Valuing Acquisitions[*]

1. Firms usually make acquisitions to create value for their shareholders. To do so, they must improve the target company's performance by more than the value of the premium that they paid. Empirical evidence shows that value is usually created for the target's shareholders (i.e., because they are paid a premium), but this is usually not the case for the acquirer's shareholders.

   The value created for the acquirer can be summarized in the following way;

   Value for acquirer = (Stand alone value of target + Value of performance improvements)
   – (Market value of target + Acquisition Premium)

   - The stand alone value of the target is the intrinsic value of the target as a stand-alone company run by its former management team
   - the value of performance improvements are the improvements that will be realized when the acquirer's management team takes over (this will usually show up as improvements in cash flows)
   - in the case where the stand-alone value of the target equals its market value, the value created for the acquirer will be equal to the difference between the value of performance improvements and the acquisition premium.

2. The following strategic rationales for acquisitions typically create value, according to McKinsey & Company:
   - improve the performance of the company
   - consolidate to remove excess capacity from an industry
   - create market access for the target's (or in some cases, the acquirer's) products
   - acquire skills or technologies more quickly or at lower cost than they can be built in-house
   - pick winners early and help them develop their business

   It is more difficult to create value from the following acquisition strategies:

   - roll-up strategy[1]
   - consolidate to improve competitive behavior
   - enter into a transformational merger
   - buy cheap

[*] *Sources*: Damodaran, Investment Valuation, 2nd ed.
McKinsey & Company, Koller, Goedhardt, and Wessels, *Valuation: Measuring and managing the value of companies, 5th ed.*

[1] According to Wikipedia, a roll-up is "a technique used by investors (commonly private equity firms) where multiple small companies in the same market are acquired and merged".

3. Valuing the acquisition

The valuation of an acquisition is not fundamentally different from the valuation of any firm, although the existence of control and synergy premiums introduces some complexity into the valuation process. For the acquisition to create value, the value of the combined firm must be greater than the sum of the standalone values of the target and acquirer.

- The first step is to value the target and acquirer as standalone firms. We can apply the same DCF techniques that we use to value companies.

- Valuing synergies
  A common reason often cited in M&As is improvements in operating performance (i.e., synergies). When valuing synergies, we need to answer two questions:

  What form is the synergy expected to take?
  Operating synergies often take the form of cost savings or revenue enhancements, for the combined firm. Cost savings can come from many sources: R&D, procurement, manufacturing, sales and marketing, distribution, and administration. Cost savings typically manifests itself through higher operating margins. Revenue enhancements can come from increased market share (higher growth), or longer high growth period. McKinsey & Company find that companies are better at estimating cost savings than revenue enhancements.

  Financial synergies can come from an increase in debt capacity, tax benefits, and mergers between firms with excess cash (low growth opportunities) and high growth firms that are cash poor.

  When will the synergy start affecting cash flows?
  Synergies usually take time to materialize. Since we are taking the present value of synergies, the longer it takes for it to show up, the smaller is the value.

- Valuing control
  Acquiring poorly managed firms and removing incumbent management, or at least changing existing management policy or practices, should make these firms more valuable, allowing the acquirer to claim the increase in value. The increase in value is what is often called the value of control.

  The value of controlling a firm comes from changes made to existing management policy that can increase the firm value. Assets can be acquired or liquidated, the financing mix can be changed and dividend policy reevaluated, and the firm can be restructured to maximize value.