The Sources of Revenue Synergies in Mergers & Acquisitions

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Abstract

Mergers & Acquisitions (M&A) have become in today's modern business environment an important tool used by companies for achieving the growth and creation the value for shareholders. Creation the synergies in the M&A process is one of the most important reasons that stands at the base of the acquisition decisions of the companies. Many M&A transactions are justified by the amount of projected synergies.

In this paper, we propose to clarify the sources of revenue synergies in horizontal mergers. Revenue synergies are, theoretically, developed based on the resource-based theory. Combining complementary resources can help firms gain strategic advantage and increase their revenues. We have tried to answer to the questions like: what kind of complementary resources can be combined by companies for obtaining the revenue synergies; what are the modalities in which the combination of these types of complementary resources can generate revenue synergies.

Keywords: *synergy, revenue, acquisition, company, resource, combination, sales, value*

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1. Introduction

Mergers & Acquisitions (M&A) have become, in today's modern business environment, an important tool used by companies, across various industries and, of different sizes, to develop and, achieve, the strategic objectives. Many corporate executives recognize that growth through acquisition is a faster way to build competitive advantage than organic growth. The final goal of any merger or acquisition is to increase the wealth of acquiring company`s shareholders. And, achievement of this objective, is conditioned by creation the synergies in the process of businesses combination. Many M&A transactions are justified by the amount of projected synergies.

The synergy is defined as additional value that is generated by combining of two companies. It appears in situation in which the combined company is more valuable than the sum of combining firms, valued as standalone entities.The value

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of estimated synergies represents an important component of the price paid by a company (acquiring company) to take over another (target company). McKinsey & Company (2017) found that, on average, companies making acquisitions have been paid a premium of 40 percent, or more, than their targets' market value. And, the premiums that are paid for acquired companies are justified, essentially, by the level of estimated synergies.

The synergies that can be generated, as result of a M&A transaction, was divided in two categories: operating and financial synergies (Damodaran, 2005). Operating synergies represent an important type of synergies that can be generated in process of businesses combinations. They represent the types of synergies that are related to the operating cycle and, are the result of the improvements in the operating performance of the new-formed company.Operating synergies was divided in two categories: cost and revenue synergies. Cost synergies refer to the reductions of costs generated by integration of two companies (bidder and target company). Revenue synergies represent the increase in the level of revenues as result of combining the companies. These appear in conditions in which, the new formed company (the integrated company), has a greater potential to generate revenues, than its components companies, operating as standalone entities. The enhancement of revenues is expected to appear in conditions in which the post-merger combined entity is able, either to increase the quantity of sold products and/or services or, to obtain higher prices for its offering.

Many times, the strategic objective of an acquisition is the increasing the revenue growth rate at the level of new formed company. It is considered that the growth, not cost savings, is the source of sustainable, long term success.

In this paper, we propose to clarify the sources of revenue synergies, in horizontal mergers, characterized by the fact that combining companies can provide similar or complementary goods and services, at the same stage of a value chain, in the same or, different markets (Dao, 2010). We try, first, to highlight the important results of the theoretical research related by one of the most important type of operating synergies that is followed and, many times, is achieved, by the companies implied in horizontal M&A transactions. The focus is put on highlighting what has been written in the specialty literature about the concept and sources of revenue synergies generated in the process of businesses combinations. We have used many different sources of information; the most important were the academic literature written by organizational strategists. Because the nature of generated synergies depends on the type of M&A transaction, a complete understanding of the concept of synergy is related by the overall understanding of the whole M&A process.

On the base of these penetrations of scientific research, in the second part of our paper, we propose a classification of revenue synergies, function of the nature of complementary resources that are combined for their obtaining. We divide the revenue synergies in three categories and, try to highlight the most important sources of revenue synergies for each category. We made this by making references to existing knowledge gained from specialty theory in this domain.

Also, for the confirmation of our results of research we, also, make references to the results of the most important findings of the current empirical studies made by well-known companies as Deloitte, KPMG, McKinsey & Company. So, we combine our opinion with regard the classification and sources of revenue synergies, with the knowledge gained from specialty theory and, with information highlighted by the empirical studies made by specialized companies on this subject.

2. The importance of resources in value creation process

The synergies occur when the combined company performs better than the component companies, individually, as result of combining activities, sharing and leveraging their resources. The obtaining of synergies depends on the ways in which the combined company can uses resources more effectively than the two companies separately. The new formed company must be able to obtain more profit through a better utilization of combining companies ‘resources. Ansoff (1965) highlighted that when the managers think to synergies they consider “can be earned more money through a better utilization of the company’s resources”. In general, the resources and opportunities of the companies are limited. In these conditions, a process of value creation can be based on the improved utilization of the combining companies ‘resources.

The predominant role of resources with regards to M&A has the root in the Resource-Based View Theory. According to this theory, companies possess different abilities and resources (Penrose, 1959). Resources available are valuable if a company can utilize these resources to gain market advantages. In order to secure sustainable competitive advantage, the resources should be valuable, rare, inimitable and non-substitutable (Barney 1991).

According to Barney (1991), the firm's resources include "all assets, capabilities, organizational processes, firm attributes, information, knowledge, etc. controlled by a firm that enable the firm to conceive of and implement strategies that improve its efficiency and effectiveness." The resources have been classified by Barney (2001) in tangible and intangible resources.

As special assets, skills, and capabilities, resources are the unifying thread through which firms seek to develop the innovative goods and services that are required for success in the highly competitive global marketplace (Collins D.J., Montgomery C., A., 1998). Strategically valuable resources are those that allow the firm to exploit specific environmental opportunities or to protect itself from environmental threats (Grimm & Smith, 1997).

Applied to businesses combinations, the RBV suggests that resources may motivate and direct external growth (Hitt & Harrison & Ireland, 1998). As such resources are very difficult to develop internally, within the companies, these can be obtained, with the help of other companies, as result of M&A transactions. From a resource-based point of view, M&A transactions represent, a strategic tool for the management, to acquire tangible or intangible resources and, create long-term

competitive advantages. The combination of resources of two companies builds the basis of value creation.

The researchers have highlighted that combination of similar and complementary resources is the source of value creation in M&A transactions.

It is considered that the companies implied in a M&A transaction bring complementary resources when the sets of resources that are combined are mutually supportive (Hitt & Harrison & Ireland, 2001). Milgrom & Roberts (1990) highlight that two resources are considered complementary when they are mutually reinforcing (they provide 'something that completes the whole). In this case, having more of one organizational attribute increases the returns from having another (Milgrom & Roberts, 1995). According with Milgrom & Roberts (1995), resources can be thought of as being complementary if the sum of their individual resource cost is less than their value when linked together.

In contrast, the resources of the combining companies are considered similar when exists a significant overlap between these. And, such overlap can exist in terms of both the types and quantities of resources possessed by the two firms (Hitt & Harisson & Ireland, 2001).

In the context of RBV theory, complementary resources have received a great attention. According to RBV theory (Barney 2007), synergies generated by complementary resources of combining companies are recognized as the main driver of M&A transactions decisions. The efficient combination of resources that, successfully, complement each other, can lead to generating a sustainable competitive advantage, at the level of new formed company. Studies on resource-related diversification (Penrose, 1959; Montgomery& Wernerfelt,1988) highlight that companies must implement a related diversification strategy to obtain synergies.

As Hitt & Harisson & Ireland (2001) outline „synergy has an important relationship with complementary resources and with the successful integration and operation of firms once a merger or acquisition has been completed". A key reason for this is that firms with highly similar resources also have highly similar strategic capabilities and vulnerabilities in the marketplace (Chen M., J., 1996).

3. Sources of revenues synergies in horizontal acquisitions

Deloitte (2017) highlights that an important driver of M&A transactions is the increase of revenues. Also, was highlighted that a survey of 528 executives engaged in such deals indicate that nearly 60% of sought synergies were anticipated to come from revenue rather than cost sources (Deloitte, 2016). The specialty literature highlights two major sources of revenue synergies in horizontal acquisitions (Hill et all 2012, Dess et all 2006):

- combining the complementary resources of combining companies;
- increasing the market power of the company formed as result of transaction.

Revenue synergies are, theoretically, developed based on the resource-based theory. Combining complementary resources can help firms gain strategic advantage and increase their revenues.An important question is: what kind of complementary resources can be combined by companies for attaining the goal of obtaining the revenue synergies? For obtaining the answer to this question, we have tried to identify, what is reflected in the specialty literature and empirical studies, with regard the modalities of increasing the revenues in the case of M&A transactions. A study made by KPMG (2016) highlights that, the primary objectives, in a great proportion of M&A transactions, are growing revenue through expanding customer base, entering into new lines of business and, expanding geographical reach. Capron (1999) highlights that the revenue synergies, in the horizontal acquisitions are the result of increasing the market coverage and innovation capability at the level of new formed company.

The following question is: how a company can increase the degree of market coverage? According to many researchers (Aaker 1996, Srivastava et al., 1998), in the case of horizontal acquisitions, the enhancing market coverage can be realized through two modalities: product line extension and geographic extension of the market. Rahman M. (2015) highlights that the growth of the sales is the result of the achievement of a number of intermediate goals such as: expansion of the customer base, expansion of geographic reach, and adding new lines of business or, new products.

The widening market coverage should allow the merged firm to sell existing products to a larger body of consumers, thus enhancing sales revenues (Srivastava, et al., 1998; Ficery, et al., 2007). The conclusion is that the combination of products, customers, and geographical markets, as result of acquisition, should enable increasing the sales revenues and operating profits, at the level of new formed company.

Teece (1980) highlights that more common sets of complementary resources, that are combined in businesses combinations, are complementary product lines, technologies, know-how, geographical markets and customer groups. An important aspect, for understanding the sources of revenue synergies, in M&A transactions, is related by the fact, the horizontal strategies, can allow gaining competitive advantage and, increasing the revenues, as result of creating value for customers.

As was highlighted by Knoll (2008), the primary value drivers of revenue (growth) synergies, are increased customer utility and innovation, from combining resources across businesses to address external market opportunities. The researchers (Clemens & Row, 1991; Capron, 1999) highlight that, the combining the complementary resources can generate the increasing the revenues, at the level of new formed company, by creating newly-added value to the existing product e.g. via cross-selling or product bundling, as well as creating totally new product classes.

On the base of these penetrations of scientific research, we divide the revenue synergies, generated in the M&A transactions, in three categories:

- revenue synergies generated by combining complementary products and customer groups;
- revenue synergies generated by combining complementary assets and capabilities;
- -revenue synergies generated by combining complementary geographical markets.

In the next part of the paper we will refer to these types of synergies.

a) Revenue synergies generated by combining complementary products and groups of customers

Companies can create revenue synergies by combining complementary products and/or services. This type of synergies appears in the case of product line extension when the company adds to or expands its existing line of production. Combining two businesses can bring a range of new products and services to existing customers. In these conditions, selling the products of one company, will encourage, the sale of the products and/or services of the other company. The revenue synergies, in this case, can be the result of cross-selling and/or bundling the products and/or services of the companies implied in transaction. The cross-selling the products and services of combining companies to existing customers, is a typical revenue synergies driver. Also, the sales opportunities, at the level of new formed company, can increase, as result of products bundling (forming and selling the sets of products and/or services that combine the products and/or services of combining companies).

b) Revenue synergies generated by combining complementary assets and capabilities of the companies implied in transaction.

Another source of revenue synergies is represented by enhancing capabilities and activities of combined company as result of combining the complementary assets and capabilities of the companies involved in the combination. The revenues can increase, for example, when resources are combined and shared for production and distribution of a larger quantity of products. Such synergies can occur in functional areas such as: manufacturing, marketing, selling and distribution, etc. The revenue synergies in the manufacturing department (named, many times, as manufacturing synergy) can be the result of increasing the productivity, at the level of new formed company, as result of transferring the technologies and employee skills, and, other complementary manufacturing assets and capabilities of the involved companies.

The revenue synergies can, also, be, the result of enhanced marketing, sales and, distribution activity, at the level of new formed company, as result of combining of, so called, marketing or, market-based, assets and capabilities of the merging companies. The combination of complementary market-based resources,

of the companies implied in M&A transaction, can be an important source for generating growth opportunities at the level of the combined company. The existing literature highlights that the market-based (or, marketing) resources of the company include elements as brands, skilled sales and marketing people, distribution channels, customer relationships, general marketing expertise, etc. (Capron & Hulland, 1999; Hooley & Broderick & Möller ,1998). Sudersnam (2003) highlights that, value creation in horizontal mergers, through revenue growth, can be achieved as result of leveraging marketing resources and capabilities of merging firms. The combination of products, brands, distribution channels, customer relationships, and other marketing capabilities, of combining companies, allow generating of, so called, marketing synergies. The additional revenues, in this care, are the consequence of increased brand equity, improving the distribution of products and, other marketing activities, at the level of combined company. As was highlighted by researchers (Barney, 1991; Srivastava et all, 1998), overall superior marketing capabilities can lead to customer value, which in turn can be translated into premium prices and/or increased volumes Brands are critical assets in mergers and acquisitions (Keller, 1993; Rao & Mahajan & Varaiya, 1991). The combined firm may be able to generate additional sales in the case in which the acquiring company's brand name` is used to market the target's products, or vice versa (brand extension strategy). Another option is cobranding strategy (or, dual-branding strategy) where the brands of the involved companies are combined to confer the existing products or services of both companies the positive image of both brands. Many times, an important goal of an M&A transaction is combining and sharing the distribution channels of the implied companies. The new formed company may be able to expand its sales by using its access to a larger distribution network.

A very important source of revenue synergies, in a M&A transaction, is the product innovation, which can be the result of combining the complementary assets and capabilities of combining companies' research and development (R&D) activities. Additional sales can be realized as result of combining the scientific and technological complementarities of the involved companies. Companies hope to create synergy by capitalizing on the complementary assets in the acquiring and acquired firms to produce valuable and unique products or services (Ravenscraft & Scherer 1987). Innovation has become an, increasingly, important source of value creation in many industries. Increasingly, the innovative output via M&A becomes more and more important and is at the heart of many ventures (King et al. 2003). The R&D activity has an important role in obtaining the competitive advantage and staying ahead of competition. The combination of knowledge, patents, R&D projects and, other intellectual property rights, can allow the merged company to create more competitive products and, increase the market share and growth rate of its revenue (the synergies, in this case, are called, innovation synergies). Dyer and Singh (1998) claim that, the more complementary resources are included in a merger, the higher the learning success and, the probability of generating sustainable competitive advantages.

c) Revenue synergies generated by combining complementary geographical markets

Companies can create revenue synergies by combining complementary geographical markets and groups of customers. Many firms choose M&A as a tool to expand into a new geographic area (national or international). Geographic expansion can help a company to gain market share in other countries or, in other regions within the same country. As is highlighted in CFI's course (2019): "Merging two firms with varying geographies and customers may allow the merged firm to take advantage of the increased demographic access, producing higher revenue". McKinsey & Company (2018) highlights that a survey of 200 M&A executives identified that the most pursued sources of revenue synergies are following: cross-selling the products to the existing customers, geographic expansion, and bundle the products.

An empirical study made by Deloitte (2017) highlights that leaders of the companies implied in M&A transactions tend to pursue, more types of revenue synergies, for a given deal. Also, for obtaining of these, they propose to combine shorter-term initiatives, such as cross selling and sharing existing distribution channels, with longer-term initiatives, such is innovation. This study reflects that leaders consider that, the most important source of sustainable growth, in the case of a M&A transaction, is long-term innovation in the products and services that a firm offers. Also, they appreciate that, the cross-selling of products and/or services and, sharing the distribution channels, in the existing markets, are two very utilized initiatives that can boost revenues in the short term.

4. Conclusions

Mergers & Acquisitions (M&A) have become in today's modern business environment an important tool used by companies for achieving the growth and creation value for shareholders. Creation the synergies in the M&A process is one of the most important reasons that stands at the base of the acquisition decisions of the companies. Many M&A transactions are justified by the amount of projected synergies. The value of estimated synergies (operating and financial) represents an important component of the price paid by strategic investors when they make investments in companies.

A significant part of projected synergies (called operating synergies) is, generally, the result of improvements in the operating performance of the company formed as result of a M&A transaction. These can be generated as result of reductions of costs (cost synergies) or, increasing the revenues (revenue synergies), at the level of this entity. Many times, the strategic objective of an acquisition, is the increasing the growth rate of revenues. It is considered that the growth, not cost savings, is the source of sustainable, long term success. Deloitte (2017) highlights that an important driver of M&A transactions is the increase of revenues.

Cost and revenue synergies occur when the combined company performs better than the component companies, individually, as result of combining activities, sharing and leveraging their resources. In this paper, we want to clarify the sources of revenue synergies in horizontal mergers. Revenue synergies are, theoretically, developed based on the resource-based theory. Combining complementary resources can help firms gain strategic advantage and increase their revenues.

We have proposed to clarify two aspects. First, we wanted to identify the types of complementary resources that can be combined by companies for attaining the goal of obtaining the revenue synergies. On the base of the penetrations of scientific research, we divide the revenue synergies, generated in the M&A transactions, in three categories: revenue synergies generated by combining complementary products and customer groups; revenue synergies generated by combining complementary assets and capabilities; revenue synergies generated by combining complementary geographical markets. Second, we wanted to highlight modalities in which the combination of these types of complementary resources can generate revenue synergies in M&A transactions. The sources of revenue synergies in businesses combinations are the following: cross-selling and bundling of products and/or services; enhancing capabilities and activities as result of combining the complementary assets and capabilities of the involved companies (manufacturing, marketing and R&D capabilities); geographic expansion.

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