Projected Merger Synergies ≠ Cognizable Efficiencies

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My consulting work has entailed developing merger synergy estimates, evaluating the cognizability of the Parties' synergy estimates on behalf of the Agencies,[1] and assisting merging Parties to refine, document and present synergy estimates to the Agencies. With few notable exceptions, the merger synergy estimates I have reviewed, both personally and through case law, have had limited success in passing the hurdle of cognizability.

In my work assessing merger synergies presented to the Agencies during the merger review process, and often subsequently during litigation, I note that frequently the merging parties appear not to understand the significant difference between a merger synergy and a cognizable efficiency. As a result, the synergy estimates presented to the Agencies have not been rigorously developed and documented using the criteria the Agencies utilize. These criteria include:

- Is the synergy merger specific?
- Is the synergy amount verifiable?
- Is the cost savings associated with the synergy due to a diminution in service or quality?

In my experience, the merging parties seldom provide sufficient explanation, analysis, and supporting documentation to allow the Agencies to answer these three questions[2] and as a result the potential efficiency is questioned and/or rejected.

My intent in writing these notes is to assist management and their counsel in understanding the rigor and process needed to transform merger synergy estimates into credible cognizable efficiency estimates. I am an accountant, not an attorney, so my observations are limited to the perspective of an accountant and businessperson.

What are Merger Synergies?

Barron's defines a synergy as the action of a combined enterprise to produce results greater than the sum of the separate entities.[3] Thus the main purpose of estimating potential merger synergies is to assist the boards of directors and the shareholders of the companies contemplating a merger to determine if

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1 Throughout, Agencies refer to the Department of Justice and the Federal Trade Commission.

2 Further analysis may be done to ascertain fixed versus variable efficiencies, extent of pass through to consumers in the relevant market, and the impact of proposed divestitures on the efficiency estimates.

3 Barron's Dictionary of Business and Economic Terms, 5th edition.

the merger will enhance shareholder wealth. The expected results of the merger are generally measured and reported as an accretion to earnings per share.[4]

It is only if the merger is large enough to necessitate reporting[5] and/or if the Agencies fear the merger could result in competitive harm, that the merger synergies developed by the parties for business purposes[6] will need to be rigorously analyzed, justified, and documented for Agency review.

What are Cognizable Efficiencies?

The Horizontal Merger Guidelines[7] ("Guidelines") promulgated by the Department of Justice and the Federal Trade Commission lay out the criteria used to determine whether or not a claimed synergy is likely to be a cognizable efficiency. As defined in the Guidelines, cognizable efficiencies are cost-saving[8] opportunities that are verifiable, merger specific, and not the result of a diminution in quality or service.

The agencies recognize that "[e]fficiencies can increase the firm's ability and incentive to compete which may result in lower prices, improved quality, enhanced service, or new products."[9] Efficiencies are a potential offset to competitive harm but are only credited against the harm if they are merger-specific, verifiable, and not due to a reduction in quality or service. Thus, the purpose of merger synergies (enhancing shareholder value), is different than the purpose of cognizable efficiencies (offsetting competitive harm). An understanding of the different purposes driving the estimation of is needed to successfully translate a merger synergy analysis into a compelling cognizable efficiency analysis.

In subsequent posts I intend to discuss the "best practices" I have observed and employed in translating merger synergy into cognizable efficiencies. These best practices are based on a rigorous "bottom-up" integration planning process.

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4 In for-profit enterprises; non-profits have alternative metrics that reflect their mission, however as one leading antitrust counsel noted, "No margin, no mission."

5 As an accountant, I do not offer any advice on premerger notification requirements—antitrust counsel should be consulted.

6 The pre-merger identification of merger synergies developed by management and outside consultants use a top-down approach due to time constraints and to avoid the prohibition on sharing competitive information.

7 The Horizontal Merger Guidelines issued in 2010 and the Commentary on the Horizontal Merger Guidelines, issued in 2006.

8 While merger synergies often reflect revenue enhancing opportunities, I have found nothing in the Merger Guidelines, or the court cases reviewed, to indicate that revenue enhancements qualify as cognizable efficiencies. This is a legal question and should be addressed to counsel.

9 Merger Guidelines, p. 29.