changes to face a form of public disclosure and accountability. It would be appropriate for taxpayers to understand the strategic rationale, the synergies benefits case, the starting point for implementation planning and a clearly defined approach to measuring and reporting outcomes which clearly define the baseline.

In the same way that an independent body, The Takeover Panel, oversees public company transactions, it could be appropriate for a similar remit to be undertaken by an institution to oversee public sector merges.

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