

Income Tax Valuation Insights

REASONS WHY ACQUIRERS OFTEN OVERPAY IN
MERGER AND ACQUISITION TRANSACTIONS

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Analysts often use the guideline merged and acquired company method in the valuation of businesses and business interests for federal income tax planning and compliance purposes. This is because corporate taxpayers, tax lawyers, and Internal Revenue Service agents believe that “the market is the best arbiter of value.” Unfortunately, this “truism” is not always true.

Federal tax regulations indicate that various income tax deductions (e.g., charitable contributions) and transfer taxes (e.g., gift/estate taxes) should be based on the “fair market value” of the related property. This article explains why corporate acquirers often pay more than “fair market value” for mergers and acquisitions. In fact, corporate acquirers sometimes pay more than investment value, use value, or other common standards (or definitions) of value. In such cases, the empirical pricing data related to these transactions will be of little use to analysts who use the market approach—guideline merged and acquired company method—for income/gift/estate tax valuation analyses.

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INTRODUCTION

Corporate acquirers sometimes pay too much in merger and acquisition (M&A) transactions. The objective of this discussion is to identify and explain the most common reasons why acquirers overpay in pricing M&A transactions.

Before we can accomplish that objective, first, we will define what is meant by the phrase “pay too much” in a transaction. The first section of this discussion will attempt to establish objective criteria to quantitatively assess whether a buyer “paid too much” in an acquisitive transaction.

Second, we will explore the implications and ramifications of overpaying for corporate acquisitions. That is, we will consider the circumstances in which allegations of “management overpaid for the target company” are made. The discussion of the legal duty and fiduciary responsibility of corporate acquirers should be left to securities lawyers. Our discussion will focus on the valuation duty and economic responsibility of corporate acquirers not to overpay in M&A transactions.

Third, we will describe the common reasons why acquirers overpay. This discussion will be based on Willamette Management Associates’ 35 years of institutional experience providing valuation consulting, economic analysis, and financial advisory services related to M&A transactions. The list of common reasons will not be presented in order of priority.

Rather, we will list reasons that are generally common across various industries, deal sizes, and time periods.

Fourth, we will consider what lessons acquirers can learn from these historical overpayment reasons. In particular, we will consider what procedures should be included in (1) the due diligence investigation procedure or (2) in the transaction pricing and structuring procedure to mitigate the possibility of the buyer overpaying.

With the implementation of the Sarbanes-Oxley Act and the current focus on corporate governance/management responsibility, corporate acquirers should consider any reasonable procedures that will help them avoid overpaying for M&A transactions.

OBJECTIVE CRITERIA TO ASSESS IF
A BUYER “PAID TOO MUCH”

Valuation analysts often disagree on what quantitative conclusion is the fair market value of a target company. This is true even if the analysts all (1) have the same information sources available to them and (2) attempt to be as objective as possible in their valuation analyses. Less objective observations of whether a buyer paid too much for a target come from competitors of the acquirer, securities brokerage firm industry analysts, and even financial press reporters. Even without comprehensive data and objective valuation analysis, commentators will often allege that an acquirer overpaid for a target company.

Nonetheless, the important question is: are there quantitative benchmarks that will objectively assess whether an acquirer overpaid for a target company?

The answer to the above question is yes (for the most part). However, before describing these objective benchmarks/criteria (and any parenthetical reservations), it is noteworthy that paying more than “fair market value” does not equate to overpaying. It is a common misconception that paying more than the target company’s fair market value implies an overpayment. In fact, relatively few transactions are closed at the hypothetical fair market value. And, many buyers rationally and consciously pay more than fair market value in M&A transactions.

Fair market value typically implies what a hypothetical willing buyer will pay to a hypothetical willing seller for the subject business. In a fair market valuation, the willing buyer (and

the objective analyst) theoretically considers the economic benefits of target company ownership that would be available to the marketplace. The marketplace is defined as the general population of likely willing buyers.

In other words, the willing buyer would ignore any buyer-specific, post-merger synergies or economies of scale. That is because those economic benefits would not be available to the marketplace in general. So, in a fair market valuation, the buyer would project only those target company economic attributes available to all (or at least, most) buyers. However, the fair market valuation would not include any unique economic benefits created by the specific merger of the specifically identified buyer and seller.

In an actual capital market transaction, a hypothetical willing buyer does not negotiate with a hypothetical willing seller. Rather, an actual buyer negotiates with the actual seller. An actual buyer will rationally consider all of the economic benefits of the target company from the unique perspective of that specific unique buyer.

Accordingly, each buyer will estimate buyer-specific post-merger synergies, economies of scale, consolidations, transfer prices, and strategic benefits. Each specific buyer will estimate how much it can pay for the target company based on that buyer's (1) costs of capital and (2) targeted investment hurdle rate. Ultimately, each buyer considers its specific risks and expected returns when assessing how much it can afford to bid for the target company.

FAIR MARKET VALUE VERSUS INVESTMENT VALUE

In the valuation lexicon, each buyer will estimate the "investment value" or the "acquisition value" of the target company. These value indications represent what an individual buyer would be willing to offer for a target company given (1) the buyer-specific, post-merger financial projections and (2) the buyer-specific required rate of return on investment. The actual buyer's acquisition value for the target may be higher than or lower than the hypothetical buyer's fair market value for the target.

In a competitive bid for the target company, an individual buyer will likely be outbid if its acquisition price is less than fair market value. That is because other buyers will presumably bid the fair market value price or higher. In that case, the individual buyer still made a rational offer. Because of its investment hurdle rate or some other reason, that buyer could not afford

to bid the fair market value price. If that buyer had offered the fair market value price, that individual buyer would have paid too much.

In a competitive bid for the target company, the successful buyer will likely offer (1) more than the fair market value but (2) less than its individual investment value/acquisition value. The successful buyer may have to offer more than fair market value in order to outbid the pack of other bidders.

Nonetheless, the successful buyer may not need to offer all of the acquisition price that it can "afford" to pay, given its unique acquisition risk and expected return assessment. Theoretically, the successful buyer will only need to offer \$1.00 more than the next highest bidder.

Of course, in a competitive bid, each potential buyer will not know the bidding strategies of all of the other potential buyers. The successful buyer may have to offer most, if not all, of its acquisition value in order to ensure that it wins the bidding process.

However, even if the individual buyer bids all of its buyer-specific acquisition price premium (i.e., premium above fair market value), the buyer still made a rational offer. Because of its unique expected synergies or some other reason, that buyer could afford to bid the price it did. If that buyer had limited its offer to hypothetical fair market value, it would have lost its bid for the target company.

In a competitive bid for the target company, the seller will typically accept the highest offer it receives. If the initial offers are less than the hypothetical fair market value, the seller will continue to shop the target company until it attracts a buyer that can afford to pay the fair market value price.

If the seller encounters an individual buyer that bids more than fair market value, the seller will reject the fair market value offers and accept the higher, buyer-specific bid. If one buyer can afford to pay a buyer-specific price premium over the hypothetical fair market value price, the seller will accept the higher price in lieu of the fair market value offers.

OBJECTIVE PRICING CRITERIA

So, what are the "objective" benchmarks or criteria that determine how much an individual buyer can afford to offer for the target company?

First, a buyer can afford to pay a price up to the amount where the acquisition internal rate of return (IRR) equals the

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buyer's cost of capital. If the acquisition IRR equals or exceeds the buyer cost of capital, then the buyer did not overpay for the acquisition. Second, a buyer can afford to pay a price up to the amount where the acquisition net present value (NPV) equals or exceeds zero. The NPV analysis is based on the buyer company cost of capital.

Both of the above two criteria assume that the acquirer management can accurately estimate the buyer company cost of capital. And, the buyer company cost of capital should appropriately consider the risk of the investment.

In addition, both of the above two criteria assume that the acquirer management can accurately project the target company economic income generation. And, for purposes of either criteria, target company economic income is typically measured as net cash flow.

It is noteworthy that the application of the above criteria may not result in a fair market value price. Rather, the above criteria will result in the maximum price that the buyer can afford to pay for the target company. That maximum price will be buyer-specific, as compared to market-general. Typically, the buyer-specific maximum price for a target company will be greater than the target company fair market value.

IMPLICATIONS OF OVERPAYING FOR A TARGET COMPANY

There are a number of negative economic effects on a corporate acquirer that overpays for a target company acquisition. When a dissatisfied stockholder, a government regulator, or any other party asserts that an acquirer "paid too much" in an M&A transaction, it usually means that one or more of these negative economic effects has become obvious.

The following list will present 10 common economic effects of overpaying for a transaction. This list is not exhaustive. And, this list only includes economic effects. It excludes litigation, human resource, and other effects of overpaying for an acquisition.

IMPLICATION 1

Overpaying results in a reduction in the value of the buyer's stockholders' equity. For a closely held acquirer, the total value of the owners' equity will decrease. For a public acquirer, the price of the acquirer's common stock will decrease. Neither of these value decrements are recorded on the buyer's balance sheet. The decrease in the value of the buyer's equity is an economic effect. It is not recorded for financial reporting purposes.

Alternatively, if the acquisition is fairly priced, the value of the target should exactly equal the amount of cash or stock that the buyer gives up for the target. The financial accounting for a business combination is fairly complex. But, the economic accounting is fairly straightforward. The debit for "invest-

ment in acquired company" should exactly equal the credit to either "cash issued" or "stock issued."

IMPLICATION 2

Overpaying results in a dilution in the buyer's ownership interest in a merger transaction. For a closely held acquirer, the buyer's ownership percentage in the merged entity will be lower than it should be. For a public acquirer, the buyer shareholders' ownership percentage in the merged entity will be lower than it should be. These negative effects will occur on both (1) an absolute and (2) a relative (relative to the seller) ownership interest basis.

Let's assume the acquirer company value is \$300 million and the target company value is \$100 million. Based on these fair prices, the acquirer stockholders should own 75 percent of the merged company, and the target stockholders should own 25 percent of the merged company.

Next, let's assume the acquirer pays \$150 million for the target (i.e., overpays by \$50 million). In the overpayment scenario, the acquirer stockholders will only receive 66.7 percent of the merged company, and the target stockholders will receive 33.3 percent of the merged company.

IMPLICATION 3

Overpaying results in a reduction of the buyer's cash and credit resources available to make more economically sound investments. In the previous example, we assumed that the acquirer overpaid for the target by \$50 million. In such a scenario, the acquirer would no longer have \$50 million to spend on (1) fairly priced acquisitions, (2) capital investment projects, (3) research and development activities, (4) marketing programs, (5) stock redemption payments, and so forth.

Presumably, all of these forgone investments (whether capital expenditures or operating expenses) would have been more economically sound than the overpayment for the target company. For purposes of this discussion, the term economically sound means earning an expected IRR greater than the investment-risk-adjusted cost of capital.

In the above example, once the \$50 million overpayment is made, it is not available to make alternative investments. And, this is true whether the \$50 million was paid from cash reserves or from the acquirer's finite debt capacity.

IMPLICATION 4

Overpaying results in increasing the buyer's cost of capital. This economic effect occurs for several reasons. First, the buyer's cost of debt capital increases. This is an indirect result of implication 3. That is, as the buyer overpays for the target, the buyer will have to use more debt capital. As the buyer's use of debt increases (beyond a certain point), the buyer's cost of debt increases.

Second, as the buyer uses more debt (beyond a certain point), the banks/bondholders will require the buyer to invest more equity capital into the transaction financing.

Third, as the buyer's use of debt and cost of debt increases, equity holders will require a higher return on their riskier investment. All of these factors contribute to increasing the buyer's weighted average cost of capital (WACC).

As the buyer's WACC increases, the excess expected returns on the target acquisition decrease. And, with a higher WACC, otherwise marginal acquisition or capital investments will fall below the buyer's investment hurdle rate. This will reduce the future growth opportunities for the buyer.

IMPLICATION 5

Overpaying may expose the buyer management to allegations of (1) inefficient stewardship of corporate assets and (2) inadequate corporate governance procedures. For public company buyers, overpaying may expose management to enhanced scrutiny related to the Sarbanes-Oxley Act.

In order to respond to such allegations, buyer management will have to (1) devote time and effort, (2) dedicate corporate resources, and (3) incur legal, public/investor relations, and other fees. Even if any investigations prove that the allegations were baseless, the buyer company will have spent corporate resources that could have been utilized elsewhere.

In addition, even if allegations of poor corporate stewardship/governance are proved untrue, the buyer company management reputation may remain tainted in the capital markets community.

IMPLICATION 6

Overpaying may expose buyer management to shareholder class action litigation related to (1) claims of dissipation of value or (2) other allegations. Both public company and private company buyer managements may be subject to this litigation risk.

As discussed with regard to implication 5, even a successful defense of such allegations will require management to devote time, effort, and resources. And, such time, effort, and resources are scarce and would have to be diverted from other acquisition, capital investment, or operational management activities.

In addition, even after a successful litigation defense, the buyer company and the buyer company management may have tainted reputations as a result of being litigation defendants.

IMPLICATION 7

Overpaying may expose management of a closely held corporation buyer to allegations of shareholder oppression on the part of dissenting or other minority stockholders. Often, the minority stockholder complaint is that the excess purchase price should have been (1) retained in the company to increase enterprise value, (2) invested in capital investments or other growth opportunities to increase enterprise value, or (3) distributed to the stockholders as dividends.

As discussed above, the closely held corporation management will have to devote time, energy, and resources to defending against such a shareholder oppression claim. And, even a successful defense of such a litigation action results in (1) wasted/diverted resources and (2) dissatisfied stockholders.

IMPLICATION 8

Overpaying may expose the management of a not-for-profit or other Section 501(c)(3) organization to allegations of private inurement. These complaints are often made either (1) by the Internal Revenue Service or (2) by federal/state industry regulators.

With regard to the private inurement statutes, overpaying for the purchase of any assets (including an acquisition) is per se illegal. The management of the not-for-profit buyer organization does not have to benefit from the overpayment. As long as the seller was overpaid, resources were diverted from the public benefit to the private (i.e., seller's) benefit.

IMPLICATION 9

Overpaying will likely result in a loss of investor confidence. This is particularly true with regard to investors in public companies.

Stock analyst reports, industry financial analysis reports, and the general financial press disclose instances when public company managements clearly overpaid for M&A transactions. This reporting alone will tend to cause a decrease in the buyer company stock price. Unfavorable (i.e., sell) recommendations from securities analysts exacerbate (1) the loss of investor confidence and (2) the decrease in the buyer company stock price.

IMPLICATION 10

Overpaying will likely result in a decrease in the debt/bond rating of the buyer company. Again, this is particularly true with regard to buyer companies that have public debt outstanding. Bond rating services consider numerous company perfor-

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mance financial ratios, including various debt coverage ratios. Overpaying for acquisitive transactions typically causes the deterioration of these financial ratios.

The lowering of a company's bond rating has the immediate effect of increasing the company's cost of debt capital. It also has the secondary effects of (1) increasing the company's cost of equity capital and (2) increasing the company's WACC.

The above list of negative implications from overpaying is not exhaustive. The above list of negative implications is not presented in any particular order or priority. However, it does indicate that there are numerous negative consequences (both direct and indirect) of a buyer overpaying for a target company. Given these negative consequences, the next topic for discussion is: why would a corporate acquirer pay too much for an M&A target?

REASONS WHY CORPORATE ACQUIRERS OFTEN OVERPAY FOR MERGERS/ACQUISITIONS

The following discussion presents a list of ten common reasons why corporate acquirers pay too much for M&A targets. For purposes of compiling this list, "pay too much" is defined as (1) pay a total consideration greater than the target company investment/acquisition value to the buyer, given the target's expected economic benefits to the buyer or (2) pay a total consideration that will yield an investment IRR that is lower than the buyer's cost of capital/WACC.

This list is presented as a "top 10" list of reasons. This list is not comprehensive; there are many possible reasons why specific buyers pay too much, given the facts and circumstances of a particular transaction.

This list is not presented in order of frequency or priority. It represents ten common reasons why buyers pay too much, based on long-term observations of hundreds of publicly disclosed M&A transactions in dozens of industries.

REASON 1

Industry-wide consolidation pressures motivate many overpriced M&A transactions. Buyer management perceives (correctly) that competitors are making acquisitions. It may appear that only the largest competitors will survive after the industry consolidation. So, buyer management perceives (incorrectly) that it needs to make acquisitions—even overprice acquisitions—in order to be one of the survivors in the industry.

REASON 2

Stock market pricing pressures motivate many overpriced M&A transactions. The stock market often (although not with-

out exception) responds favorably to M&A announcements. This is because such announcements generally indicate growth, expansion, and investment at the buyer company.

Such announcements are often accompanied by buyer management predictions of post-deal synergies, economies of scale, market dominance, and other economic benefits. So, unless the deal is so overpriced as to be obvious to the market, the immediate effect of the buyer management's announcement of a deal is a higher buyer stock price.

REASON 3

Buyer company management often expects significant post-merger synergies and economies of scale. Based on these projections of post-merger economic income, buyer management does not believe it is overpaying for the target. However, the synergistic expectations and the corresponding financial projections often turn out to be unsupported, unfounded, and inflated. Compounding these unrealistically optimistic expectations, buyer management often underestimates post-merger integration problems and related costs.

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REASON 4

Corporate M&A analysts have to justify their existence to their buyer corporation employers. This includes "analysts" at all levels—from staff financial analysts to the most senior finance/corporate development executives. To prove their worth to the buyer (or to the board, to the stockholders, etc.), these analysts perceive that they have to find and consummate transactions. In order to consummate transactions, the analysts are willing to recommend/pay inflated prices for targets.

In the corporate hierarchy, M&A analysts want to close deals to impress senior management. Senior management wants to impress the board. And, boards seem to be impressed with managements that can get deals done.

REASON 5

Buyer companies set their M&A deal hurdle rates independent from—and below—their actual cost of capital (WACC). For example, buyer company management may decide on an M&A investment hurdle rate (IRR) of 15 percent. It may perform considerable competitive analyses and conduct extensive meetings before selecting this hurdle rate.

However, if the hurdle rate is selected independent of the buyer's cost of capital, then the selected hurdle rate will be inappropriate for M&A pricing purposes. For example, if this buyer's actual WACC is 18 percent and if management select-

ed 15 percent as the M&A hurdle rate, then the buyer may consistently overpay for transactions.

REASON 6

Buyer management often believes that it will be more operationally efficient in running the target company than seller management was. As a related issue, buyer management often believes that it can achieve a lower cost of capital than seller management could. Accordingly, based on these expectations, buyer management does not perceive that it is overpaying for the target company.

However, the seller management often is not inefficient. In fact, the seller management may be operating the target company as efficiently (and with the lowest cost of capital) as possible, given the target's industry and competitive position. Such ego-based, unreasonable expectations can cause buyers to overpay.

REASON 7

Buyer management often does not perform sufficient due diligence procedures in order to uncover all of the target company contingent liabilities, operational problems, obsolescence issues, or other company-specific risk factors. Often, the deal is announced before the buyer management has completed a rigorous due diligence investigation.

Even if the post-announcement due diligence reveals risk factors that should cause the buyer to rethink the transaction, the buyer management is often too emotionally (or professionally) committed to the transaction to call off the deal.

REASON 8

Even when buyer analysts identify target company problems during the due diligence investigation, buyer management often believes that it can "fix" the problem post-closing. This is often a case of buyer ego winning out over buyer judgment.

Typically, if the target company problem was easily solvable, seller management would have implemented a solution. Instead, what often happens is that buyer management inherits the seller management problems.

REASON 9

Both buyers and sellers often prepare unrealistically optimistic projections regarding target company results of operations. These optimistic projections, then, become the basis for the transaction pricing. While seller management projections are typically expected to be biased, buyer management projections may be even more optimistic.

The typical (but typically erroneous) assumption of many M&A analysts is that the future will be better than the past. M&A analysts may misread market/industry/economic conditions in the preparation of overly optimistic projections. This often occurs at or near the top of a business cycle (e.g., in the late 1990s). In such periods, many M&A transactions are closed at excessive prices.

REASON 10

Buyer management often relies on only one valuation approach in the transaction pricing analysis. While several analytical methods may be used in the same approach, buyers often rely exclusively on the income approach to price the offer.

Many buyers give little or no weight to market approach valuation methods in the transaction pricing analysis. And, most buyers do not even consider asset-based approach valuation methods in the M&A pricing. Accordingly, buyer management forgoes the opportunity for alternative valuation approaches (1) to provide confirmatory pricing evidence or (2) to identify an overpricing situation.

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SUMMARY AND CONCLUSION

Corporate acquirers sometimes pay too much for M&A transactions. There are objective corporate finance guidelines to determine (1) what price constitutes a reasonable (financially sound) transaction price and (2) what price qualifies as an excessive purchase price. These objective financial analysis benchmarks were discussed above.

There are numerous negative economic effects to a corporate acquirer of paying too much for an M&A transaction. Ten of the common negative implications were described above.

There are numerous reasons why corporate acquirers pay too much for M&A transactions. A "top 10" list of common reasons was presented. In order to avoid the significant economic detriments associated with overpayment, M&A analysts, buyer managements, and buyer boards should carefully consider these common reasons why acquirers pay too much when pricing acquisitive transactions. With sufficient financial analysis, due diligence, and management prudence, each of these "top 10" reasons can be avoided.

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