# Bulletin

Water

Energy

Retail

Transport

Financial services

Healthcare

Telecoms

Media

Post

Competition Policy

Policy analysis and design

Regulation

Strategy

Contract design and evaluation

Dispute support services

Market design and auctions

**FEBRUARY 2016**

# Hope or experience?

## AVOIDING THE PITFALLS IN RETAIL MERGERS

*The retail merger cycle is picking up again, as new partnerships offer a temptingly direct way to face into multi-channel competition. But experience and academic analysis show that winning a deal can often turn into a winner's curse. So, how to distinguish the deals from the duds? The discipline applied in Competition Authority assessments can provide a surprisingly helpful approach.*

Recent months have seen repeated announcements and speculation about retail mergers, from grocery and general merchandise, to DIY sheds, convenience stores, betting shops and petrol stations. In each case, the rationale is based on some combination of:

- entering a new product or geographic market;

- achieving greater scale; and/or
- creating more valuable assets and capabilities.

There is now an extensive academic literature on merger synergies that looks ex-post at claims made by the parties before the deal. These studies tend to be pretty discouraging; to the extent there are any benefits, they are often wiped out by a bid premium and fees.

Yet M&A activity continues to be fuelled by management's hopes that their takeover will be the exception. And it is often buttressed by corporate advisers and sometimes shareholders, with eyes on the prize rather than lessons from the past. How can we bridge the gap?

## TESTING, TESTING

Every business recognises that any significant investment in M&A activity requires rigour. But few have repeated experiences of deals. So they naturally turn to external advisors, with their own considerable experience of doing deals and sources of evidence, to supplement in-house capabilities.

But there is a less well-known, and more immediate, form of expert analysis on the synergies claimed by merging parties: the work done by Competition Authorities. Competition Authorities have the ultimate call on whether to allow a merger, block it, or pass subject to strict "remedy" conditions. To decide, they have to satisfy themselves – to a legal standard of proof - as to where any economic value in a merger really lies, and who will benefit. In doing so they challenge whether the anticipated benefits are truly merger-specific, timely, and verifiable. This process not only affects the strategic rationale for a proposed merger: it is also a rigorous test of management's arguments and beliefs about the benefits of the transaction.

We have found that the authorities' standards of proof for the a potential synergies, in terms of both the quality of the evidence and the rigour of the analysis, can be significantly higher than those applied by corporate advisers, or institutional shareholders, when it falls to them to decide whether to vote for a merger at the end of the day.

Our experience of these processes - from conception and valuation, to scrutiny by the competition authorities, to post-transaction assessment of the subsequent outcomes, has led us to identify eight key questions. Any synergy hunter looking at a proposed merger, particularly in the retail sector, should not rest until they can answer them.

## PIECES OF EIGHT

When looking at synergies, ask yourself the following questions.

1. **Costs or income?** You will need to work out which side your bread is buttered on. Synergies can arise on both the cost side (e.g., by combining offices in overlapping locations) or the revenue side (e.g., through product repositioning, improved coverage, or the ability to improve margins). Be

especially sceptical of claimed revenue opportunities; if income growth is based on improving margins through "market power" expect this to be flushed out by the competition authorities (and blocked) if, indeed, such power really exists.

2. **Competitiveness or profits?** Be clear about where cost synergies sit. Cut variable costs, and you can take the benefit either through profits or a more competitive customer proposition. Cut fixed costs, however, and while your profits might go up, you won't fundamentally change your competitive position. Don't try to hide a poor proposition by looking only for fixed cost savings.

3. **Have you been granular enough?** Be clear about the root cause of economic value from synergies. Are you relying on scale effects, or on improved resource allocation within a larger entity? In a "vertical", as opposed to "horizontal", merger, synergies may be derived from improved incentives along the value chain. Rigour in separating out these hoped-for effects enables the most important effects to be identified and modelled properly. And just because something is difficult to estimate empirically doesn't mean you can't isolate and robustly challenge the cause and effect.

4. **Big, or just easy to see?** In most transactions, head office savings are the easiest to point to and measure. But these are rarely large enough to justify a transaction. Most really valuable cost synergies will be found in operations and procurement, even if they are harder to estimate and value. Historically, in the retail sector, the prime source of merger synergies was the rationalisation of the combined physical estate. Looking forward, synergies have to be sought in online platforms, fulfilment and distribution. In a rapidly-changing retail environment, these are harder to estimate - and still harder to deliver.

5. **Buying better?** Big numbers may be ascribed to procurement synergies, but too often these are a stab in the dark, based on general assumptions about "economies of scale". Push to identify if these are derived from greater efficiency or from greater bargaining power - these are different effects and you need to know which you are placing your bets on. If you are relying on greater supplier efficiency, list out what you will really do differently and what value you need to share with the supplier. What surprises most retailers is that few suppliers give the biggest discounts to scale. What matters more is having something unique about the distribution channel, a genuinely lower end to end cost base, and the opportunity for sales growth.

6. **When is bigger not better?** Almost nobody looks explicitly for diseconomies of scale. But bigness rarely comes without complexity, and complexity carries cost - particularly in retail. Meanwhile economies of scale peter out at different levels in different parts of organisation, so that unnoticed diseconomies may kick in even while observed economies are still increasing. Identifying the costs and risks of increased complexity in the merged organisation is challenging but essential.

7. **Does it need a transaction?** Some sources of synergy really do require a full transaction, but many don't. There is a wide range of commercial relationships – from supplier relationships to partnerships to rental agreements to JVs – that can exist between parties, and where value creation can be built without a full integration process. Make sure you've explored these before embarking on the most expensive course of action.

8. **What price integration?** Almost everybody underestimates integration costs, partly from optimism and partly from lack of information. Cost efficiencies usually take longer than planned to achieve, or require higher-than-planned levels of investment. In retail, nasty surprises with respect to lease exit costs have been a particularly common source of financial disappointment. And the cost of merging cultures, together with the collateral damage of unwanted departures, is rarely allowed for sufficiently.

## DON'T JUST BLAME THE EXECUTORS

When deals are done, and expected synergies fail to materialise, poor execution usually gets the blame. There is ample literature on this, and no shortage of advisors to help, but most of it boils down to good old retail management skills.

- Leadership – the CEO and senior team must be seen to focus on integration (and be clear what they are no longer focusing on).
- Clarity on roles – confusion and uncertainty in the early days can be disastrous; so make it very clear who will be leading what.
- Business as usual – retail is fast moving and depends on detail, so anything that distracts the core business can be fatal.
- Culture – successfully merging cultures doesn't happen by accident; it needs an explicit plan and a dedicated team to execute it.
- Supply chains – modern retailers are critically dependent on strong supplier relationships; make sure the key suppliers know what is happening, and don't let unnecessary risks build.
- Incentives – many retailers work best when given clear targets and offered bonuses with a clear line of sight. Create incentives for what you stop, as well as what you start.

While it's easy to blame poor execution for disappointing merger results, our experience is that over-optimism is more likely to be the problem. But even boards who know this tend to get sucked into the process once a bid is underway, with attention increasingly focused only on price. Once a bid has been announced the timetable set by takeover rules tends to create its own momentum. And the register of shareholders - the ultimate decision-makers - may change dramatically during a bid, becoming dominated by short-term traders rather than long-term holders of the stock with a genuine interest in the sustainability of the business.

So it's critical to do the analysis as rigorously as possible before the starting-gun is fired. Here are four useful "to do's" to support a sceptical mind-set.

**Stress test the strategic rationale.** The analysis must be grounded in a real understanding of both businesses, but even when you get to detailed "due diligence" in the data room, the number of things you don't know will remain large. Keep a list of these front of mind, and don't be afraid to challenge the strategic argument as you learn more.

**Watch the incentives.** Even without success fees, corporate advisers' natural instincts are to want to get the deal done. They are more commonly incentivised to minimise / maximise the price than to test the rationale, and that's the light in which they will view (and calculate) synergies. So take bags of salt to each meeting.

**Task someone to act as devil's advocate, not just to test the numbers.** It may be easier to get an independent adviser to challenge the rationale than to give the task to an in-house team, who won't be anxious to cross the chief executive. But whichever way you go, make sure that in assessing the synergy estimates the downsides - complexity, diseconomies, cultural conflict - are fully incorporated in the equation. In our experience, good private equity houses do this explicitly; retailers do it much less often.

**Gather war stories.** Confidentiality tends to limit your information; in particular, militating against learning from people who have been through similar mergers in comparable industries. But where and when you can, go direct to the source of experience: don't rely only on "case studies", in which the truth may be tactfully buried. As much as possible, talk to real people with real scars on their backs.

## CONCLUSION

Though all boards should know that the history of mergers is poor, the thrill of the battle and the attitude of a shifting shareholder base quickly switches the focus from rationale to price, and synergy estimates suffer in consequence. So it is no wonder they fail to materialise on the scale (or timescale) predicted.

The only way to avoid disappointment is to:

- stay focused on the source and effect of each element of the hoped-for synergies;
- insist on an equal focus on the disbenefits and risks of a merger; and
- respond flexibly to new information as the gaps in your knowledge begin to be filled through the due diligence process, and don't be afraid to revisit the rationale.

Above all, remember that learning from comparable experiences, particularly in your own sector, is more valuable than the smartest bit of modelling by corporate advisers.


| CONTACT | **Phil Maggs** philip.maggs@frontier-economics.com |
|---|---|
| | **Richard Bradley** richard.bradley@frontier-economics.com |
| | **Simon Gaysford** simon.gaysford@frontier-economcis.com |
| | **FRONTIER ECONOMICS EUROPE** BRUSSELS \| COLOGNE \| DUBLIN \| LONDON \| MADRID |
| | www.frontier-economics.com |