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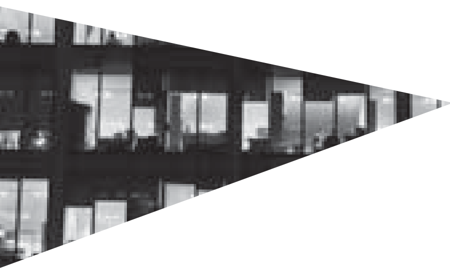
Capital Agenda Insights



How much synergy do you need?

Boardroom issues

- Will the deal truly create value, providing a net present value (NPV) that is significant compared to the investment?
- Have the assumptions underlying the deal model been adequately tested, including synergies, dis-synergies, business disruption and integration costs?
- Is management prepared to deliver the synergies with a well-planned integration program?

The CEO tells the board, "This acquisition will be accretive to earnings per share in the first year." If true, is that enough to justify the deal? The short answer is: no. In some cases, an accretive deal can actually reduce shareholder value.

The board should ask a more challenging and important question: Will the acquisition create enough new value to overcome the acquisition premium, dis-synergies, business disruption and integration costs? New value is created through synergies, which are changes made by the buyer so that the acquisition target is worth more than it was in the seller's hands.

How large must synergies be to justify a deal? Larger than you might expect. Synergy targets often must exceed 30% to 80% of the purchase price. On a $1 billion deal, the present value of cost and revenue synergies may need to total $300 to $800 million. This article explains how to determine if expected synergies are sufficient for deal success.

What's wrong with accretion?

Earnings are an important contributor to value, but a deal's harm to the balance sheet can more than offset the value of increased earnings. Of course you want to see earnings per share increase, but not if your share price ultimately drops. If your company has access to cheap currency (a low cost of borrowing or a high stock price), it is easy to do an accretive deal. However, your cheap currency doesn't change the market value of the target, and the target may not be the best use of your resources. If you overpay for a target, your share price may suffer even if your earnings per share get a near-term bump. This is a result of reduced earnings growth prospects from committing resources to the wrong investment. (See sidebar, *Why is earnings-per-share accretion not a proxy for value creation?*)

So how do you evaluate the deal?

Start by acknowledging that you will pay too much! Well, not really too much, but you will win the bid only by paying more than the target is worth to anyone else. Furthermore, acknowledge that you will spend additional time and resources to integrate or improve the target. Finally, acknowledge that the integration will be disruptive to both your company and the target, costing you yet more.

So how do you start in the hole from a value perspective and end up with a positive NPV? You must create a lot of value through synergies. Synergies, broadly speaking, include any value the buyer will bring to the target. That includes increased growth opportunities (known as revenue synergies) and reduction of costs, working capital and fixed capital.

EY

Building a better working world

The chart below shows that the synergy target is the sum of the acquisition premium, various costs and an NPV target. Stating all numbers in present value allows them to be simply added within the chart. The chart's values are illustrative but not unusual.

In spite of paying a premium and then investing more on integration, the acquirer should be worth more after the deal than it was before the deal. Many acquirers, therefore, will set an NPV target with sufficient safety margin to protect against valuation mistakes or integration problems. You should be careful, however, to avoid double-counting risk by padding the NPV target and also risk-adjusting the discount rate. Setting the NPV target too high may cause you to walk away from a good deal.

Even though deal models usually include the items in the chart, it is useful to draw the chart for each deal. It helps provide an intuitive understanding of the deal's economics and, therefore, helps prioritize due diligence efforts. The chart is not a replacement for a discounted cash flow analysis; rather, it is a visual presentation of a discounted cash flow analysis.

Drawing the chart from the perspective of other potential buyers can provide the acquirer with insight as to how much the competition may be willing to pay for the target. Synergies and costs may differ widely among bidders, especially where there is a mix of strategic and financial bidders.

Costs to consider

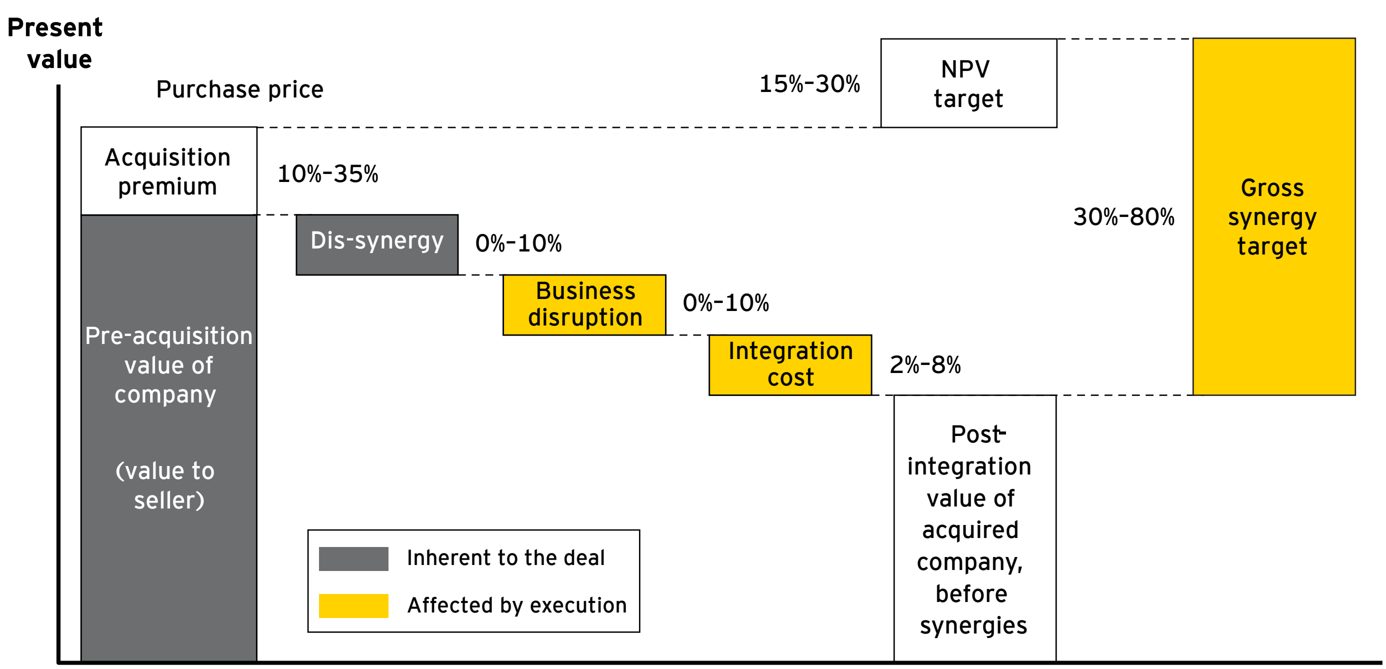
There are three cost categories shown in the chart that detract from value:

Dis-synergy means that some of the target's value will be lost in the hands of the acquirer. Some examples:

- If the buyer has richer employee benefits than the target, costs may rise if it is necessary to align benefits.
- The deal may be subject to employee collective bargaining agreements, which could raise compensation costs.
- If the target is a supplier to the acquirer's competitors, the target may lose customers.
- If the target is being carved out from a larger company, the target may have enjoyed an internal customer or advantaged sources of supply that will be unavailable to the buyer.
- Regulators may force the sale of some assets based on anti-trust considerations.

Business disruption results from a poorly run integration. Managers may be distracted by integration activities, losing focus on the day-to-day running of the business. Integration mistakes may lead to mishandled customer orders. Inattention to employee concerns

Acquisition value analysis



Note: Values are all shown as percent of purchase price for consistency. Acquisition premiums are traditionally shown as percent of pre-acquisition value. 10% to 35% of purchase price is equivalent to 11% to 54% of pre-acquisition value. Value ranges are typical, although actual values are sometimes outside these ranges. For computation of minimum synergy level (30% to 80%), not all values were assumed high or low simultaneously. The values are intended to be illustrative, as actual values must be estimated for any specific deal based on the circumstances of that deal.

may increase attrition of critical talent. Unlike dis-synergies, these costs are not inherent to the deal itself: they may be avoided with a carefully planned and managed integration. While it is difficult to model costs that should not exist, any large risk that can be anticipated should be considered for inclusion in the deal model. For example, if the integration plan calls for relocation of the target's headquarters' staff to another city, critical sales executives or research and development staff may leave. It may be appropriate to model a temporary reduction in the sales pipeline close rate or a delay in new product releases.

Integration cost is the investment that will be made to merge the companies. Some integration cost is unrelated to synergy achievement and is not discretionary, such as merging financial reporting processes. Similarly, in the case of a buying a carved-out business from another organization, it may be necessary to replace missing business functions (e.g., human resources, finance, information technology). Investments made to achieve synergies are discretionary, such as merging of information systems or severance of redundant work forces. Even where investments are made to achieve synergies, it is informative to show these costs separately from the related synergies. Showing synergies net of costs hides the true investment, which is important if the synergy does not work out as intended. For example, relocating a warehouse may reduce distribution costs, but losing a major customer may reduce the savings.

Why is earnings-per-share accretion not a proxy for value creation?

A bad deal can lower earnings growth prospects or raise the acquirer's cost of capital, even if earnings per share increase in the near term. Even without synergy, a deal will be accretive in these three scenarios:

1. The acquirer pays for the target with stock, and the price-to-earnings ratio of the acquirer is higher than that of the target.
2. The acquirer pays with borrowed cash, and the target's earnings are greater than the acquirer's cost of borrowing.
3. The acquirer pays with cash on hand, and the target's earnings are greater than the interest earned on the cash.

Value should be measured with a discounted cash flow analysis, using an appropriate discount rate that is not simply a function of the buyer's cost of capital. The discount rate should reflect the risks of the target's business, industry and geography. Because a seemingly small change in discount rate may have a large effect on the valuation, significant attention should be paid to selecting the appropriate rate.

Adding it all up

Adding up the chart's values suggests that gross synergy targets (not net of the three cost categories) often must be 30% to 80% of purchase price to justify a deal. Net of costs, the synergy range would be 25% to 65% of purchase price. Remember that a deal may be accretive to earnings per share with no net synergies and a positive acquisition premium. However, such a deal would be destructive to shareholder value, as the NPV would be negative.

Asking the right questions

The "Acquisition value analysis" chart provides insight into the economics of a deal. After plotting values from the deal model, the deal team must consider which numbers are most likely to be wrong. Synergy and cost estimates are based on assumptions that are often difficult to evaluate before a deal is done and, therefore, have wider margins of error than the value of target's base business.

In spite of the larger unknowns in the synergies and costs, due diligence activities are traditionally focused on understanding the target being acquired. The wide ranges on the chart illustrate the importance of a broader due diligence effort to validate assumptions about the synergies and costs of integration. More thorough due diligence may allow for less safety margin in the NPV target, improving the odds of winning the bid.

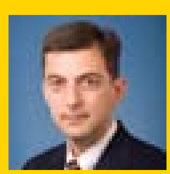
Even if the target's value and synergies are well estimated at the time of the deal, events after the deal's close can change the outcome. A well-run integration is needed to maximize synergies, minimize integration costs and avoid business disruption. Achieving the promise of the deal requires a focused effort by professionals experienced in integration. The board needs to ask how management will ensure a successful integration.

In summary, a deal needs to be justified on value, which is much more than earnings-per-share accretion. The board should ask several critical questions, and management should prepare for the questions before they are asked. These questions include the following:

1. Will the deal truly create value, providing an NPV that is significant compared to the investment?
2. Have the assumptions underlying the deal model been adequately tested, including synergies, dis-synergies, business disruption and integration costs?
3. Is management prepared to deliver the synergies with a well-planned integration program?

For a successful acquisition, management must be able to answer "Yes" to all of these questions.

Contact the author



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