AFTER AN ACQUISITION OR MERGER, senior managers often find themselves under pressure to return benefits to shareholders – particularly if one company has paid a high premium for another. Synergies between companies and economies of scale are regarded as prime sources of value creation. Yet frequently the benefits fail to materialize: research indicates that up to 60 percent of mergers fail to create shareholder value within 10 years.

In many mergers and acquisitions, however, a potential goldmine of unexplored shareholder value exists in the form of purchasing and supply management (PSM). Our experience suggests that close attention to PSM can reduce by 10 to 15 percent the total cost of goods and services purchased by merged companies. An analysis of 50 recent high-value mergers and acquisitions shows that savings of this magnitude can recoup at least half of the merger premium, although the more scope there is for PSM

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PURCHASING'S BIG MOMENT – AFTER A MERGER

Savings can amount to half the acquisition premium

Ensuring that reduced costs actually get to the bottom line can be as challenging as mining for gold

Five mistakes to avoid

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improvements, the bigger the payback.* If there is room for improvement in both companies, the premium can be more than offset, with a surplus of pure shareholder value.

So powerful is PSM that in a recent merger of two US utilities, approval from state and federal regulators was facilitated by projections showing that savings of almost $1 billion could be made over 10 years, almost half of which would come from PSM. In another example, the senior managers of an electronics company gained the confidence to go ahead with a merger on the basis of estimated PSM savings. The actual savings they made offset almost two-thirds of the merger premium.

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* The analysis presumed that the acquired company's PSM skills were average or poorer.

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Yet many CEOs whose purchasing departments do no more than churn out orders are still blind to PSM's potential. "How tough can this be?" asked one during a recent merger. "Let's just compare price lists and take the better deal."

Taking advantage of the buried shareholder value that PSM represents *is* tough, however. Indeed, it is often overlooked because of the energy and diligence it demands. But the effort will prove worthwhile. Purchased goods and services ranging from office furniture to raw materials to outside contractors represent up to three-quarters of most companies' total spending.* And that proportion is increasing because of the trend toward outsourcing nonstrategic activities such as payroll, call-center management, credit collection, materials management, and even product assembly and shipment.

PSM can therefore yield substantial savings for any company, merged or not. But it is particularly effective immediately after a merger or acquisition because of the sense of urgency and uncertainty that such an event creates. At that moment, the potential cost savings are greater and more easily captured. Every department or function is compelled to figure out how to integrate two sets of employees and procedures and meet aggressive performance improvement targets as quickly as possible.

As a result, all of those "We'll improve our PSM practices someday" ideas rocket to the top of employees' agendas. Given the urgency, departments unaccustomed to working with PSM can be inspired to enlist its help to identify non-labor savings (that is, savings that can be achieved without laying off employees). The traditionally low-profile PSM organization can thus be elevated to a position of importance in the new entity.

In a merger of two financial institutions, retail and corporate bankers worked with the new entity's PSM team to identify savings that could be made in such disparate areas as credit reporting, check printing, automatic teller machines (ATMs), and marketing brochures – all of them previously considered to be outside purchasing's responsibility. By such means as consolidating fragmented purchases (goods and services bought by too many people from too many suppliers), devising creative strategies for negotiating contracts, introducing new suppliers, and changing the patterns of demand (by, say, adjusting how much of a material or service was used and ordered at any given time), the team gained first-year savings ranging from 8 percent for ATMs to more than 20 percent for credit reports and marketing brochures.

The post-merger effect works beyond the new corporate entity too. A merger creates uncertainty among both companies' suppliers, particularly if they

* Timothy L. Chapman, Jack J. Dempsey, Glenn Ramsdell, and Michael R. Reopel, "Purchasing: No time for lone rangers," *The McKinsey Quarterly,* 1997 Number 2, pp. 30–40.

might have to compete against each other. Although some may be able to look forward to winning more business from the combined organization, others could lose out. Many will thus strive to offer cost savings as well as new partnership arrangements, giving the merged entity greater bargaining power to renegotiate contracts. Even a modest across-the-board percentage cost cut can free up substantial cash, but many suppliers will offer far more in order to stay in the picture. A recently merged electronics company decided to ask a supplier for a 10 percent reduction in the cost of assembling printed circuit boards. But volume savings from serving a larger client, and closer involvement with the client in designing for ease of manufacturing and in specifying parts, meant the supplier came back with an offer to *double* the savings.

Mergers thus give senior managers a golden opportunity to introduce PSM skills that will produce substantial savings and perhaps ultimately become a source of competitive advantage.

The first 30 days

How should a CEO or senior management team set about tapping for the rich ore of PSM savings? The most effective strategy is two-pronged: first, look for readily accessible savings; second, search out long-term returns. To take full advantage of post-merger urgency and uncertainty, senior management must take six steps, ideally within the first month:

1. Restore stability. Although uncertainty after a merger can spur suppliers to greater achievements, it can also paralyze the new corporation if employees are anxious about the future. Senior managers must therefore quickly allay their three main worries: purpose ("Why are we doing this merger?"), power ("Who's in charge?"), and people ("What will happen to me?").* Restoring stability is vital; only then will the merged company be able to focus all its energies on initiatives that will influence performance. For PSM, that entails capturing substantial non-labor cost savings.

The news that the merged entity is now stable and focusing on value must be communicated to suppliers, along with the fact that changes in the supplier base are likely. This prepares and energizes them for what lies ahead.

2. Communicate PSM's central role in recapturing the merger premium. In many corporations, the purchasing discipline suffers from a poor image and low expectations. Historically, PSM has not been a breeding ground for top managerial talent. It is more often viewed as an administrative function than as a capability platform from which a company can achieve continuous improvement.

* James Balloun and Richard Gridley, "Understanding the challenges," *The McKinsey Quarterly,* 1990 Number 4, pp. 90–102.

To dispel unhelpful notions like these, companies should give employees a clear message about the critical role PSM is to play in making the merger successful, how purchased costs affect the company's overall financial and shareholder performance, and how all costs will have to be scrutinized with the help of the PSM department.

3. Establish high aspirations for PSM cost savings. CEOs who navigate post-merger pressures successfully do so by establishing high aspirations and targets for every function. An ambitious but feasible target for PSM would be to achieve savings of at least 10 to 15 percent within 12 months of the merger. The CEO of a diversified energy business created from two medium-sized companies set a target of $100 million in non-labor cost savings, 20 percent of it to be attained within the first six months. That target, which it succeeded in meeting, represented more than one-third of all savings expected from the merger, and almost three-quarters of the benefits anticipated within the first year.

The best approach is to establish PSM savings targets even before the merger is consummated, so that work can begin immediately afterwards.

4. Assign a high-caliber, respected senior manager to PSM. Given the stakes and the organizational barriers – purchasing's low status and the need for crossfunctional efforts – PSM should be the responsibility of a respected senior manager. Successful companies tend to select a manager from a non-purchasing department and give him or her the title of chief procurement officer. The CPO then rapidly establishes an aggressive PSM initiative and gives it focus, bringing in new talent as needed for portfolio management, inventory control, financial analysis, and category buying, the aim being to attack the entire range of the merged company's purchased goods and services.

Some companies look beyond the organization for a ready-made PSM expert, but our experience suggests that importing an outsider may be a mistake. When speed is of the essence, a capable internal leader is better. He or she will already be armed with detailed knowledge of at least one of the merged companies, and can take charge and begin harnessing savings right away. Moreover, PSM professionals with the right qualifications are still in short supply.

When one company buys another, it is sometimes lucky enough to acquire a talented CPO at the same time. In general, it is well worth assessing new talent as part of pre-merger due diligence.

5. Push employees to adopt new ways of doing business. Within the new purchasing and supply management organization, there are two important ways of doing business that may be foreign to employees, but are essential if PSM's full value is to be captured.

The first entails expanding PSM's reach to cover all spending. It is surprisingly common to find that purchasing manages less than half of a company's total spending on goods and services. Within one large insurance company, the purchasing department was responsible for barely 30 percent of expenditure; all new technology and most contract services were bought directly by individual departments. Such fragmentation does not give a company maximum negotiating power with suppliers, or enable it to identify and qualify new suppliers or to apply rigorous discipline to all outside spending.

The second involves basing decisions not just on the price of individual items, but on the new company's total cost of ownership. TCO encompasses such factors as internal business costs (including inventory carrying costs, losses on factory yields and throughput, and usage rates) and joint supplier/company costs (including ordering and expediting costs, freight and transportation costs, and costs related to specification and standardization).

Companies that limit their pursuit of PSM savings to repricing contracts to take account of extra volume may be ignoring up to two-thirds of the potential savings. On the whole, only a meager 2 to 3 percent cost cut can be achieved in this way. Following one recent banking merger, the PSM organization found it could negotiate a 5 percent volume discount on new personal computers. But by working with the IT department to reduce the number of hardware and software options available to users, outsourcing maintenance and repairs, and scrutinizing all users to see who could still work satisfactorily using supposedly obsolete PCs, it tripled the savings.

The TCO approach also garners savings by moving away from an exclusive focus on competitive bidding. As well as establishing target price, it also specifies parameters such as weight, volume, quality requirements, and lifecycle costs that might not be covered in a standard contract.

During another bank merger, a leading supplier of business forms sought to win the business of the merged entity from incumbent suppliers. The newcomer not only quoted a lower price for custom-printed forms, but also volunteered four TCO enticements, offering to buy back stocks of old paper forms from both the merged parties; to help the bank convert frequently used paper forms to electronic forms; to stock less frequently used forms in its own warehouse instead of the bank's; and to advise the merged entity on the design of a print factory (an automatic setup for taking data from a computer to a high-speed printer and then to an envelope-stuffer and postage meter).

Viewed in this context, PSM becomes a way not only of reducing costs but of achieving competitive advantage, particularly if companies learn to work with suppliers to make not just one-time gains, but continual improvements. A purely price-focused approach misses this shift in the supplier/customer relationship and its potential to spur suppliers to better performance.

6. Target quick wins. Successful merged entities quickly set up a database to enable them to track each constituent company's 20 most expensive goods and services. They determine the supplier of each item; its price; information about inventory stocking, consignment, retail delivery, and automated order entry system; and the last time supply contracts were negotiated. Armed with these facts, the new PSM organization can mobilize crossfunctional sourcing teams, which almost always include suppliers, to identify and implement opportunities to cut costs. Its aim should be to reduce total costs (not just purchase costs) by 10 to 15 percent in two years, and to make half of the savings within six or 12 months of the merger.

Often, the greatest savings can be made on items where suppliers and supply markets are themselves under pressure to perform because of excess capacity, globalization, or technological change. This usually applies to indirect items such as telecommunications, temporary labor, office supplies, computers and information services, and travel and entertainment. In the case of the merged energy company mentioned earlier, annual spending on indirect items topped $100 million. By using savvy sourcing teams to pool volumes, bring in new suppliers, standardize and reduce the number of specifications, introduce cheaper substitutes, manage demand, and appoint a watchdog to enforce the new policies, the company identified and made savings of more than $20 million within six months.

Experience shows that a PSM team can have fully evaluated a single main spending category as early as eight weeks after a merger, enabling it to start implementing ideas for savings within the first quarter. By deploying several teams, one electronics company was able to examine its 12 largest spending categories within only 180 days of its merger, resulting in a quicker harnessing of its anticipated 10 to 15 percent savings.

The first year and beyond

At the same time as seeking early savings, a newly merged company's senior managers also need to ensure that PSM serves them well in the long term. To do this they should take three steps:

1. Establish performance measurements so that PSM savings hit the bottom line. Up to half of PSM savings can easily slip through the net if there is no tracking system to ensure they are converted into profits. Savings derived from, say, substituting one item for another – a cheap, low-powered pump for an expensive, over-engineered one, for example – will show up in improved margins for a business unit. More often than not, the business unit manager will simply spend the money saved elsewhere.

Part of the problem lies in the fact that companies' general ledger systems and budgetary processes do not align well with their main spending

categories. In addition, differences in accounting procedures between two merged companies are likely to be extensive, because neither cost-center numbers nor product codes will match up. Policies stipulating where expenditures for particular items are booked or which items are capitalized or charged as expenses may also differ enormously. Worst of all, most financial accounting systems are designed to focus on costs of goods sold (such as raw materials), rather than to highlight specific purchases such as PCs, contract services, or maintenance, repair, and operations items. What's needed is systems that can track and measure PSM savings and ensure they are extracted from the merged entity's budget.

Companies should not allow information systems issues to prevent or slow the capture of savings, however. Important, time-consuming IT decisions can be deferred until the merger is complete; in the short term, a simple, "just do it" PC-centered spending database will provide the necessary information quickly.

Used imaginatively, IT systems can help cut transaction costs as well as monitor and control post-merger expenditure. One merged company recently worked with a supplier to set up an intranet Web page allowing employees to order their own office supplies directly. With fewer routine tasks to perform, the purchasing function was free to spend more time on value-added roles such as managing suppliers. No longer dealing with hundreds of suppliers, the company has vertically integrated with a single partner from which it buys most of its office supplies at a substantial volume discount. It is now able to track patterns of consumption in a way it could never previously have imagined.

2. Focus on building a world-class PSM organization. Following a merger, a PSM division is likely to need new talent from non-purchasing departments to help it handle the unusual demands made on it, and to provide the skills to attack the full range of company spending. This may mean replacing at least half of the staff eventually, although this is too time-consuming to be done during the merger itself, when savings are of paramount importance. Finding and hiring skilled PSM professionals can be tough, and will probably take longer and cost more than CEOs expect.

3. Elevate PSM's status as a virtual line of business. PSM departments in world-class organizations work with their primary customers (the company's main lines of business, plus distinct functions or departments such as manufacturing and product development) to generate and implement ideas that continuously improve non-labor cost productivity. As such, they have the potential to make a substantial contribution to the company's overall financial performance. The CEO of one large energy services company summed it up by describing his PSM department as his "highest ROI business."

Many world-class companies are starting to see PSM in this light – as a virtual line of business, complete with a virtual profit and loss statement and

a virtual balance sheet. The revenue stream on the P&L statement consists of all the savings recorded by the purchasing organization, while costs comprise direct PSM costs such as salaries. The virtual balance sheet should include inventories and accounts payable to reflect PSM's influence over these categories (*see* exhibit). Creating a virtual line of business in this way focuses attention on the savings PSM can generate.

P&L statement and balance sheet for PSM

PSM income statement

	1996	1995
Savings from sourcing teams	$78	$39
Early payment discounts	$7	$2
Cross-selling to suppliers with our products/services	$6	$1
Rebates from suppliers that cross-sell to our customers	$4	$ –
Total revenues	**$95**	**$42**
Salary/benefits	$11	$7
Sourcing team costs	$3	$2
Other direct expenses	$6	$2
Total expenses	**$20**	**$11**
Net income	**$75**	**$31**

PSM balance sheet

Assets		Liabilities	
Inventory	$87	Payables	$27
PSM system	$14	Cumulative savings	$106
Warehouse	$32		
Total assets	$133	Total liabilities	$133

Mistakes to avoid

PSM's attraction after a merger is not only the savings it can secure, but also the speed at which it can capture them so as to make quick returns to shareholders. Managers should, however, be aware of five factors that can hinder progress:

1. Too much democracy. Trying to achieve agreement right across a company before making a decision can bring progress to a halt. Consensus building is appropriate for many direct expenditures where product quality might be affected, but is seldom critical to indirect items.

One high-tech company gave a small group the authority to negotiate contracts for indirect items without having to seek approval from the various divisions that formerly did their own purchasing. "Decisions will not be made in our new company based on *your* way or *my* way; they will be made using the best way, whether it exists in our company or not," was how the CEO of another company described his new purchasing ethos.

2. Poor skills. If the purchasing divisions of both merged companies have been accustomed to churning out purchase orders rather than aiming for a sustainable reduction in TCO or redefining how to work with suppliers to achieve greater impact, then the prospects of exploiting post-merger potential will be remote. The answer is to assign promising employees from user groups to PSM initiatives, which makes it much more likely that substantial savings

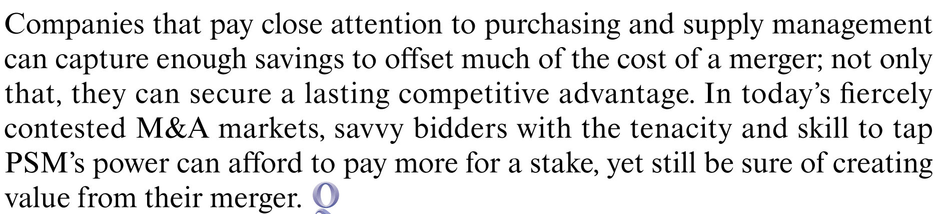
will be captured and provides an opportunity to recruit talented people into PSM after integration is complete.

3. Conflicting processes. Differences in the way the merging companies approach PSM can slow the rate at which savings are made. In one telecommunications merger, one partner had centralized purchasing, the other regional. This incompatibility, coupled with the merged company's dedication to consensus management, meant that savings could not be realized until the future PSM organization and approach were defined and agreed. That process took more than nine months, wasting valuable time that should have been spent convening crossfunctional sourcing teams and saving money.

For this reason, it is important to focus the energy of both PSM organizations on identifying cost savings, not on studying or reengineering processes. The new PSM process will become clearer once the sourcing teams have finished scrutinizing spending categories for TCO savings.

4. Lack of facts. Inadequate information about both companies' expenditure can lead managers to pursue PSM improvements less aggressively than they should, especially when purchasing information systems track less than half the total annual cost of goods and services. Yet if a company allows data shortcomings to prevent it taking action until a new information system is up and running, PSM savings will never materialize on time. Success is built on just doing it.

5. Inadequate resources. Too often, organizations caught up in post-merger frenzy either don't give PSM the priority it deserves or – perhaps worse – don't staff their sourcing teams with the brightest and best. Our experience indicates that such short-sightedness is a costly mistake: inadequately staffed and poorly led PSM programs frequently run out of steam early on, and the opportunity to capture substantial savings is lost. Top-flight people are needed both to do the work and to win credibility from the rest of the organization.



Companies that pay close attention to purchasing and supply management can capture enough savings to offset much of the cost of a merger; not only that, they can secure a lasting competitive advantage. In today's fiercely contested M&A markets, savvy bidders with the tenacity and skill to tap PSM's power can afford to pay more for a stake, yet still be sure of creating value from their merger.