

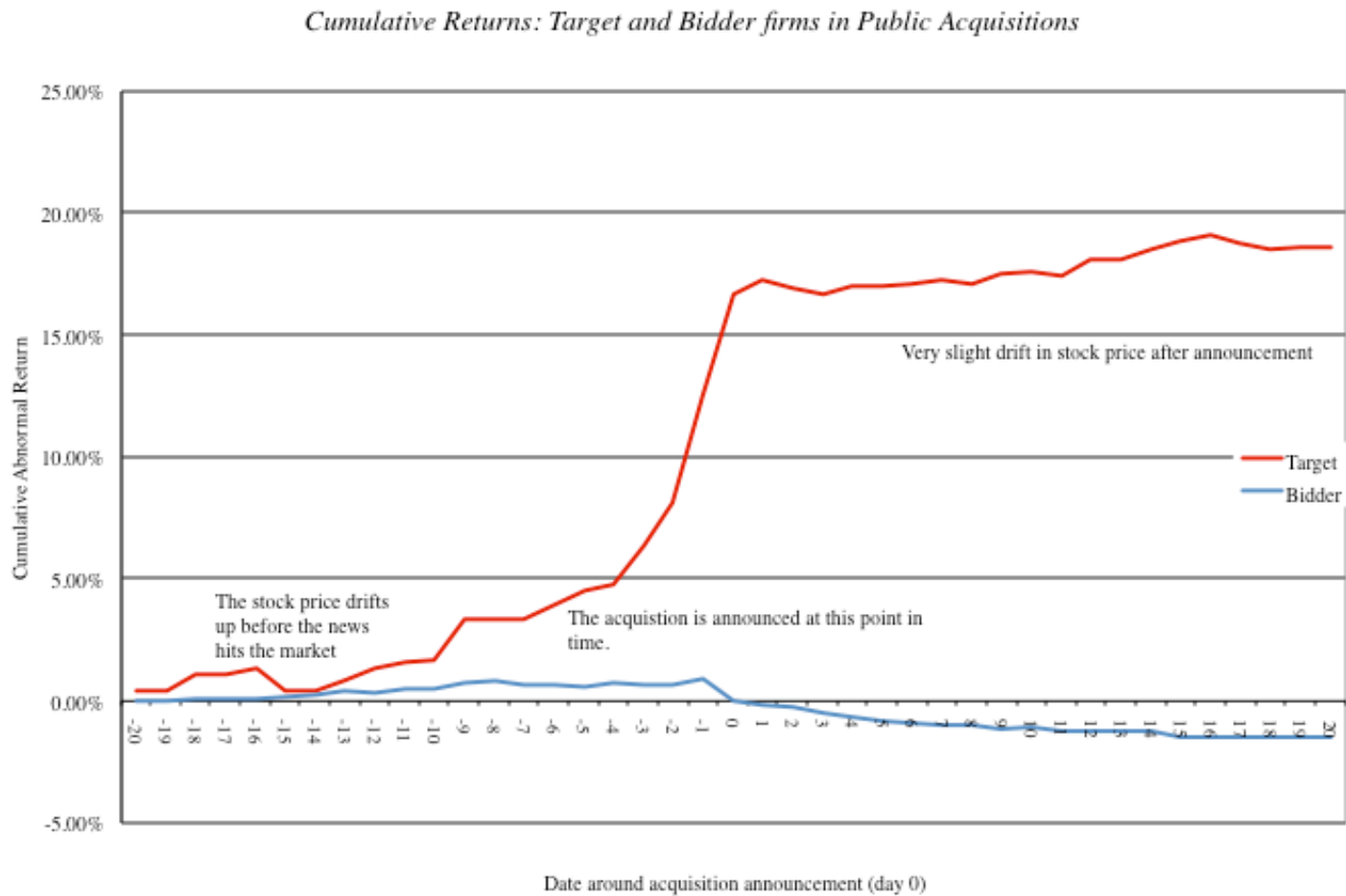


Acquirers Anonymous: Seven Steps back to Sobriety...

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Acquisitions are great for target companies but not always for acquiring company stockholders...



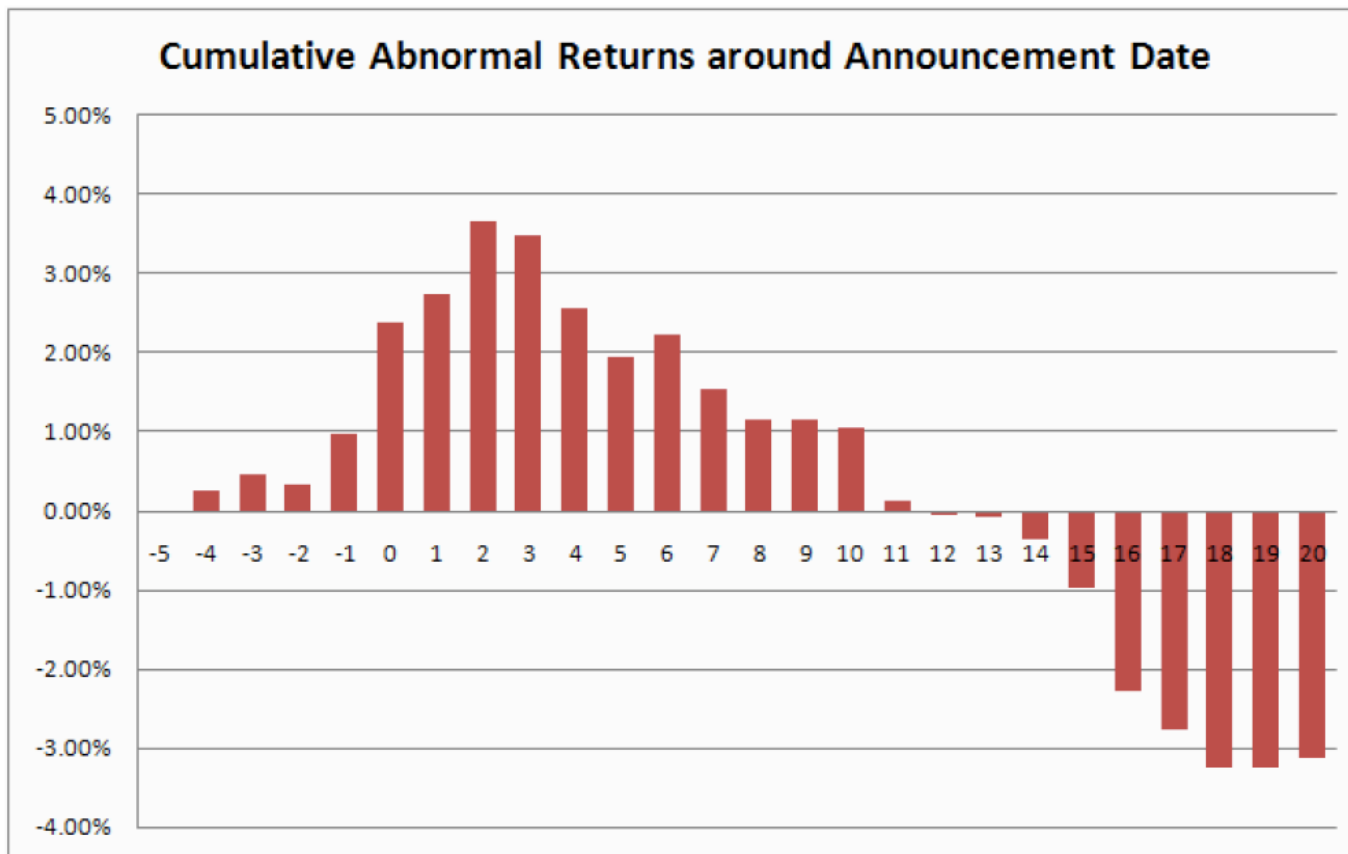
And the long-term follow up is not positive either..

- o Managers often argue that the market is unable to see the long term benefits of mergers that they can see at the time of the deal. If they are right, mergers should create long term benefits to acquiring firms.
- o The evidence does not support this hypothesis:
 - o McKinsey and Co. has examined acquisition programs at companies on
 - o Did the return on capital invested in acquisitions exceed the cost of capital?
 - o Did the acquisitions help the parent companies outperform the competition?Half of all programs failed one test, and a quarter failed both.
 - o Synergy is elusive. KPMG in a more recent study of global acquisitions concludes that most mergers (>80%) fail - the merged companies do worse than their peer group.
 - o A large number of acquisitions that are reversed within fairly short time periods. About 20% of the acquisitions made between 1982 and 1986 were divested by 1988. In studies that have tracked acquisitions for longer time periods (ten years or more) the divestiture rate of acquisitions rises to almost 50%.

A scary thought... The disease is spreading...

Indian firms acquiring US targets – 1999 - 2005

Indian Acquirers: Returns around acquisition announcements



Growing through acquisitions seems to be a “loser’s game”

- Firms that grow through acquisitions have generally had far more trouble creating value than firms that grow through internal investments.
- In general, acquiring firms tend to
 - Pay too much for target firms
 - Over estimate the value of “synergy” and “control”
 - Have a difficult time delivering the promised benefits
- Worse still, there seems to be very little learning built into the process. The same mistakes are made over and over again, often by the same firms with the same advisors.
- Conclusion: There is something structurally wrong with the process for acquisitions which is feeding into the mistakes.

The seven sins in acquisitions...

1. Risk Transference: Attributing acquiring company risk characteristics to the target firm.
2. Debt subsidies: Subsidizing target firm stockholders for the strengths of the acquiring firm.
3. Auto-pilot Control: The “20% control premium” and other myth...
4. Elusive Synergy: Misidentifying and mis-valuing synergy.
5. Its all relative: Transaction multiples, exit multiples...
6. Verdict first, trial afterwards: Price first, valuation to follow
7. It's not my fault: Holding no one responsible for delivering results.

Testing sheet

Test	Passed/Failed	Rationalization
Risk transference		
Debt subsidies		
Control premium		
The value of synergy		
Comparables and Exit Multiples		
Bias		
A successful acquisition strategy		

Lets start with a target firm

- The target firm has the following income statement:

Revenues	100
- Operating Expenses	80
= Operating Income	20
- Taxes	8
= After-tax OI	12

- Assume that this firm will generate this operating income forever (with no growth) and that the cost of equity for this firm is 20%. The firm has no debt outstanding. What is the value of this firm?

Test 1: Risk Transference...

- Assume that as an acquiring firm, you are in a much safer business and have a cost of equity of 10%. What is the value of the target firm to you?

Lesson 1: Don't transfer your risk characteristics to the target firm

- The cost of equity used for an investment should reflect the risk of the investment and not the risk characteristics of the investor who raised the funds.
- Risky businesses cannot become safe just because the buyer of these businesses is in a safe business.

Test 2: Cheap debt?

- Assume as an acquirer that you have access to cheap debt (at 4%) and that you plan to fund half the acquisition with debt. How much would you be willing to pay for the target firm?

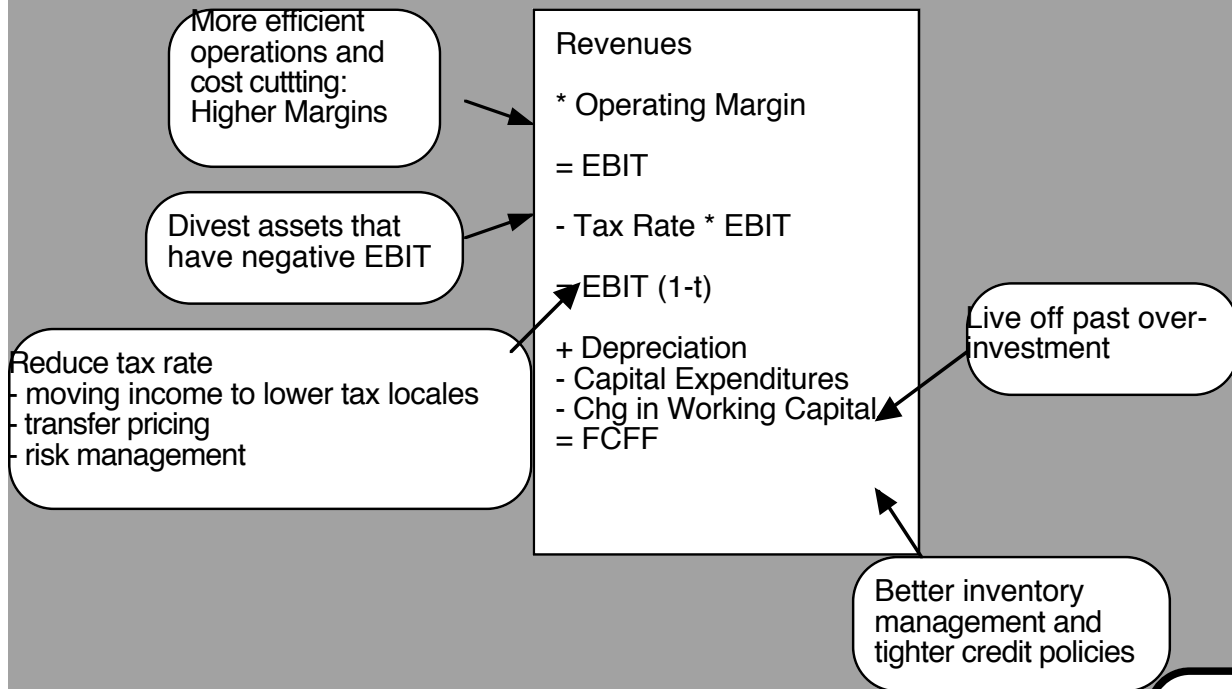
Lesson 2: Render unto the target firm that which is the target firm's but not a penny more..

- As an acquiring firm, it is entirely possible that you can borrow much more than the target firm can on its own and at a much lower rate. If you build these characteristics into the valuation of the target firm, you are essentially transferring wealth from your firm's stockholder to the target firm's stockholders.
- When valuing a target firm, use a cost of capital that reflects the debt capacity and the cost of debt that would apply to the firm.

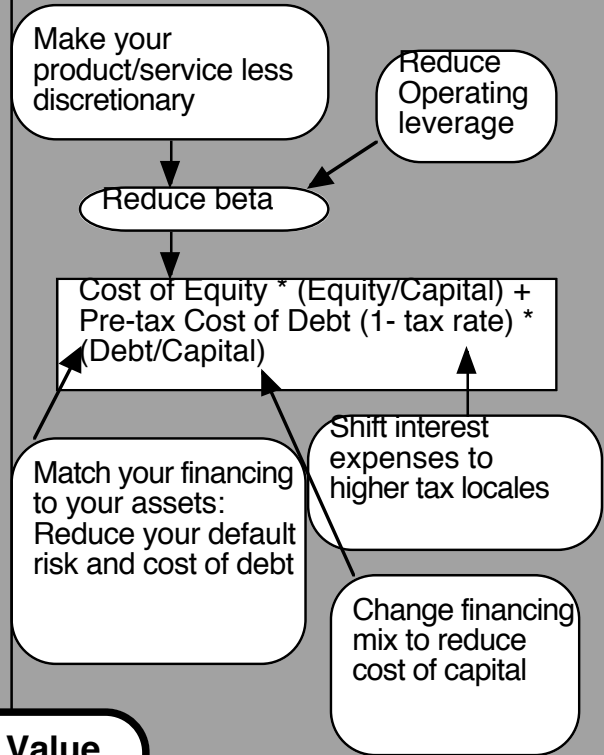
Test 3: Control Premiums

- Assume that you are now told that it is conventional to pay a 20% premium for control in acquisitions (backed up by Mergerstat). How much would you be willing to pay for the target firm?
- Would your answer change if I told you that you can run the target firm better and that if you do, you will be able to generate a 30% pre-tax operating margin (rather than the 20% margin that is currently being earned).
- What if the target firm were perfectly run?

Increase Cash Flows

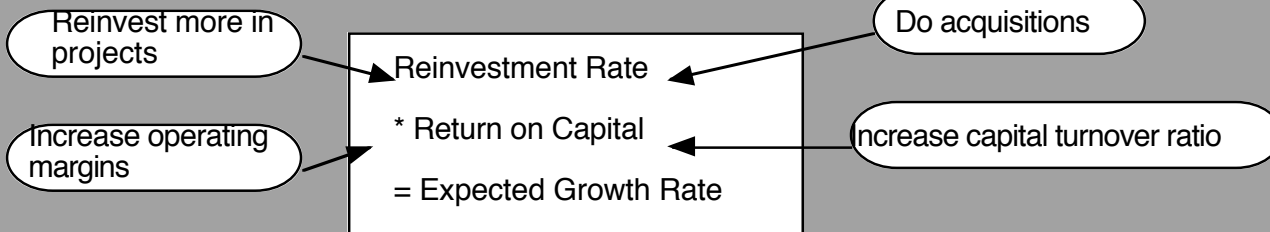


Reduce the cost of capital

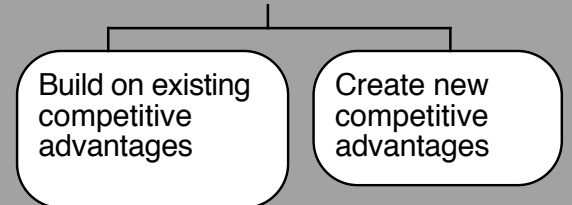


Firm Value

Increase Expected Growth



Increase length of growth period



Blockbuster: Status Quo

Current Cashflow to Firm
 EBIT(1-t) : 163
 - Nt CpX 39
 - Chg WC 4
 = FCFF 120
 Reinvestment Rate = 43/163
 =26.46%

Reinvestment Rate
26.46%

Expected Growth in EBIT (1-t)
 $.2645 * .0406 = .0107$
1.07%

Return on Capital
4.06%

Stable Growth
 $g = 3\%$; Beta = 1.00;
 Cost of capital = 6.76%
 ROC = 6.76%; Tax rate = 35%
 Reinvestment Rate = 44.37%

Terminal Value₅ = $104 / (.0676 - .03) = 2714$

Op. Assets 2,472
 + Cash: 330
 - Debt 1847
 = Equity 955
 - Options 0
 Value/Share \$ 5.13

	1	2	3	4	5
EBIT (1-t)	\$165	\$167	\$169	\$173	\$178
- Reinvestment	\$44	\$44	\$51	\$64	\$79
FCFF	\$121	\$123	\$118	\$109	\$99

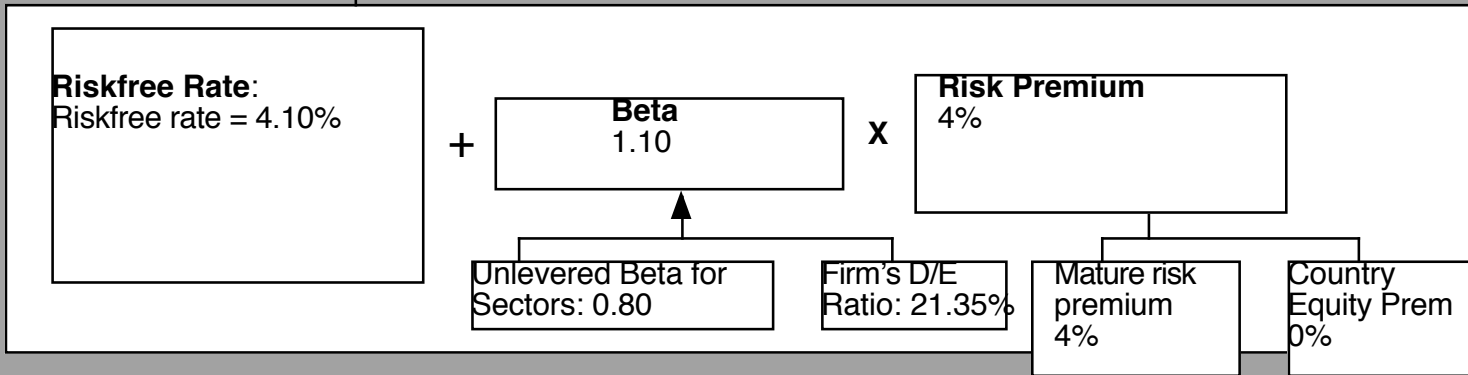
Term Yr
 184
 82
 102

Discount at Cost of Capital (WACC) = 8.50% (.486) + 3.97% (0.514) = 6.17%

Cost of Equity
8.50%

Cost of Debt
 $(4.10\% + 2\%) (1 - .35)$
 = 3.97%

Weights
 E = 48.6% D = 51.4%



Blockbuster: Restructured

Current Cashflow to Firm
 EBIT(1-t) : 249
 - Nt CpX 39
 - Chg WC 4
 = FCFF 206
 Reinvestment Rate = $43/249 = 17.32\%$

Reinvestment Rate
17.32%

Expected Growth in EBIT (1-t)
 $.1732 * .0620 = .0107$
1.07%

Return on Capital
6.20%

Stable Growth
 $g = 3\%$; Beta = 1.00;
 Cost of capital = 6.76%
 ROC = 6.76%; Tax rate = 35%
 Reinvestment Rate = 44.37%

Terminal Value₅ = $156 / (.0676 - .03) = 4145$

Op. Assets 3,840
 + Cash: 330
 - Debt 1847
 = Equity 2323
 - Options 0
 Value/Share \$ 12.47

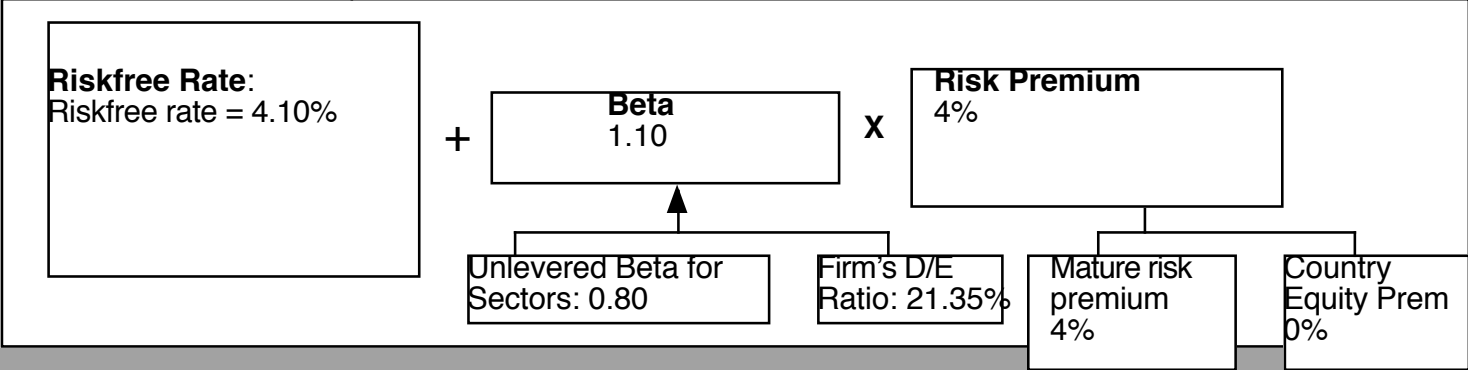
	1	2	3	4	5	Term Yr
EBIT (1-t)	\$252	\$255	\$258	\$264	\$272	280
- Reinvestment	\$44	\$44	\$59	\$89	\$121	124
FCFF	\$208	\$211	\$200	\$176	\$151	156

Discount at Cost of Capital (WACC) = $8.50\% (.486) + 3.97\% (0.514) = 6.17\%$

Cost of Equity
8.50%

Cost of Debt
 $(4.10\% + 2\%) (1 - .35) = 3.97\%$

Weights
 E = 48.6% D = 51.4%



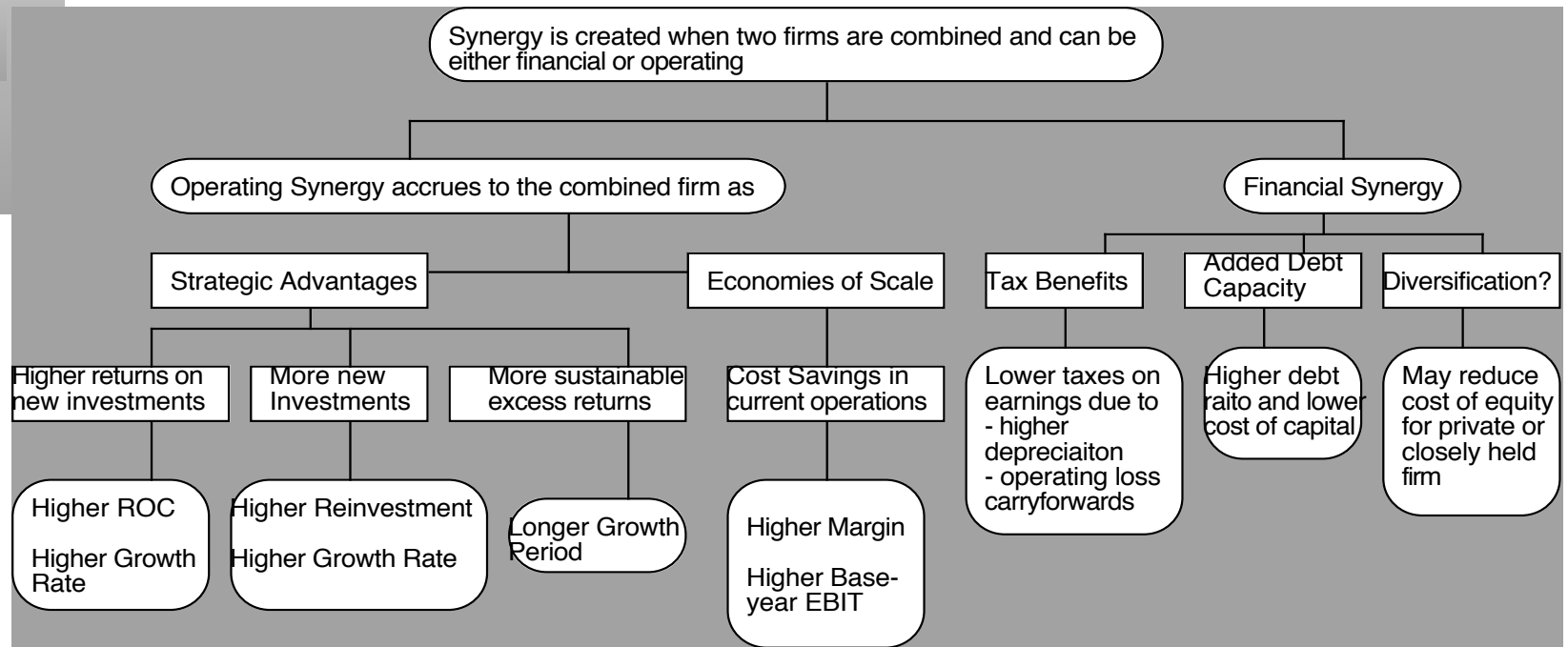
Lesson 3: Beware of rules of thumb...

- Valuation is cluttered with rules of thumb. After painstakingly valuing a target firm, using your best estimates, you will be often be told that
 - It is common practice to add arbitrary premiums for brand name, quality of management, control etc...
 - These premiums will be often be backed up by data, studies and services. What they will not reveal is the enormous sampling bias in the studies and the standard errors in the estimates.
 - If you have done your valuation right, those premiums should already be incorporated in your estimated value. Paying a premium will be double counting.

Test 4: Synergy....

- Assume that you are told that the combined firm will be less risky than the two individual firms and that it should have a lower cost of capital (and a higher value). Is this likely?
- Assume now that you are told that there are potential growth and cost savings synergies in the acquisition. Would that increase the value of the target firm?
- Should you pay this as a premium?

The Value of Synergy



Valuing Synergy

- (1) the firms involved in the merger are **valued independently**, by discounting expected cash flows to each firm at the weighted average cost of capital for that firm.
- (2) the **value of the combined firm, with no synergy**, is obtained by adding the values obtained for each firm in the first step.
- (3) The **effects of synergy are built into expected growth rates and cashflows**, and the combined firm is re-valued with synergy.

Value of Synergy = Value of the combined firm, with synergy - Value of the combined firm, without synergy

Synergy: Example 1

The illusion of “lower risk”

- When we estimate the cost of equity for a publicly traded firm, we focus only on the risk that cannot be diversified away in that firm (which is the rationale for using beta or betas to estimate the cost of equity).
- When two firms merge, it is true that the combined firm may be less risky than the two firms individually, but the risk that is reduced is ‘firm specified risk’. By definition, market risk is risk that cannot be diversified away and the beta of the combined firm will always be a weighted average of the betas of the two firms in the merger.
- When does it make sense to “merge” to reduce total risk?

Synergy - Example 2

Higher growth and cost savings

	P&G	Gillette	Piglet: No Synergy	Piglet: Synergy	
Free Cashflow to Equity	\$5,864.74	\$1,547.50	\$7,412.24	\$7,569.73	Annual operating expenses reduced by \$250 million
Growth rate for first 5 years	12%	10%	11.58%	12.50%	Slightly higher growth rate
Growth rate after five years	4%	4%	4.00%	4.00%	
Beta	0.90	0.80	0.88	0.88	
Cost of Equity	7.90%	7.50%	7.81%	7.81%	Value of synergy
Value of Equity	\$221,292	\$59,878	\$281,170	\$298,355	\$17,185

Synergy: Example 3

Tax Benefits?

- Assume that you are Best Buys, the electronics retailer, and that you would like to enter the hardware component of the market. You have been approached by investment bankers for Zenith, which while still a recognized brand name, is on its last legs financially. The firm has net operating losses of \$ 2 billion. If your tax rate is 36%, estimate the tax benefits from this acquisition.
- If Best Buys had only \$500 million in taxable income, how would you compute the tax benefits?
- If the market value of Zenith is \$800 million, would you pay this tax benefit as a premium on the market value?

Synergy: Example 4

Asset Write-up

- One of the earliest leveraged buyouts was done on Congoleum Inc., a diversified firm in ship building, flooring and automotive accessories, in 1979 by the firm's own management.
 - After the takeover, estimated to cost \$400 million, the firm would be allowed to write up its assets to reflect their new market values, and claim depreciation on the new values.
 - The estimated change in depreciation and the present value effect of this depreciation, discounted at the firm's cost of capital of 14.5% is shown below:

Congoleum's Tax Benefits

<i>Year</i>	<i>Deprec'n before after</i>	<i>Deprec'n Deprec'n</i>	<i>Change in</i>	<i>Tax Savings</i>	<i>PV</i>
1980	\$8.00	\$35.51	\$27.51	\$13.20	\$11.53
1981	\$8.80	\$36.26	\$27.46	\$13.18	\$10.05
1982	\$9.68	\$37.07	\$27.39	\$13.15	\$8.76
1983	\$10.65	\$37.95	\$27.30	\$13.10	\$7.62
1984	\$11.71	\$21.23	\$9.52	\$4.57	\$2.32
1985	\$12.65	\$17.50	\$4.85	\$2.33	\$1.03
1986	\$13.66	\$16.00	\$2.34	\$1.12	\$0.43
1987	\$14.75	\$14.75	\$0.00	\$0.00	\$0.00
1988	\$15.94	\$15.94	\$0.00	\$0.00	\$0.00
1989	\$17.21	\$17.21	\$0.00	\$0.00	\$0.00
<i>1980-89</i>	<i>\$123.05</i>	<i>\$249.42</i>	<i>\$126.37</i>	<i>\$60.66</i>	<i>\$41.76</i>

Lesson 4: Don't pay for buzz words

- Through time, acquirers have always found ways of justifying paying for premiums over estimated value by using buzz words - synergy in the 1980s, strategic considerations in the 1990s and real options in this decade.
- While all of these can have value, the onus should be on those pushing for the acquisitions to show that they do and not on those pushing against them to show that they do not.

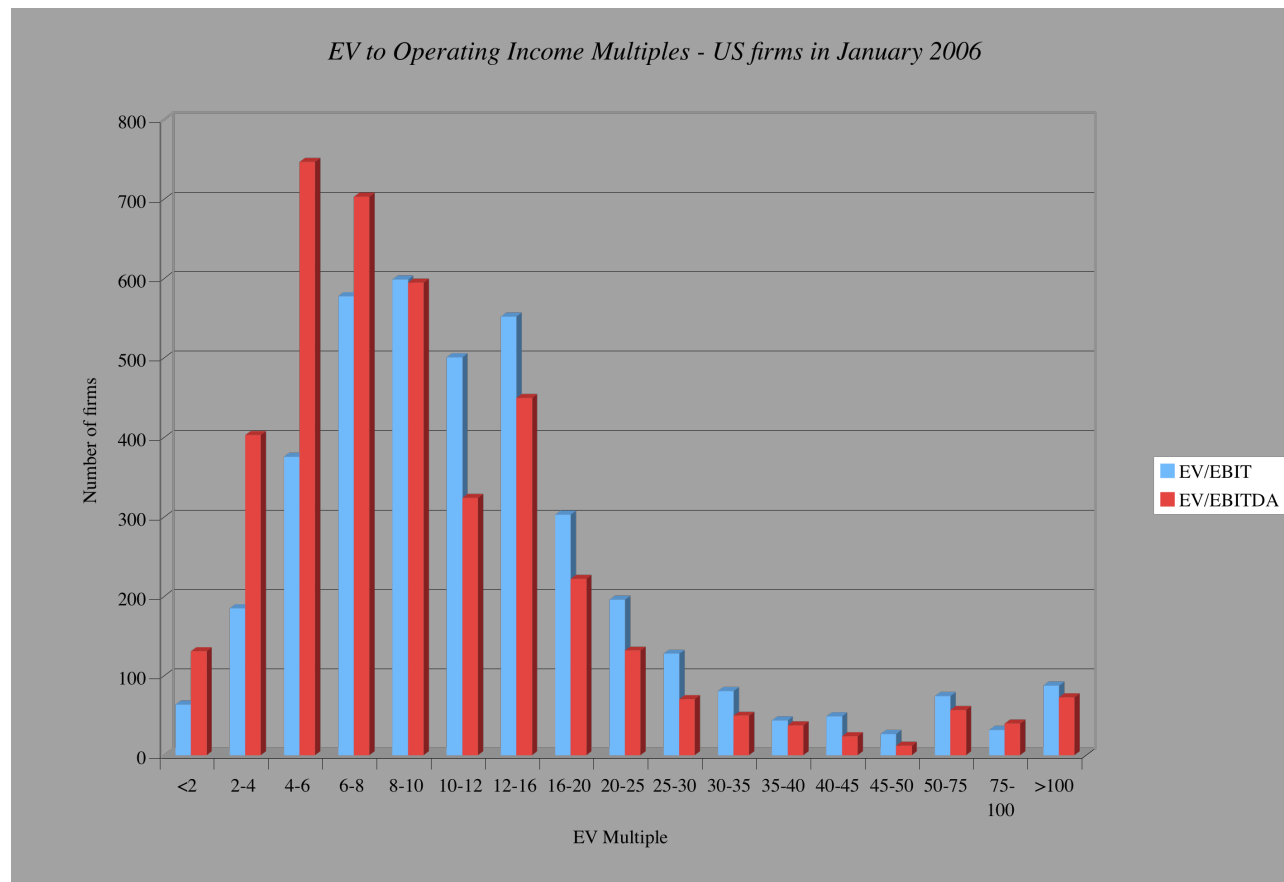
Test 5: Comparables and Exit Multiples

- Now assume that you are told that an analysis of other acquisitions reveals that acquirers have been willing to pay 5 times EBIT.. Given that your target firm has EBIT of \$ 20 million, would you be willing to pay \$ 100 million for the acquisition?
- What if I estimate the terminal value using an exit multiple of 5 times EBIT?
- As an additional input, your investment banker tells you that the acquisition is accretive. (Your PE ratio is 20 whereas the PE ratio of the target is only 10... Therefore, you will get a jump in earnings per share after the acquisition...)

Biased samples = Poor results

- Biased samples yield biased results. Basing what you pay on what other acquirers have paid is a recipe for disaster. After all, we know that acquirer, on average, pay too much for acquisitions. By matching their prices, we risk replicating their mistakes.
- Even when we use the pricing metrics of other firms in the sector, we may be basing the prices we pay on firms that are not truly comparable.
- When we use exit multiples, we are assuming that what the market is paying for comparable companies today is what it will continue to pay in the future.

8 times EBITDA is not cheap...



Lesson 5: Don't be a lemming...

- All too often, acquisitions are justified by using one of the following two arguments:
 - Every one else in your sector is doing acquisitions. You have to do the same to survive.
 - The value of a target firm is based upon what others have paid on acquisitions, which may be much higher than what your estimate of value for the firm is.
- With the right set of comparable firms (selected to back up your story), you can justify almost any price.
- And EPS accretion is a meaningless measure. After all, buying an company with a PE lower than yours will lead mathematically to EPS accretion.

Test 6: The CEO really wants to do this...

- Now assume that you know that the CEO of the acquiring firm really, really wants to do this acquisition and that the investment bankers on both sides have produced fairness opinions that indicate that the firm is worth \$ 100 million. Would you be willing to go along?

Lesson 6: Don't let egos or investment bankers get the better of common sense...

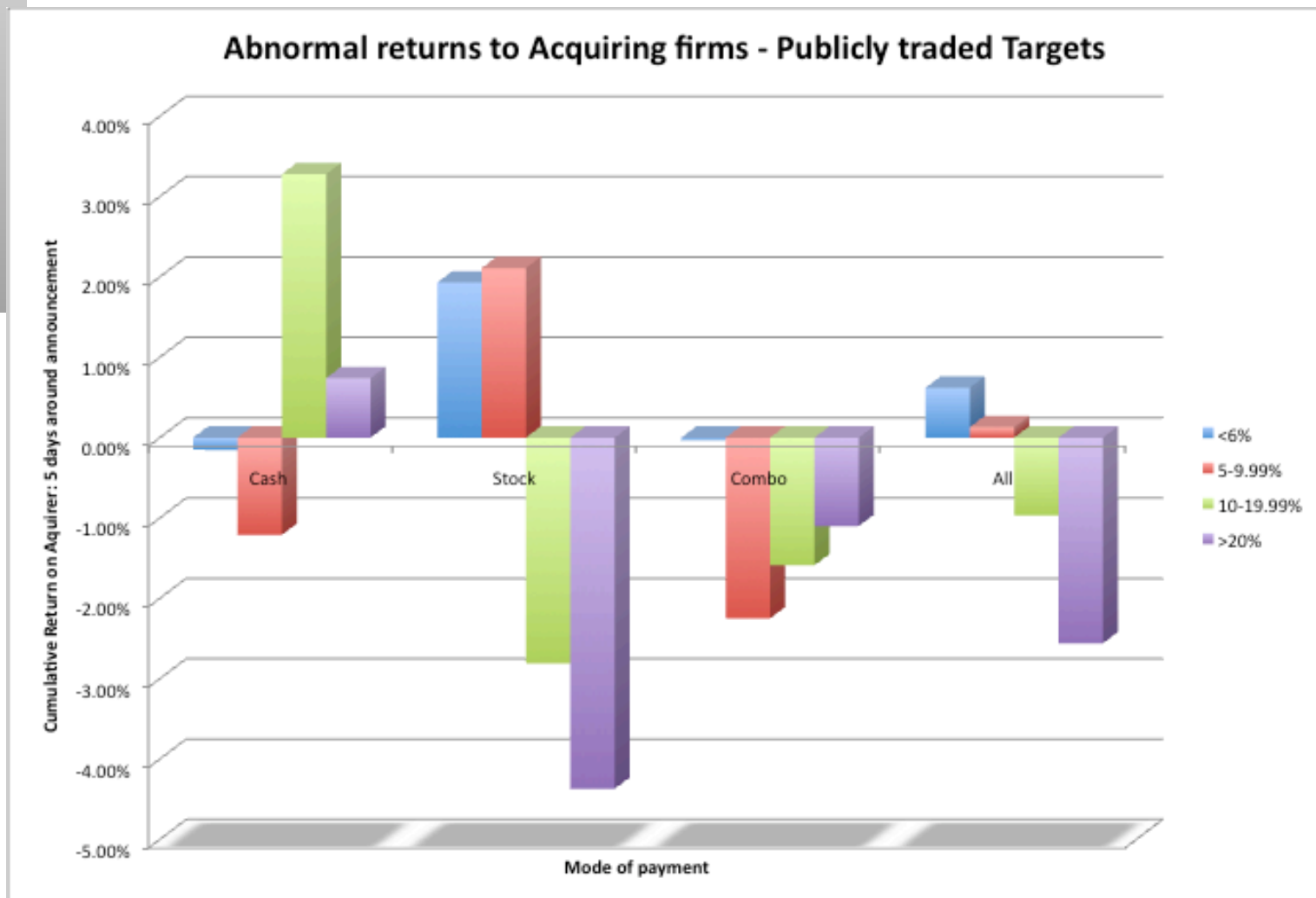
- If you define your objective in a bidding war as winning the auction at any cost, you will win. But beware the winner's curse!
- The premiums paid on acquisitions often have nothing to do with synergy, control or strategic considerations (though they may be provided as the reasons). They may just reflect the egos of the CEOs of the acquiring firms.

Test 7: Is it hopeless?

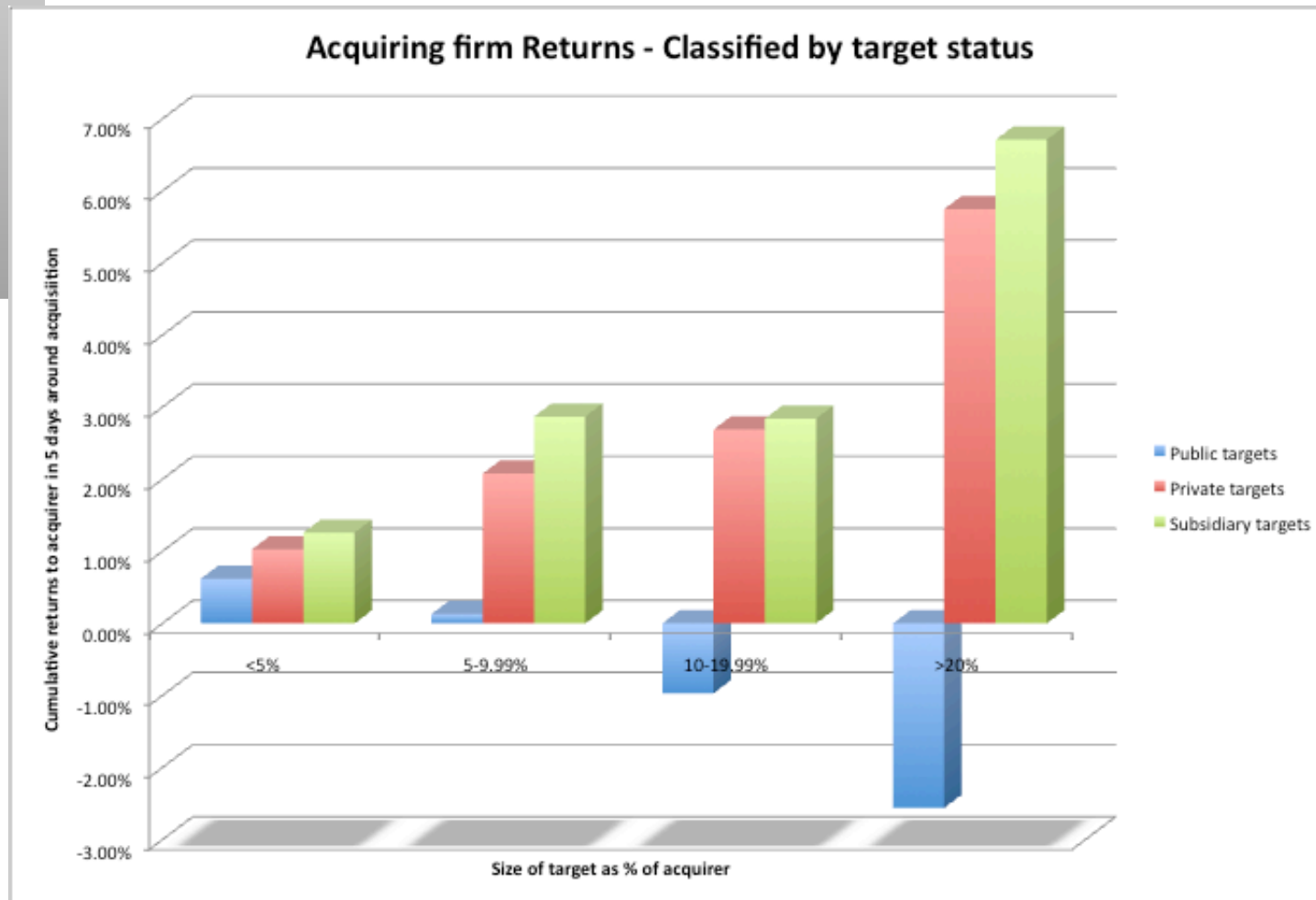
- The odds seem to be clearly weighted against success in acquisitions. If you were to create a strategy to grow, based upon acquisitions, which of the following offers your best chance of success?

This	Or this
Public target	Private target
Pay with cash	Pay with stock
Small target	Large target
Cost synergies	Growth synergies

You are better off buying small rather than large targets...
with cash rather than stock



And focusing on private firms and subsidiaries, rather than public firms...



Synergy: Odds of success

- Studies that have focused on synergies have concluded that you are far more likely to deliver cost synergies than growth synergies.
- Synergies that are concrete and planned for at the time of the merger are more likely to be delivered than fuzzy synergies.
- Synergy is much more likely to show up when someone is held responsible for delivering the synergy.
- You are more likely to get a share of the synergy gains in an acquisition when you are a single bidder than if you are one of multiple bidders.

Lesson 7: For acquisitions to create value, you have to stay disciplined..

- If you have a successful acquisition strategy, stay focused on that strategy. Don't let size or hubris drive you to "expand" the strategy.
- Realistic plans for delivering synergy and control have to be put in place before the merger is completed. By realistic, we have to mean that the magnitude of the benefits have to be reachable and not pipe dreams and that the time frame should reflect the reality that it takes a while for two organizations to work as one.
- The best thing to do in a bidding war is to drop out.
- Someone (preferably the person pushing hardest for the merger) should be held to account for delivering the benefits.
- The compensation for investment bankers and others involved in the deal should be tied to how well the deal works rather than for getting the deal done.