# **UNIT-5**

**STRATEGIC MANAGEMENT AND BUSINESS POLICY**

# **Concept of Synergy & Types**

Synergy is the concept that the whole of an entity is worth more than the sum of the parts. This logic is typically a driving force behind mergers and acquisitions (M&A), where investment bankers and corporate executives often use synergy as a rationale for the deal. In other words, by combining two companies in a merger, the new company’s value will be greater than the sum of the values of each of the two companies being merged.

**Operating Synergy**

When the combined value of two firms is greater than the sum of the separate firms apart and, when the combined firm allows for the firms to increase their operating income and achieve higher growth it is termed as **‘’Operating synergy’.’** Operating synergies arise from the following:

Economies of scale, greater pricing power and higher margins resulting from greater market share and lower competition, combination of different functional strengths such as marketing skills and good product line, or higher levels of growth from new and expanded markets.

Operating synergies are achieved through merger, acquisition or takeovers of firms which have competencies in different areas such as production, research and development or marketing and finance can also help achieve operating efficiencies. Tata Steel which is one of the biggest Indian steel companies; it took over Corus which was Europe’s second largest steel company in 2007. Tata Steel’s takeover of the European steel major Corus for the price of $12.02 billion made the Indian company, the world’s fifth-largest steel producer. The acquisition was intended to give Tata steel access to the European markets and to achieve potential synergies in the areas of manufacturing, procurement, R&D, logistics, and back office operations.

**Financial Synergy**

**Financial synergies** are most often appraised in the context of mergers and acquisitions, but latest strategic alliances include strategic partnerships. These types of synergies relate to improvement in the financial metric of a combined business such as revenue, debt capacity, cost of capital, profitability, etc. Examples of positive financial synergies include: Increased revenues through a larger customer base, lower costs through streamlined operations, talent and technology harmonies.

In addition to above, financial synergies can result in the following benefits post acquisition: Increased debt capacity, greater cash flows, lower cost of capital, tax benefits etc. The Renault-Nissan (Franco – Japanese) strategic partnership or car making alliance expects to generate 5.5 billion euros ($6 billion) of synergies in 2018 by integrating more divisions and sharing resources better within the partnership. Increased union between the French carmaker and its 43.4 percent-owned Japanese partner generated more than 4 billion euros in synergies in 2015.

The two companies go together to benefit from cost cutting.  As of December 2016, the Alliance is the world’s leading plug-in-electric vehicle manufacturer, with global sales since 2010 of almost 425,000 pure electric vehicles, including those manufactured by Mitsubishi Motors which is also now part of the Alliance. The strategic alliance partnership between Renault and Nissan is not a merger or an acquisition. The two companies are joined together through a cross-sharing agreement. The structure was unique in the auto industry during the 1990s consolidation trend and later served as a model for General Motors and PSA Peugeot Citroen.

**Marketing synergy**

**Marketing synergy** implies that the marketing-mix makes for overall effectiveness. For example, by grabbing an opportunity which makes it possible to gain increased utilisation of existing marketing and distribution facilities, it may be possible to enhance sales revenues without causing a proportionate increase in costs. Hero Honda Ltd was a joint venture between Hero Cycles of India and Honda Motor of Japan. Hero Cycle’s long experience about Indian road conditions including Indian rural and urban customers was wholly combined with Honda Motor’s superior technological capability to create the expected  synergy effect for producing a highly fuel efficient and sturdy motor cycle to suit the exact requirements of the Indian customers and meet the rough road conditions as early as 1985. The partnership lasted for 26 years.

# **Evaluation of Synergy**

When a company acquires another business, it is often justified by the argument that the investment will create synergies. The primary source of synergy in an acquisition is in the presumption that the target firm controls a specialized resource that becomes more valuable if combined with the acquiring firm’s resources. There are two main types, operating synergy and financial synergy, and this guide will focus on the latter.

Value can be created, for example, through revenue enhancement, cost reductions, increased operating cash flow, improved managerial decision making, or the sale of redundant assets. However, the value created from proposed synergies also may have an additional investment cost as well.

Synergy takes the form of revenue enhancement and cost savings.

When two companies in the same industry merge, such as two banks, combined revenues tend to decline to the extent that the businesses overlap in the same market and some customers become alienated.

For the merger to benefit shareholders, there should be cost-saving opportunities to offset the revenue decline. In other terms, the synergies deriving from the merger must exceed the initially lost value.

As a rule of thumb, synergy is a business combination where 2+2 = 5.

Many analysts, however, do not consider these incremental investments or “hidden” costs when performing a pricing analysis or valuation of a potential target. Failure to consider the hidden costs often causes the overvaluation of a potential target, which may lead to destroying value rather than creating it.

Synergy appeared due to acquisition should include higher results then it was originally expected.

Acquisition process should be well-planned. Mark Sirower, the US leader of the Merger & Acquisition Strategy and Commercial Diligence practice, named 4 components which should take place in order to achieve successful synergies:

* Strategic vision
* Operating strategy
* Systems integration
* Power and culture

The buyer should pay out the premium to shareholders of merged company. The higher the premium, the lower the potential benefit for the buyer. Therefore, synergies should not be intangible. It should be carefully forecast and discounted from net cash flows which are feasible within the chosen time frame.

Post-merger integration issues, as well as competitors’ reactions, can contribute to the hidden costs of an acquisition.

Besides the positive impact of revenue enhancements, cost reductions, and other efficiencies, valuation analysts need to price them in, too.