Using Shareholder Value Analysis for Acquisitions

We are pleased to bring to you the latest in our Executive Insights newsletter series. Through our work in implementing shareholder value at companies around the world, we often come across applications that are of particular interest to executives and managers.

In this issue, we explore the application of shareholder value analysis to acquisitions. It follows that, as instrumental as shareholder value is in objectively valuing internal strategies, it is also extremely useful in valuing potential acquisition transactions for both bidders and sellers. Without this data-based, fact-driven profile of the acquisition, companies often fall victim to faulty analysis or emotionally driven deals. Both deplete value for their shareholders. In this article, we discuss the four “acquisition pitfalls” and how to avoid them, as well as how to use the shareholder value approach to be sure your acquisition strategy is sound.

In addition to our shareholder value experience, L.E.K.’s expertise derives from our extensive global M&A practice. Over the last five years, we have worked on over 300 M&A transactions ranging in size from $10 million to over $10 billion. Our clients include major corporations, financial buyers, and governments looking to privatize their resources. We have been actively involved in the M&A market since 1986, and our experience has shown that the shareholder value approach to acquisitions is quite simply the best evaluator of potential deals.

It is widely accepted that most acquisitions fail to create shareholder value. In our experience, this occurs for one or more of the following four reasons:

- Wrong Strategy
- Wrong Information
- Wrong Price
- Wrong Implementation Plan

Fortunately, the shareholder value approach enables companies to avoid all of these pitfalls.

The shareholder value approach is the most effective method for both the buyer and the seller to determine the value of a company, as well as the value created by a potential transaction. In addition, it clarifies whether or not the transaction is strategically sound and dictates what information is required to make an informed choice. The shareholder value approach determines the likely price range during negotiations, where the price might settle, and the value captured by each party. With this information, both the buyer and the seller enter negotiations with a richer understanding of an appropriate deal price, and conduct negotiations with a better chance of creating value for their shareholders. Acquisitions create value when the value of the businesses combined is greater than the sum of their stand-alone values. The amount by which

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the combined value exceeds the individual values is commonly referred to as the value of synergies, or simply “synergies.” If synergies are not significant, there is a good chance that the parties involved are employing the wrong strategy, the first pitfall.

Synergies represent increases in value to both the target and the buyer, and arise from many sources, including:

- Access to new markets, production capacity, distribution channels, knowledge or technologies
- Economies of scale
- Elimination of duplicate costs
- Defensive synergies (the value associated with not allowing a competitor to complete the transaction)

Whenever synergies exist, the target company is worth more to a potential bidder than to its current shareholders. This creates an opportunity for both the buyer and seller to create value by striking a deal at a price somewhere between the values to each party. The range of prices is referred to here as the negotiating range.

The stand-alone value of the target plus the anticipated synergies to both the buyer and target set the upper end of the negotiating range. This represents the buyer’s walk-away price; above this price the buyer is paying more for the target than it is worth to his shareholders, and therefore is destroying shareholder value.

Therefore, determining the correct acquisition price involves using the shareholder value approach to define the negotiating range and to estimate the division of synergy values between the buyer’s and seller’s shareholders. This avoids the third pitfall – wrong price – provides a road map for achieving synergies, and aids in preventing the stand-alone fourth pitfall – wrong implementation plan.

1. The buyer’s walk-away price should actually be lower, because at this price the buyer still has to realize all of the synergies in order to break even on the transaction. Some financial reward is usually expected to incent the buyer to create the synergies and bear the risk that might not be realized. We will discuss how to use scenario analysis to estimate this financial reward later in this newsletter.
Defining the Negotiating Range

Again, the target’s value as a stand-alone entity determines the low end of the negotiating range. For public companies, this can be estimated by multiplying the target’s current stock price by the number of outstanding shares, and then adding the value of debt. This calculation results in a value that incorporates the market’s expectations of the target’s future performance.

If the market expects that the company will continue to operate as a stand-alone entity, this is a quick and economically reliable way to estimate the target’s stand-alone value. However, if the market expects that the company will be acquired, there may be an “acquisition premium” built into its price. This premium reflects the market’s assessment of both the probability of a deal and the potential synergies that the deal will create. Adding estimated synergies to this overstated stand-alone value can result in double-counting synergies and overpaying for the target.

To avoid this, a recent date must be identified when the market first became aware of the potential for a transaction (e.g., the date information about a potential deal leaked to the market), and the target’s stock price just before that date should be used to estimate its stand-alone value.

An even more effective method to estimate the stand-alone value of a target is to use shareholder value. This involves estimating the target company’s value drivers and cash flows, and employing the generally accepted and well-proven discounted cash flow approach to calculate value. High-quality value driver analysis prevents companies from falling prey to the second pitfall of acquisitions – wrong information.

To estimate the upper end of the negotiating range, the value of synergies has to be added to the target’s stand-alone value. Synergy values can be estimated by analyzing each synergy’s impact on a firm’s value drivers and rerunning the shareholder value calculation.

2. Asset-based approaches are sometimes used to estimate stand-alone values. However, be aware that such models implicitly assume that the target firm is worth more dead than alive. Whenever the best strategy for the stand-alone firm is anything other than ceasing operations, selling off all assets and retiring liabilities, asset-based approaches can underestimate the target’s stand-alone value.

3. Comparable multiple and transaction models are sometimes used to estimate the target’s value including synergies. While these approaches can be useful for estimating expected prices by targets, they can lead bidders to overpay. Both approaches implicitly assume that the bidder can achieve the same average value of synergies as was expected from historical transactions. In other words, this approach relies on the ability of previous buyers and sellers to correctly assess value.
Once synergies are estimated, their expected values are summed to estimate the total value of synergies arising from a transaction.

While this is easily said, identifying and quantifying synergies often requires extensive interviews with key managers, analysis of company and peer group data, and comprehensive financial modeling. However, buyers often are too optimistic about the timing and magnitude of synergies to consider these factors, resulting in an inappropriately high walk-away price.

This can be avoided by contacting the people actually involved in the creation of each synergy and reaffirming that they are truly able and motivated. Affirming key managers’ buy-in to achieve the synergies before the transaction and linking their compensation to the results is the best way to ensure that synergies will actually be realized.

Finally, it is important to estimate the costs associated with, and timing required to, realize each synergy. All synergies are not created equal. Typically it is easier to achieve cost synergies (head count reductions, supplier consolidation) than revenue synergies (cross-selling, bundling).

Utilizing Scenario Analysis

Another useful tool in defining the negotiating range is scenario analysis. To apply scenario analysis, possible events that could favorably or unfavorably impact the target’s value must be identified (a competitor enters or leaves the industry), and then the probability of their occurrence must be assessed. Key managers and industry experts are often good sources for this information. Next, the impact of each scenario on the target and synergy value drivers must be estimated, and shareholder values associated with each scenario must be calculated.

As more and more scenario values are calculated, one develops what is known as a “value probability distribution,” which reflects the best understanding of the uncertainty in the target’s value. This value probability distribution illustrates the range of values the target could achieve, and the estimated probability that it will assume each value. Considering this range in negotiations is far better than hoping that all possible conditions were taken into account and captured in a single final target price.

4. Computer programs can facilitate this process by employing a type of Monte Carlo analysis known as “simulation analysis.”
This analysis helps buyers avoid overbidding, allowing them to set their walk-away prices according to the probability of actually creating value at that price. For example, these distributions can answer questions such as, “If we pay $X for Target Y, what is the probability that we will end up creating value?”

In addition, this analysis serves as a road map or prioritization for the post-acquisition integration process. While many companies take a “wait and see” approach to integration, the best method is a “full speed ahead” approach in order to capture synergies. The scenarios or sensitivities that create the most value must be the highest priority in the 90 days post acquisition. If most of the value is in cross-selling products to the target company’s customers, the focus must be on marketing and sales, while the synchronization of the information systems departments can wait.

The combination of scenario analysis and the shareholder value approach has two other important applications. First, the above question can be turned around to ask, “If the seller wants a price of $X, what do we have to believe in terms of synergies in order to create value?” The question can then be answered in concrete, value-driver terms (revenue growth rates of 10% and/or operating margin improvements of 5%). This tool is particularly useful when constructing contingency-based deals such as those in which drivers form the payout formula. Management can then more easily assess the probability of these operating improvements actually occurring. Unless the proposed acquisition is a blockbuster, buyers must be leery of value-driver forecasts that have never been achieved in the history of the industry by any competitor – industry dynamics limit business performance.

An instructive example here is Quaker Oats’ acquisition of Snapple from Thomas H. Lee Company for $1.7 billion. While it would have been difficult to predict the $1.4 billion write-off that Quaker Oats recently took on the disposal of Snapple, shareholder value analysis would have revealed the extremely high levels of sales growth, cost reductions and other synergies implied by the original acquisition price. For example, in 1994, when Quaker purchased Snapple, its operating profit margins were 16% and revenues had increased by $182 million over the previous year. In order to justify a purchase price of $1.7 billion, Snapple would have needed to experience one of the following combinations of sales growth and profitability:
Even if Snapple’s profit margins doubled to 32% because of operational synergies with Quaker Oats, revenues would still have needed to increase an average of $170 million annually for each of five years to justify a $1.7 billion purchase price. Clearly, this forecast was extremely optimistic, and the Snapple acquisition would have been difficult to justify from a shareholder value perspective.

Second, a buyer can apply value driver analysis to other bidders to determine their likely walk-away price. This is particularly useful in auction situations in which a great deal of effort is sometimes consumed chasing a deal that has a low probability of occurring. The buyer must simply ask how likely a competing bidder is to achieve the same value-driver enhancements that he is trying to achieve.

We utilized this approach recently when conducting analysis for a major buyout fund. It indicated that post-acquisition, even after taking into account a significant increase in leverage, the new management would have to increase revenues by 20% per annum simply to offset the cost synergies of a competing industrial bidder. Our client bowed out, and the deal was struck 30% above what would have been their walk-away price. They put their time and money to use in higher-value-adding activities.

Estimating How Synergy Values Will Be Divided Between the Buyer’s and Seller’s Shareholders

The empirical research on the issue of dividing synergies between the buyer’s and seller’s shareholders is not reassuring to buyers. On average, much of the synergy value ends up going to the seller’s shareholders. This result is especially ironic, since buyers usually initiate acquisition transactions and shoulder the burden of achieving the synergies.

The figures are even more stark for multiple-bidder transactions, in which the same study finds average returns to target shareholders approached 45%. To understand why this happens, one must examine the bidding environment. If there is only one bidder for a target company, allocation of synergies is usually based on the amount of synergy creation “due” to each party, their options for achieving similar synergies outside the transaction, and each party’s negotiation skills.

5. This and similar studies look at buyer and target stock prices around the date of transaction announcements to assess the market’s view of the deal’s value creation potential to each party. If the buyer’s stock price went up, the inference is that the market believed the target was worth more than the buyer paid for it. If the buyer’s stock price went down, the market signaled the belief that the buyer overpaid.
However, when there is more than one bidder, the negotiation dynamics often shift in favor of the seller. For example, assume that we have two bidders for a target company and Bidder B can achieve slightly greater synergies with the target than Bidder A. If Bidder A offers a price anywhere below its walk-away price, it will be to Bidder B’s advantage to place a higher bid. Assuming both bidders are rational, the bidding will continue until Bidder B bids a price that is slightly higher than Bidder A’s walk-away price. At that price, Bidder A ceases bidding and the deal is struck.

Notice that the only synergies that Bidder B can retain for its shareholders are the unique synergies that it can create with the target company. All the synergies that are common to both Bidder A and B end up going to the target’s shareholders. Thus, the majority of synergy value ends up going to targets, because most acquisition synergies can be realized by more than one bidder.

This reflects the basic shareholder value principle of finding the highest-valued use for all assets. If the buyer cannot answer the question, “Why is this target worth more to us than to any other bidder?” then, in a competitive bidding environment, he will either be outbid by someone who can answer the question, or pay a price that transfers most of the synergy value to the seller.

Therefore, the best way to estimate how synergy values will be divided between the buyer’s and seller’s shareholders is to identify and value the unique synergies that the buyer can create with the target, using the shareholder value approach.

**Summary**

Employing the shareholder value approach will enable companies involved in M&A to execute transactions with the following characteristics:

- Right Strategy
- Right Information
- Right Price
- Right Implementation Plan

This, in turn, will ensure that the deal will create value for shareholders.
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