DELIVERING STRATEGIC SOLUTIONS ACCA'S 2000 ANNUAL MEETING

A merger or an acquisition provides a rare chance to refashion a company's working arrangements, from frontline operations all the way to headquarters. But in spite of the hordes of senior managers, investment bankers, accountants, and consultants hunting for post merger synergies, few seem to notice pricing. This oversight is odd, since even small changes in pricing can have a dramatic effect on the bottom line and contributes much as 30 percent of the value of all synergies realized by a deal. Post merger pricing is a subtle art requiring much detailed work, which perhaps explains its neglect. It doesn't mean simply raising prices across the board, a move consumers would resist and regulators forbid unless there were corresponding improvements in benefits to customers. On the contrary, merging companies should assess pricing from a number of angles. Do the prices of the merged company accurately reflect changes in benefits to its customers, for example? Do its discount rules make sense after the merger? Do pre merger price structures make a good fit with changes in operations and distribution? What messages will a new price structure send to competitors? When should it be introduced? To answer such questions, a management team must delve deep into the details of pricing, and the team's efforts should be well rewarded.

Post merger pricing can contribute as much as 30 percent of the value of all synergies realized by merger deals. Why is it usually neglected? The hidden value in post merger pricing. Aligning price with new value.

The goal of any company's pricing policy is to charge as much as customers will pay for the benefits conferred by its products, assuming that those benefits are distinguishable, in quality and therefore price, from those offered by competitors. Mergers can increase such benefits by improving the quality of products and services, by adding attributes and services to products, and by improving terms and conditions of ownership. Granted, these things may not happen, or not right away. Customer service and sales support may suffer until the sales forces and customer service facilities of the merging companies learn how to cooperate and how each other's products work.. But prices can be raised when the benefits and cost savings of the merger exceed those that the acquirer advertised as justification for it. In the mid-1990s, for example, Cross National Bank (all company names in this article are disguised) acquired many local and regional banks and integrated them into its established operations, providing extra benefits to customers who chose not to leave. Among these benefits were access to the company's automatic-teller machine network, now one of the largest in the country and the security offered by a larger, better-capitalized organization. Cross National realized that it had an opportunity to raise prices to a level appropriate to these improved benefits. As soon as the benefits were made available to the customers of an acquired bank, they were absorbed into Cross National's pricing program. This invariably improved the profitability of the acquired bank and had little impact on its sales volumes. A merged company can just as decisively destroy value by failing to align prices with enriched customer benefits. In the early 1990s, for instance, International Compressors acquired State Compressor, which sold the same type of product but with fewer design features and at a lower price. State also had a weak field service network and a less comprehensive warranty. To reduce the cost of servicing and administering the two product lines after the merger, International equipped its field service team to support State's products and equalized the warranty terms and coverage of the two lines. It left the price of State's compressors unchanged. Shortly afterward, State's sales rocketed, to the surprise of International's management, which believed that the design limitations (and thus higher maintenance costs) of State's compressors made them less of a bargain than International's, despite their lower price. In reality, the new availability of International's superior field service and more extensive warranty had removed the drawbacks of State's product, which had now become a great value at the old price. The new price-to-benefit ratio of State's products eroded the market share not only of International but also of its competitors, Micro-Comp and European. Both reacted by cutting prices. International felt compelled to follow suit to maintain its share. Over the next 12 months, industry price levels fell by 7 percent, and the profitability of the merged company dropped to roughly half that of its two constituent parts before the merger .

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Uncovering accumulated discounts

A company's price structure comprises not just its list prices but also all of the other factors, such as discounts, allowances, and bonuses, that account for the money the seller eventually receives, what is known as the "pocketprice."1 Left uncontrolled, these less visible factors can easily mount up:just the "off-invoice" discounts (those that don't even appear on the invoice)commonly equal 15 percent or more of the recorded sales revenue of a company, particularly if it sells its products through distributors or retailers. Merging companies often have different price structures. The leaders of the merged entity need to understand what will happen if both structures remain in force after the merger. When two industrial-components suppliers recently merged, for example, they initially thought they had little to gain from consolidating the terms and conditions they gave to distributors, since their pricing structures looked fairly similar.

Closer examination, however, uncovered several small differences with a large combined impact. The minimum order size for waiving their restocking fees varied, as did their discounts for cash payments, both companies had a minimum order policy but only one strictly enforced it –and their charges for expediting orders had different conditions and levels.

Thus the merger forced the combined company to answer the question, "Which discount structure is right?" The company assembled a task force to compare the two structures. The team determined how different terms for cash discounts affected each company's average days outstanding on receivables, the impact of strict adherence to minimum orders on ordering patterns and costs, and other relevant pieces of information. In response,

the company consolidated its terms and conditions for discounts, achieving an improvement of almost 2 percent in return on sales. Many merging companies don't trouble to analyze each organization's dis-count structure in detail, because they don't understand how much they are giving away to customers in the form of accumulated discounts. Particular functions may manage their own discount programs–logistics, for example, might give discounts on freight, while marketing gives them on cooperative advertising–so the aggregate cost of such programs remains obscure. In the worst case, the combined company may unwittingly and wastefully continue to apply elements of both its predecessors' discount programs to all post merger sales. A merger between suppliers may have the perverse effect of granting discounts for larger volumes to customers that haven't increased the size of their orders at all. Take the hypothetical case of two companies; Superior Inc. and Elite Co., that sell to the same retailer. Both offer a2 percent volume bonus or reimbursement on annual purchases worth from$250,000 to $1 million as well as a 4 percent bonus on purchases that exceed $1 million. The retailer buys $950,000 worth of goods from Superior and $250,000 worth from Elite, earning a 2 percent discount from both. Superior then merges with Elite. The resulting company keeps its predecessors' volume bonus thresholds. The retailer is now purchasing $1.2 million worth of goods from the merged company, entitling it to a 4 percent discount–that is, a windfall of $24,000–without increasing its purchases. Of course, the retailer may interpret this as compensation for reduced competition between its suppliers. Nonetheless, the merged company inadvertently destroys value by ignoring the effects of the merger on the scale of discounts available to its predecessors' shared customers.

Using price structures to fuel post merger demand

A company may find that to bear fruit, the synergies it expected from a merger must be linked to pricing incentives. In the recent integration of two large tire manufacturers, for instance, the merged company took advantage f its acquired marketing and merchandising insight to introduce a new price structure. The merged company could offer its retail dealers a one-stop shop for a suite of tires. Its larger size also gave it an opportunity to give dealers more marketing and merchandising support. But nothing in the old price structure would have kept dealers from taking advantage of the company's increased support while still buying tires from competing manufacturers. By care-fully analyzing the various discount structure options, the merged company adopted a more performance-based Dealer Partnership program that encouraged dealers to stock the full breadth of the company's expanded product line. The program gave rewards to dealers that purchased multiple brands and did a large percentage of their business with the merged company–rewards that smaller competitors with narrower product lines couldn't offer.

Discovering and adopting better pricing practice

Two companies of similar size can generally realize large savings by eliminating duplicative functions after merging. But when a larger company merges with a smaller one, there is less duplication to eliminate and therefore little to gain in the way of additional scale economies. Such a merger of unequals can nonetheless provide a valuable chance to improve pricing practices, policies, and systems throughout the combined company. Say that the larger company takes a haphazard approach to pricing, offering discounts to long-standing customers merely because they are long-standing, while its smaller counterpart is skilled at coordinating all the factors affect-in pocket prices. If the combined company adopts the smaller company's better practices, the whole enterprise benefits. But if the larger one assumes that its approach to pricing is bound to be better than that of its smaller acquisition, it diminishes the value of the merger. In one instance, a consumer durables company acquired a somewhat smaller company with complementary product lines. The smaller company was better at managing account-level pricing: it could measure the profitability of accounts, applied strict controls to discretionary discounts, and had feed-back mechanisms that identified opportunities to adjust prices for individual accounts. But the combined company adopted the acquirer's arcane yet lax system of managing account-level pricing. Meanwhile, the salespeople of the acquired company, released from their accustomed controls, began to grant larger discounts. Over time, the loss of its pricing processes and systems destroyed a good deal of value.

A merger of unequals can provide a valuable chance to improve the combined company's pricing practices, policies, and systems.

The fevered atmosphere surrounding a merger between companies of any size generally makes it easier than usual to change people's behavior. Companies can take advantage of this environment to improve their internal pricing processes, including who decides when to give which bonuses and discounts, and who collects and analyzes account information from the consolidated companies.

Setting the intensity of competition

While the supply of and the demand for an industry's output generally set the ceiling and floor of price ranges, the competitive conduct of the companies within an industry has a big influence on where, within that range, prices actually fall. The conduct of an individual company is determined by its intentions in the market (would it rather increase market share than profits or vice versa, for example), its ability to realize those intentions, and its perception of its competitors' intentions and abilities. When a merger occurs, it is not only the new company that reassesses its intentions and abilities; so too do its competitors. Changes made by the merged company to its marketing strategy and pricing can alter the intensity.

Adhering to antitrust law

To protect consumers, antitrust law rightly forbids companies to compare each other's pricing structures before a merger. But legal vehicles do allow companies to get a head start on exploring many of the post merger pricing opportunities outlined in this article. "Clean teams" consisting of independent third parties may analyze competitive information from both companies if the findings aren't shared with them until after the merger. Should the deal fall through, no member of the clean team may advise either competitor. Independent pricing teams in each merging company can begin the very time-consuming process of gathering and analyzing its own data in preparation for post merger pricing collaboration. Joint pricing teams may focus their work before the closing on issues that don't require them to share sensitive pricing information or formulas. Taking the time needed to compare each merging company's pricing methods and procedures at the earliest possible stage of the process allows companies to improve their pricing struc-ture almost immediately upon signing the deal. But as aboveboard as these approaches may appear to be, companies that are planning to merge must consult with legal counsel before embarking on them.

of competition in the whole industry. Precisely that occurred in the consumer durables industry. The two market leaders–Simmons and Jeffrey–fought furiously for market share, often through destructive price wars. They poached each other's prime accounts and angled, largely in vain, for exclusive arrangements with retailers. Because most retailers preferred to carry several competing brands, both companies usually had to give back, in the form of trade discounts, the price increases they had earlier imposed. Then Simmons was acquired by Jericho, which sold unrelated consumer products. Jeffrey's president called for an analysis of the merger's likely impact on competition. The managers reported that Jericho focused on profits and rarely competed on price. On the basis of this information, Jeffrey announced that it would no longer seek exclusive relation-ships with retailers and would raise the profit margins of a number of its products by increasing prices 2.5 percent. Its sales planners decided to cease overtly courting key accounts "owned" by Simmons but due for re negotiation. Jeffrey's take on the competition was right on target: Jericho followed Jeffrey's price increases and stopped courting accounts "owned" by Jeffrey.

Seize the day

Distributors, customers, employees, and competitors expect a merger to bring change. But those expectations don't last long. As soon as the customers and distributors of the merged company encounter its terms, conditions, and discounts, for example, those customers and distributors start to view them as constituting the new pricing structure.2 Similarly, employees accept as the norm whatever practices and processes are in place at the outset. As time goes on, it becomes more difficult to change prices. Clearly, a pricing plan must be an integral part of an overall merger design if the potential to create as much as 30 percent of a merger's total synergies is to be realized. Work on such a plan is best started before a deal closes (see sidebar, "Adhering to antitrust law"). Unfortunately, recent surveys show that many deals end up destroying rather than creating value for shareholders. The exception to this rule is repricing to reflect enhanced customer benefits. But it would be a mistake to raise prices until customers believe that they have started enjoying those benefits. A 1998 McKinsey study found that 58 percent of US mergers actually shrink shareholders' interests in the acquiring company and that 33 percent ultimately destroy value in the combined entity.

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