

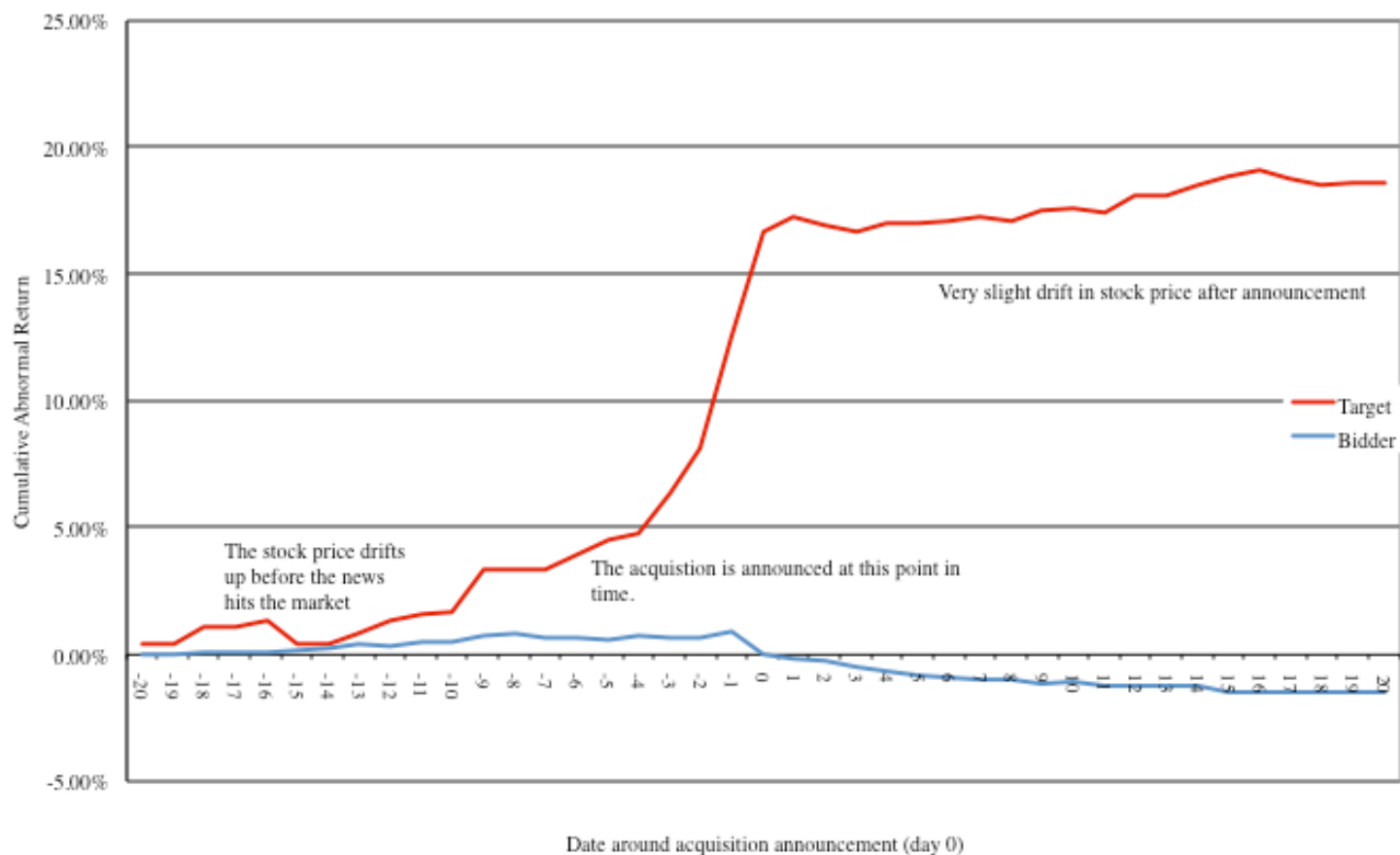


Acquirers Anonymous: Seven Steps back to Sobriety...

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

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Cumulative Returns: Target and Bidder firms in Public Acquisitions



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

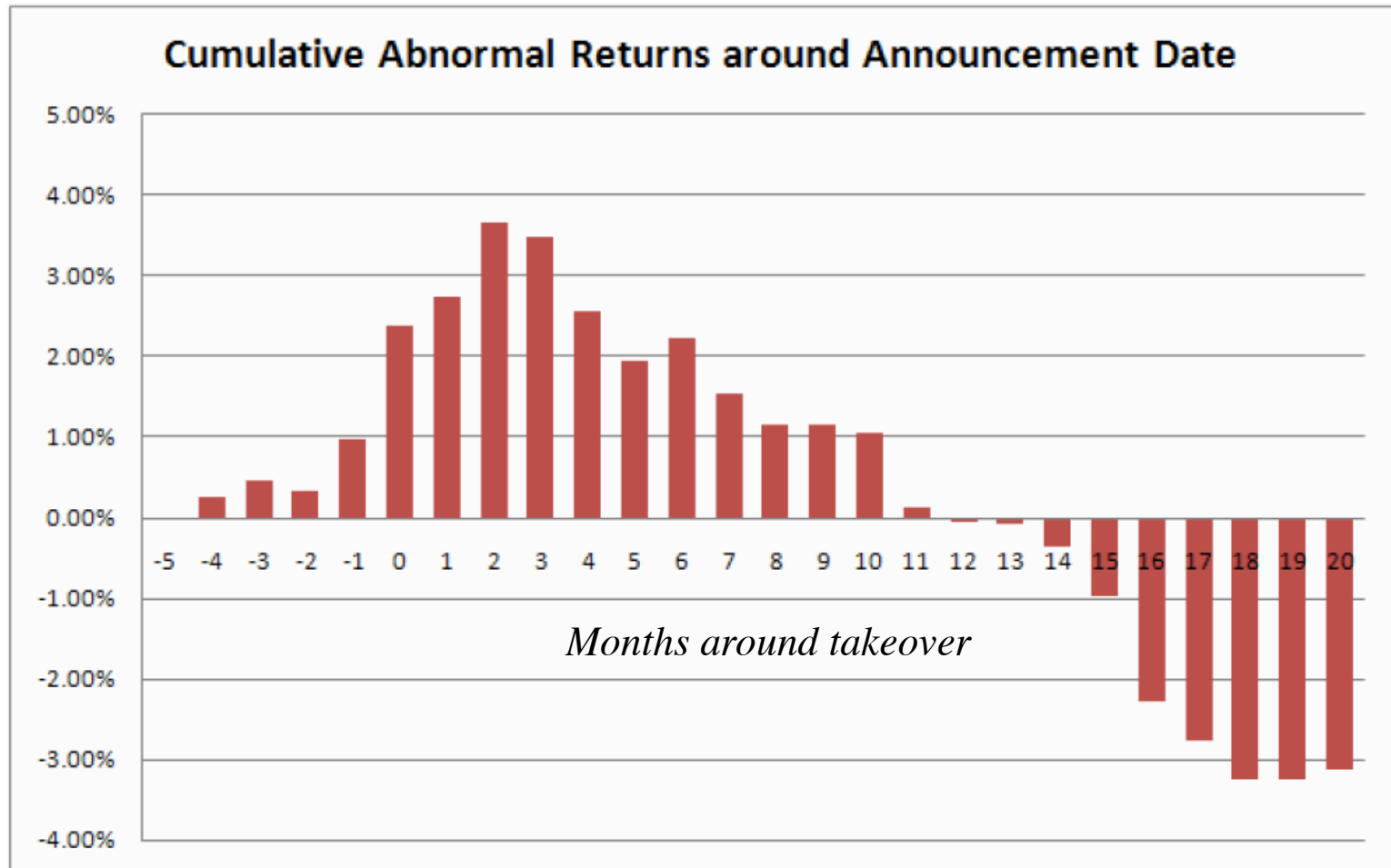
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- Managers often argue that the market is unable to see the long term benefits of mergers that they can see at the time of the deal. If they are right, mergers should create long term benefits to acquiring firms.
- The evidence does not support this hypothesis:
 - McKinsey and Co. has examined acquisition programs at companies on
 - Did the return on capital invested in acquisitions exceed the cost of capital?
 - Did the acquisitions help the parent companies outperform the competition?
 - Half of all programs failed one test, and a quarter failed both.
 - 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.
 - 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

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

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- 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...

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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

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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

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- 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...

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- 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

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- 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?

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- 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..

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- 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

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- 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?

Lesson 3: Beware of rules of thumb...

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- 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....

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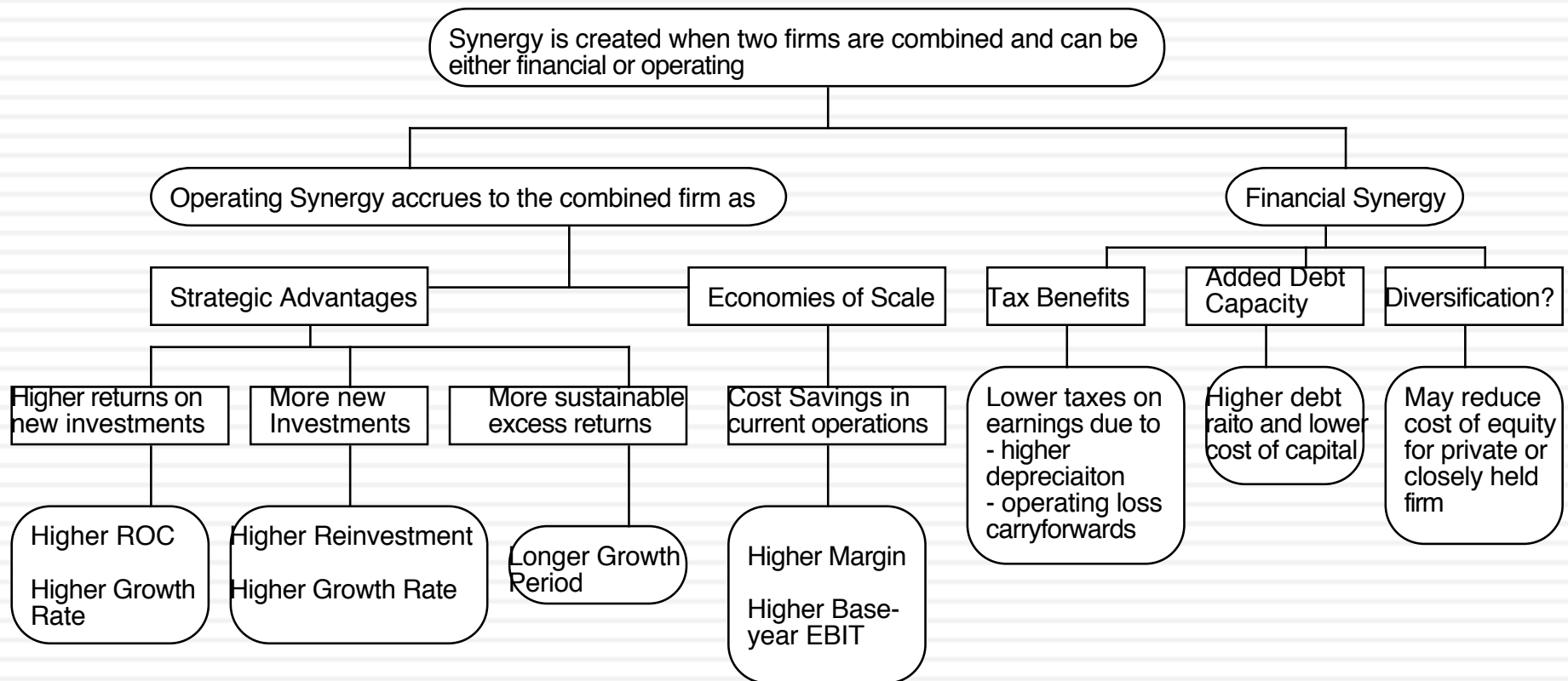
- Assume that you are told that the combined firm will be less risky than the two individual firms and that it should have a lower cost of capital (and a higher value). Is this likely?

- 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

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Valuing Synergy

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- (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.

$$\text{Value of Synergy} = \text{Value of the combined firm, with synergy} - \text{Value of the combined firm, without synergy}$$

Synergy - Example 1

Higher growth and cost savings

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	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?

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- Assume that you are Best Buy, 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 Buy 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?