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SYNERGIES IN BUSINESS VALUATION

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ABSTRACT

Since the 1980s, conventional wisdom has been that most acquisitions do not succeed. In 1987, Michael Porter of Harvard University observed that between 50% and 60% of acquisitions were failures; several other studies support this conclusion. Mercer Management Consulting noted that between 1984 and 1994, 60% of the firms in the "Business Week 500" that had made a major acquisition were less profitable than their industry. In 2004, McKinsey calculated that only 23% of acquisitions had a positive return on investment. Boston Consulting Group, in 2007, suggested that acquisitions transfer value from the acquirer's shareholders to those of the target. Results vary depending on the type of acquisition, the similarity of the two protagonists, the industry, involved international or domestic competition, etc. but the overall trend remains the same, even though there are major difficulties in measuring acquisition performance. Usual methods such as: measuring the stock market reaction; valuing the entity after acquisition; determining abnormal returns, synergies & economies of scale, are all unable to isolate the individual impact of the acquisition from those multitude of events that occur all the time in business.

KEYWORDS

mergers, valuations, synergies, abnormal losses, differential efficiency.

INTRODUCTION

In the long history of business, there never have been as many acquisitions as took place in the mid-2000s; for example, in 2007, firms spend a record $4.5 trillion dollars in cash and securities worldwide on such transactions. However, the vast majority of them do not create shareholder value and some even destroy it. There are many explanations for this phenomena; lack of cultural integration of two different, often competitive entities, and failure to achieve promised economies of scale and synergies, are the most common. So why do businesses continue to seek this form of growth if the returns are unsatisfactory? Possible reasons are: "eat or be eaten", the importance of size, the ego and the economic interests of the leaders, copy-cat behavior, pressure from investors, globalization, and predators from emerging economies. As the trend shows no sign of letting up, maybe acquisitions are actually more effective than previously thought.

An analysis of 302 major mergers that took place in the six years between July 1, 1995 and August 31, 2000, published in Business Week magazine, October 4, 2002, revealed that 61% diminished value for the stockholders of the acquirer. One year after the deals, their mean return was 25 percentage points below the average of comparable companies. Only 39% improved values, with an average return of 28 percentage points above their peers. Overall, the rate of return was 4.3% below that of competitors and 9.2% less than the Standard & Poor's 500 Index.

It is generally seen that there are four basic mistakes, which are the main causes of failed deals:

1. Overestimating cost savings and synergies.
2. Paying excessive prices, which transfer the bulk of the economic gains to the shareholders of the target rather than to those of the acquirer.
3. Delays in integrating operations, frustrating both customers and employees.
4. Concentrating on cost cutting and paying little attention to revenue enhancement and retention of top sales staff.

WHY MERGE?

As there seem to be numerous reasons speaking against mergers and acquisitions, one must ask why so many eager participants pursue them so vigorously in so many fields. Listed below are many of the reasons quoted by management for engaging in merger and acquisition activity.

A. DIFFERENTIAL EFFICIENCY

This is the predominant reason for mergers. For example, the management of ABC Corp. is more efficient than that of XYZ, Inc. If after merging, the efficiency of XYZ is brought up to that of ABC, the overall returns will improve, unless a too high premium over book value was paid. This type of transaction results in social, as well as shareholder gains. Entities operating similar businesses are most likely to succeed in this situation, as they are able to detect below average performance and have the know-how to improve it.

B. INADEQUATE MANAGEMENT

The target's management may be quite able, but simply not on the same level of efficiency as that of the acquirer. In other cases, the target's inept management may have been a main reason for an acquirer to act.

C. OPERATING SYNERGIES

Horizontal mergers between competitors may result in economies of scale or better utilization of capacity. Complementary capabilities, such as overlapping regions or common lists of suppliers/customers can lead to improvements in efficiencies beyond those available through internal expansion. Provided it does not infringe on anti-trust laws, vertical integration combining firms at different levels of an industry, may result in beneficial and more profitable coordination of operations.

D. FINANCIAL ENGINEERING

A merger combining two or more similar organizations in different parts of the country may result in a lower cost of capital, making both debt and equity funds cheaper. This would be partly due to reductions in risks and a lower-size premium. If the various cash flows advance independently of each other, with one making up for a slack period in its counterpart, the possibility of failure is lowered and the cost of debt may be reduced even further.

At the time of writing (January 2011) interest rates are low, another related benefit is that the return on a cash purchase will normally exceed 3% of money in the bank (about 1%).

E. UNDERVALUATION

Many mergers are, in effect, stimulated by a build-or-buy choice for the acquirer. If the target is sufficiently undervalued so that additional capacity, at a cost comparable to building it new could be immediately obtained, the transaction is advantageous. At various times in the past, Tobin's Q-Ratio (the total market value of a firm divided by the replacement value of its net assets) for many entities has been below one. For example, if the Q-Ratio is 0.80 and the average premium over book value is 35%, the resulting purchase price is only 1.08 times the replacement costs of the net assets; the premium representing the going concern element. Changes in Tobin's Q-Ratio partially explain why merger activity rises and falls during growth and recession periods. This does not however, apply to intangible assets, which may have a higher value to an acquirer than to the target. For example, a cotton-spinning mill was the most efficient in the industry because it had developed robots that made three independent attempts to fix broken threads on the fly, without shutting down the equipment or calling for human assistance. Although they were successful only 30% of the time, the plant was able to deliver more than its rated capacity based on standard down time. Privately owned, it was acquired at a high PER by a public company, which then proceeded to apply the technology to all its plants.

F. STRATEGIC OBJECTIVES

One well-established approach to increasing stockholder value is to enter into a merger to achieve a strategic objective, such as geographical expansion, economies of scale or taking advantage of managerial capabilities that are not fully resourced. Each of these creates synergies, which are required by FASB to be taken into account in determining fair value.

G. MANAGEMENT EGO

An active market for "corporate control" can manifest itself in a variety of industries. Acquirers are driven by many of the previously mentioned reasons but in some cases by "managerialism" – more commonly known as "ego trips". These have been a motivation for founding many conglomerates based on the philosophy that bigger is better. They also give senior executives an opportunity to enhance their compensation—at least for a few years. But not all ends well, and greedy executives may indeed come at a high price for many.

H. MARKET POWER

This is based on the usually erroneous assumption that a larger firm has greater market power and stronger relationships with its customers. In horizontal mergers, a lower number of participants in an industry may be advantageous to the remaining ones.

I. PRACTICE MAKES PERFECT

In 2000, Bain & Company, international management consultants, studied 724 US companies with revenues of more than $500 million, and examined the results of the 7,475 acquisitions they had made since 1986 by comparing management's approach to acquisitions with returns delivered to shareholders.

Based on splitting buyers into the following four groups, the results were reported in the Harvard Business Review, March 2003.

1. Constant: Acquired irrespective of economic cycles
2. Recession: Increased activities during recessions
3. Growth: Acted principally in growth periods
4. Doldrums: Tended to concentrate purchases in periods between recession and growth.

The most significant conclusion is that the more deals an entity undertook, the more value it delivered. Those completing over 20 deals in 15 years on average outperformed firms that made four or less by a factor of 1.7, and non-buyers by almost 2. While frequency is important, so is consistent activity through economic cycles. Constant buyers were by far the most successful, outperforming the growth category by 2.3 times and the doldrums by a factor of 1.8. Recession came in second, exceeding growth by 1.4 times.

The most successful buyers followed similar patterns. They started with small deals, formalized their processes and created feedback systems to insure they would learn from mistakes. Targets were continually reviewed and promising entities identified. Line management was involved in due diligence, permanent teams were established and clear parameters devised for integration.

Most importantly, constant buyers excelled at saying "no". Some parties to a deal, such as investment bankers, often have powerful incentives for it to be consummated, but successful acquirers set a "walk-away" price and stick to it.

With mergers, the risks of giving in to wishful thinking are high. Even if the planning is sound, the price right and the expected synergies are achieved, there is still the chance that Murphy's Law, "anything that can go wrong will go wrong", might manifest itself.

DETERMINATION OF SYNERGIES

In planning a business combination and establishing the price to be offered, an acquirer frequently anticipates considerable synergies and strategic advantages resulting from the addition. However, those benefits often fail to materialize to the extent envisaged and, as pointed out in the Business Week article mentioned at the beginning of this chapter, overpaying for expected synergies is a major reason for failure. The key to successful transaction is to "pay for what you get, not for what you think you get", and to make sure that the gains are shared fairly between both sets of stockholders.

Synergies are represented by the net incremental discretionary cash flows directly arising from the transaction. They generate much of the hoped-for higher value of the combined enterprise than the sum of its predecessors. In addition to increasing discretionary cash flows, benefits arising from a merger may also reduce risks associated with operations of either entity and have a positive impact on creating future opportunities.

The Fair Value of a reporting or cash generating unit, requires the valuator to take into account the benefits of the anticipated synergies that could be obtained by market participants. This means that Fair value is at some strategic level and may be higher than fair market value

A. INTRINSIC AND INVESTMENT VALUES

When negotiating the purchase price, the acquirer is likely to accept "what it gets" as a "floor". This is the fair market value of the target as it stands, commonly known as intrinsic value. The "ceiling" is "what it thinks it gets", represented by the investment value which takes into consideration planned changes, anticipated expansions, expected future opportunities and the changed risk profile. The purchase price normally falls between these two amounts. A means of obtaining both amounts are described in the section, "Quantification of Synergies".

B. ALLOCATION OF BENEFITS

In any merger or acquisition, the benefits resulting from the transaction should be split between both sets of shareholders.

C. SHAREHOLDERS OF THE TARGET

The shareholders of the target receive the greater portion when:

1. Its existing prospects appear better than those of the acquirer and so increase the intrinsic value. However, this may turn out to be just an illusion.
2. Both managements, in collaboration, identify more benefits than the acquirer alone, leading to a higher investment value. Such rosy forecasts sometimes result in imaginary synergies, discount rates that do not reflect all the risks and exaggerated estimates of the acquirer's abilities, leading to overpayment.
3. A "White Knight" appears to instigate competitive bidding.

D. SHAREHOLDERS OF THE ACQUIRER

To ensure that the shareholders of the acquirer receive a reasonable portion of the synergies and benefits, a maximum price must be established for the purchase. This will reflect:

1. Expected benefits
2. Costs associated obtaining them
3. When they are to be received
4. Likelihood of achieving them
5. Risks associated with their realization

QUANTIFICATION OF SYNERGIES

The definition of Fair Value was discussed in a previous Chapter together with its relationship to fair market value. It assumes that the acquirer is able to obtain those synergies, available to market participants. If they are not realized and the Fair Value of the net assets turns out to be less than the amount paid, a goodwill impairment loss will likely occur.

A. SOURCES OF SYNERGIES

Synergies fall into two broad categories: increased revenues and cost savings; both may affect the amount paid for the target.

B. FACTORS THAT INCREASE REVENUES

i. Cross-selling of complementary items
ii. Integration of product lines
iii. Diversification of customers
iv. Better use of sales channels and marketing programs

v. Higher selling prices

C. FACTORS THAT REDUCE COSTS

i. Accelerated entry to the target's business
ii. Improved economies of scale
iii. Increased purchasing power and volume discounts
iv. Lower cost of capital
v. Access to better technology
vi. Secure source of supplies
vii. Elimination of duplicate administrative activities
viii. Reduced capital expenditures
ix. Improved use of working capital
x. Better capacity utilization and productivity

D. EXTRA EXPENSES

Integrating an acquirer and a target normally leads to extra expenses, one-time occurrences not often subjected to the same level of analysis as applied to predicted revenue increases and cost reductions. They frequently exceed the budget and sometimes the acquirer's wildest expectations. In applying SFAS 141(R) or IFRS 3, this characteristic must be taken into account by the valuators.

Potential extra costs are set out below, some one-time expenses, others will spread over more than one reporting period.

i. Temporary double management
ii. Severance pay
iii. Combining sales forces, control and information systems
iv. Dealing with overlapping customer relationships
v. Transferring personnel
vi. Monitoring the integration
vii. Terminating leases
viii. Additional legal activities
ix. Unforeseen actions of competitors
x. Miscellaneous contingencies
xi. Assimilating the different business cultures
xii. Company moving costs

E. THE VALUE OF SYNERGIES

Synergies are difficult to value directly; they are often quantified by the difference between the investment and intrinsic values of the target (see above). Both are established separately for existing operations, emerging activities and future opportunities.

The intrinsic value of existing operations is commonly obtained by capitalizing current earnings. Emerging activities are almost always valued by discounting projected cash flows, while future opportunities will usually be given little weight until target's management provides more detailed information. In all cases, the Market Approach, based on Guidelines, should be used as confirmation of the primary method chosen.

For investment value, FASB and IASB recommend the Discounted Cash Flows method. The Boards do not differentiate between existing operations, emerging activities and future opportunities. While their suggestion is satisfactory for the first two, the Real Option method is sometimes useful for future opportunities. It is relatively easy to realistically reflect the expected synergies and extra expenses in DCF values by including management's forecasts for

i. The perceived benefits
ii. Costs associated with them
iii. Timing of their realization

The probable risks linked to the realization of the anticipated benefits should be reflected in the discount rate, which will likely be lower for investment than for intrinsic value.

When it is difficult to establish the timing of the perceived benefits or the chances of obtaining them, estimate the amounts and related costs for various scenarios. Select these separately for the investment values of existing operations and for emerging activities, then apply weights on the basis of their probabilities. In such circumstances, the elements of the First Chicago Method, previously described in detail, should be considered.

i. Success: expected conservative post-acquisition synergies
ii. Survival: half of the expected synergies are achieved
iii. Failure: synergies are not realized

As the risks associated with the realization of the benefits are reflected in the probabilities, all three scenarios would use the same discount rate.

F. STRATEGIC ADVANTAGES

Certain benefits from an acquisition may not have an identifiable impact on the cash flows and are generally strategic advantages rather than synergies. In our view, they are better reflected by including them as risk reductions when using a Build-up Method to establish the discount rate; examples are:

i. Diminished competition
ii. Increased market share
iii. Incremental growth opportunities
iv. Lower risks

G. TIMING OF REALIZATION

One of the most common errors in an acquisition is underestimating the time it will take to implement the changes necessary to realize the expected synergies. This is often related to the difficulty of forecasting the target's ability to combine its culture with that of the acquirer. It is virtually impossible to increase revenue, if, for example, the marketing and distribution arms of the respective firms cannot coordinate their efforts because one system is highly centralized and the other geographically diversified.

H. NON-CORE ACTIVITIES

In nearly every acquisition, the target is carrying on some activities that have a limited "fit" with the major functions of the combined enterprise. In the past, many businesses attempted to reduce risks and accelerate growth by diversifying into product and service areas not directly related to their "core" business.

When the value of the entity is less than that of the total of its components, this situation is described as a conglomerate discount. An example was Seagram’s, the successful distiller, who first obtained effective control of DuPont through a 23% holding, as that portion of profits were included in reported earnings but only dividends recorded in cash flows, the company PER declined, ostensibly due to “lack of forces”. Later in an attempt to generate growth, management replaced the DuPont holding with all of Universal, the film and music empire. After Seagram’s acquisition by Vivendi, the original liquor business was sold off in bits and pieces. The net result was a decline of over 50% in the controlling family's fortune.

In assessing the synergies of an acquisition, it is essential to determine which operations or assets are non-core and decide early, when and at what price they could be sold. The fundamental methodology is to separate the target into its components and value each separately. While comparable transactions can provide some benchmarks, remember that no two companies are alike in regard to risks or potential cash flows. Careful analyses will ensure that the comparable transactions are comparable

A major reason for a conglomerate discount is a lack of information at the reporting or cash generating unit level. This creates risks, which always result in lower values no matter what the reason. Items that are difficult to determine for the acquirer are the transaction and tax costs associated with breaking up parts of the entity. With the merger complete, finding buyers for the "orphans" may take longer and be more costly than anticipated, as their availability becomes known bargain hunters will appear. The acquirer must also consider the possibility of being left with unwanted units for which no buyers can be found. In such cases, there can only be speculation about the eventual form of divestiture (e.g., asset or share sale, spin-off, etc.).

I. SHARING INFORMATION

Once the target accepts that it is "in play" and seeks to maximize its price, the more information or assistance it supplies to the acquirer, under confidentiality agreements, the better the results will be. Certain items will often be held back, especially if the firms are competitors. A well-organized information "war" room can increase the sale price and reduce due diligence transaction costs usually factored into the sale price.

J. GENUINE ASSETS

In a Strategic Finance magazine November 2000 article, Joel Litman of Diamond Technology Partners, a Chicago strategy consulting firm, pointed out that most entities have genuine assets that are not shown on any financial statement except as part of goodwill because they do not qualify as Intangible Assets; some examples he listed include:

K. INTANGIBLE OBLIGATIONS

In addition to Intangible Assets, many entities have obligations that may be considered intangible, as they arise on a prospective basis and are without physical manifestation. It is essential to identify and assess such items although some will be contingent and never materialize. All too often, when not properly analyzed, they turn up at the wrong time, without a chance of being rectified. Examples are:

i. Acknowledged contingent liabilities
ii. Pension and benefit plan obligations
iii. Environmental liabilities
iv. Contingent income taxes

L. ENVIRONMENTAL LIABILITIES

When considering acquisitions of physical assets great care must be taken to ascertain that they are "clean", particularly when toxic materials have been handled on the site, by the present or a previous owner. The acquirer must assess the probability, timing and quantum of costs which may be incurred to correct environmental problems, past, current or future, ensuring compliance with all relevant legislation and regulations on an ongoing basis. Situations exist where the value of a business was virtually erased by the costs of cleaning up a location. While large profits had previously been earned from the plant, the acquirer inherited the environmental liability and became responsible for cleaning up the unfortunate contamination from an owner well back in the chain of title.

In many jurisdictions environmental legislation is far reaching and often based on the "deep pocket" theory, whereby the one with the most resources pays for cleanup and reclamation.

While auditors are not required to express an opinion on the adequacy of an entity's environmental practices or compliance with pertinent laws and regulations, they must obtain sufficient evidence to provide reasonable assurance that any items on the financial statements that could be affected by environmental considerations are fairly presented. Although this gives no assurance that the costs of a cleanup have been fully taken into account, it should be the starting point for the valuators assessment of this type of exposure. In certain cases a consulting engineer or environmental specialist may be necessary.

M. CONTINGENT INCOME TAXES

Income taxes must always be considered in an acquisition, especially relating to potential adjustments for unassessed (open) years or for the utilization of previous losses. They must also be taken into account when purchasing shares of the target, as the acquirer will inherit the tax bases of all the underlying assets. This may result in contingent tax liabilities materializing when the related items are sold. It is important to estimate the timing and proceeds of any planned dispositions, especially if they are expected relatively soon. The present values of any contingent income taxes should be treated as a liability for valuation purposes at the acquisition and be reflected in the amount paid.

CONCLUSION

Since the 1980s, conventional wisdom has been that most acquisitions do not succeed. In 1987, Michael Porter of Harvard University observed that between 50% and 60% of acquisitions were failures; several other studies support this conclusion. Mercer Management Consulting noted that between 1984 and 1994, 60% of the firms in the “Business Week 500” that had made a major acquisition were less profitable than their industry. In 2004, McKinsey calculated that only 23% of acquisitions had a positive return on investment. Boston Consulting Group, in 2007, suggested that acquisitions transfer value from the acquirer’s shareholders to those of the target. Results vary depending on the type of acquisition, the similarity of the two protagonists, the industry, involved international or domestic competition, etc. but the overall trend remains the same, even though there are major difficulties in measuring acquisition performance. Usual methods such as: measuring the stock market reaction; valuing the entity after acquisition; determining abnormal returns, synergies & economies of scale, are all unable to isolate the individual impact of the acquisition from those multitude of events that occur all the time in business.

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