

Securities Industry News

December 4, 2006

What Makes Markets

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Mergers, Acquisitions and Outsourcing

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Corporations and private equity firms are discovering a new weapon in their quest to gain greater value from mergers and acquisitions (M&A)—outsourcing. Acquirers are just beginning to recognize how outsourcing can help them to realize expected post-deal synergies and achieve the desired end state for these transactions quickly. This is not surprising when you consider that the speed and effectiveness of post-deal integration largely determines the realization of synergies, the level of incremental cash flow and the overall value M&A deals generate. The faster firms get the acquired company operating as an integrated and efficient whole, the more value can be captured.

According to a number of industry observers, companies that make the rapid and efficient integration of acquisitions a core competency are the same that effectively use M&A to create shareholder value. With that in mind, the role of outsourcing in this process becomes clear. When used intelligently and strategically, outsourcing and offshoring can open up a new front in these firms' quest for greater financial returns from M&A by significantly speeding up post-deal integration, maximizing expected synergies and realizing cost-efficiencies sooner.

Outsourcing and offshoring are not new trends. What is new is the growing awareness of the potential for outsourcing as an M&A tool. As such, a firm's ability to identify and implement effective outsourcing arrangements before and during the deal has the potential to appreciably increase financial returns.

Moreover, the ability to analyze, deploy and manage outsourcing when acquiring businesses, and to build a network of reliable outsourcing service providers, will increasingly become a core competency for firms undertaking significant levels of M&A activity. PricewaterhouseCoopers has seen an increase in corporate clients seeking greater insight into the potential for outsourcing at acquisition targets. In one recent case, a client expanded the scope of a buy-side due-diligence effort to include a detailed examination of outsourcing in order to determine which processes and functions might be outsourced and the size of the potential cost saving that could potentially be captured.

In some cases, outsourcing has proven to be so effective at helping organizations realize synergies from M&A quickly by optimizing post-deal integration that some, particularly private equity firms, are cementing long-term relationships with outsourcing providers. Many acquisitive firms look to



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leverage and deepen relationships with one or a select number of service providers. Others, like General Atlantic and Warburg Pincus, have taken ownership positions in outsource service providers. The next step, outsourcing similar functions from across a private equity firm's portfolio companies to one service provider, is currently being evaluated by a number of firms.

Value Creation Not a Given

It is the potential to quickly realize cost synergies that makes outsourcing such a powerful and compelling M&A tool to companies and private equity firms that have learned the hard way that generating value from M&A is not a given. They need only look back to the 1990s for proof.

Studies by strategic consultancies in the late 1990s and early 2000s found that a large number of M&A deals actually destroyed shareholder value. While there are differing theories as to why, many point to a lack of focus on exploiting all the potential savings available from a well-planned, well-executed integration—in other words, leaving the potential value of synergies on the table. Often, a successful transaction was defined more by the financial engineering than the successful strategic integration of two businesses.

More recent data and experience suggests

that an increasing number of firms are starting to crack the code when it comes to ensuring that M&A creates value. These improved results can be traced to the new approach companies have been taking to manage the integration of acquired and merged businesses once the bankers and lawyers have gone home. A key component of this approach is, many executives now realize, that value creation must come from effective operational and strategic fixes rather than financial engineering. Organizations that make value creation through M&A a core competency are focused on identifying synergies by rigorously assessing post-deal integration opportunities and pitfalls during the initial evaluation of a new transaction opportunity.

These developments have made the time particularly ripe for companies to leverage outsourcing. By developing outsourcing as a core competency, acquisitive companies create and hone a tool that allows them to identify and exploit another layer of potential savings.

Broadly defined as contracting out specific services and activities to a third-party provider in any location, outsourcing of information technology, finance and accounting, human resources, transaction processing, and more can increase efficiency and reduce costs in many circumstances. As witnessed in the recent Arcelor-Mittal Steel merger negotiations, identifying areas of incremental value is important for any acquirer in a competitive situation. It is their ability to deliver those savings that determines whether or not the transaction will be a success.

Outsourcing will play an ever greater role in this process. Indeed, it is becoming clear that all M&A professionals will need to understand outsourcing at some level or have access to outside experts who can find the best way to leverage existing outsourcing arrangements in the context of the merged

entity. There are several steps involved in using outsourcing as an effective M&A tool and developing it as a core competency.

Start Early

Ideally, outsourcing becomes a consideration even before the deal is closed. Many questions that can be addressed during legal and operational due diligence can help companies and private equity firms to create appropriate post-deal outsourcing arrangements. Starting early, acquirers can understand the details of outsourcing arrangements that already exist both at the target and the acquirer by considering:

- What, if anything, is being outsourced?
- Who is responsible for the functions that are outsourced in each company?
- Who manages the outsourcing relationships and the related contracts?
- What are each company's contractual obligations within existing outsourcing arrangements?
- How much money is being spent on outsourcing?
- The state of those outsourcing relationships.
- The structure of those relationships.
- Existing pricing and governance models for these relationships.
- The overall effectiveness and capabilities of existing outsourcing providers.
- Whether the incumbent provider(s) can handle additional volume if necessary in the wake of an acquisition.

If a significant analysis of these areas is not possible during due diligence, firms should try to get as much of this information as possible in order to move quickly toward integration through outsourcing once the deal closes.

This can be a difficult and time-consuming process that occurs at the same time as myriad other activities associated with an acquisition or merger. Therefore, companies need to decide whether they have the time and resources to build the necessary capabilities in-house and to dedicate those resources to dealing with these issues in every deal or whether it makes more sense to bring in outside experts to deal with all or some of these outsourcing-related issues.

Managing post-deal integration increasingly means finding ways to leverage outsourcing to gain cost savings and operational synergies. For example, outsourcing can be a pure cost-reduction play by taking over tasks that are being done internally at a cost of, say, \$90 per hour and doing those same tasks for significantly less. In many cases, these savings are even greater if companies undertake process improvement to reduce costs and increase efficiency before turning those processes over to an outsourcing provider.

Post-deal outsourcing does not have to

start from scratch. One or both of the companies involved in a transaction may already be outsourcing certain functions and have an effective outsourcing model that can be leveraged for the benefit of the combined company. This is also the time to examine both companies' outsourced processes in more detail to see what can be made more efficient and how much additional cash flow can be realized through these changes.

With an inventory of existing outsourcing relationships from both companies, the newly combined entity can determine if any of those relationships can and should be leveraged to deliver synergies more quickly and create incremental value. This decision will depend on how well those existing outsourcing relationships are working and whether there are ways to gain new value from outsourcing analogous functions in the new company. For example, the target company might have an outsourcing arrangement for human resources that is more efficient than what the acquiring company has or what the private equity firm can provide through its own vendors. Or an outsourcing relationship may have led to unique ways of doing business that could quickly lead to benefits for the combined company.

If an acquiring company has already outsourced its accounts payable (AP) to a provider in Bangalore, India and transformed its AP process to significantly increase the efficiency of those processes, that relationship and those processes could allow the acquirer to quickly take AP out of the acquired company and move it to the outsourced provider to more quickly reap the benefits of the associated savings and efficiency.

In addition to considering the cost-effectiveness and efficiency of these outsourcing relationships, it is also important to realize that any relationship with an outsourcing service provider that can manage the complexity of regular acquisitions is itself more akin to a partnership or joint venture than a straightforward vendor relationship. It is imperative, if the strategy is to leverage the acquirer's outsourcing service provider over a number of different acquisitions, that the provider be brought into the planning process and that the relationship is designed with this type of activity in mind.

At the same time, it is important to look more closely when either of the companies involved in a deal does not outsource a function to understand the reasons. A process or function in one of the companies might be too unique or specialized to fit into a generic outsourcing arrangement. This information could help the new company benefit from lessons already learned and avoid making the same mistakes.

Because there is value to be derived from leveraging strong outsourcing relationships

in M&A transactions, it is a good idea for private equity firms in particular to develop relationships with outsourcing providers that allow them to integrate new acquisitions (both stand-alone and portfolio investments) quickly into existing outsourcing arrangements.

Some private equity firms are developing long-term relationships with outsourcing vendors that provide the necessary level of service and can get new acquisitions up and running quickly, with minimal interruption. In addition to desirable economics and required service levels, these providers must demonstrate that their integration management capability is deeply embedded in the relationship and available to the private equity firm at all times. By relying on this network of trusted providers to handle outsourcing-related integrations, a private equity firm can focus on managing the overall integration and transition.

Private equity firms can also benefit from creating an outsourced shared-services environment for all, or many, of the companies in their portfolios. Individual companies adding divisions through acquisition may also find that shared services provide quick uniformity in processes that, in turn, become easier to manage from a compliance perspective.

In the movement among some of the largest private equity firms to leverage the scale of their portfolios to create efficient, virtual back-office functions serving multiple investees, areas of early focus include procurement, insurance and other employee services. For each, the key is to make sure the shared-services organization can handle the additional volume of work brought by the merger or acquisition.

The issues involved with shared services are slightly different for private equity firms that are working with a portfolio of companies. If the portfolio includes ten companies, the firm can negotiate individual outsourcing contracts for all of those companies with a single provider. These contracts should reflect each company's unique circumstances while also leveraging the operational efficiencies and cost savings that come from servicing all ten companies for better value and service.

Time is of the essence when it comes to combining two companies into a greater and more efficient whole. When used appropriately, outsourcing is a valuable tool that companies and private equity firms can use to evaluate potential merger partners or acquisition targets before the deal closes and to integrate the new company after the deal closes. ■