

## CORPORATE ACQUIRER PROCEDURES TO AVOID OVERPRICING M&A TRANSACTIONS

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### INTRODUCTION

Corporate acquirers often pay too much in merger and acquisition (M&A) transactions. For purposes of this discussion, we will define “pay too much” as:

1. pay a total consideration in excess of the target company fair market value,
2. pay a total consideration in excess of the target company intrinsic value to the acquirer (i.e., the present value of the expected post-deal economic benefits to the acquirer), or
3. pay a total consideration that will result in a transaction internal rate of return (IRR) that is less than the acquirer’s cost of capital.

By the end of 2003, the national stock market indices (including NYSE, Nasdaq, DJIA, and S&P) are slowly recovering from a three-year downturn in investor returns. At the same time that the capital markets are slowly recovering, the M&A markets are slowly rebounding—in terms of both (1) deal volume/number of transactions and (2) deal size/valuation pricing multiples. And, this rebound appears to be occurring both (1) across industry segments and (2) across deal sizes.

Accordingly, this is an opportune time for M&A market participants to (1) reflect on the overvaluation pricing mistakes of the last bull market and (2) consider developing/implementing systematic procedures to minimize the potential of overpaying for future M&A transactions. For purposes of this discussion, the term *M&A market participants* is broadly defined to include buy-side and sell-side principals, financial intermediaries and investment bankers, and debt and equity investment sources.

There are many reasons why acquirers pay too much for target companies. Some of these reasons are industry-specific or organization-specific. Some of the reasons are institutional—for example, M&A analysts and advisors are often compensated for closing the deal at the negotiated price—and not for closing the deal at the “correct” valuation. Some of the reasons are structural—for example, M&A analysts price the deal according to a predetermined investment hurdle rate (which may or may not equal the acquirer’s cost of capital).

There are human behavior explanations for why acquirers pay too much. Corporate M&A analysts want to be recognized for identifying and consummating transactions. Financial intermediaries are typically compensated only when a transaction closes, regardless of the reasonableness of the deal price.

Also, stockholders reward corporate directors and senior managers with high stock prices (and, indirectly, with substantial stock option gains) when their companies grow through acquisition. And, these high stock prices seem to result even if (1) growth through acquisition is not the optimal corporate strategy and (2) the company has overpaid for the acquisitions it has made.

After the burst of the M&A market bubble in the late 1990s, explanations for why acquirers overpay have been presented in both business and academic journals. In contrast to analyzing why acquirers have historically paid too much, this discussion will focus on procedures that assist acquirers to

not overpay in future transactions.

Instead of examining the valuation sins of the past, this discussion focuses on due diligence and pricing procedures that will result in economically sound valuations. These procedures relate to investigating, pricing, negotiating, and structuring the M&A transaction. These procedures are intended to:

1. result in a transaction price and structure that is consistent with the acquirer’s strategic and corporate finance objectives or
2. allow the acquirer to recognize and reject an overpriced transaction.

The following discussion will present a “top 10 list” of acquisition due diligence and transaction analysis procedures that assist acquirers to avoid overpricing M&A transactions. Certainly, this list is not comprehensive with respect to all transaction pricing and structuring procedures. Rather, this listing is intended to present procedures that are fundamental and yet frequently overlooked—even by experienced M&A analysts. And, the following list is not presented in any particular order of importance or priority.

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## TRANSACTION VALUATION PROCEDURES

The first five recommended procedures relate principally to M&A transaction pricing. The second five recommended procedures relate principally to M&A transaction structuring. All procedures are intended to assist acquirers to avoid overpaying for transactions.

### PROCEDURE 1. CONSIDER MULTIPLE VALUATION APPROACHES AND METHODS

Many M&A analysts are most comfortable using the income approach and, specifically, the discounted cash flow (DCF) method to value acquisition targets. The DCF method is conceptually sound and allows for a great deal of analytical rigor. This method is particularly well suited to analysis of (1) changing financial projections and (2) alternative valuation variables. For example, the DCF method allows for the estimation of both equity and enterprise value based on alternative debt service, capital structure, and rate of return assumptions.

Nonetheless, the DCF method is only one of several income approach valuation methods. And, the income approach is only one of several business valuation approaches. Analysts should consider the application of several different direct capitalization and yield capitalization methods as part of an income approach valuation analysis. Likewise, analysts should consider the application of alternative methods within the market approach and asset-based approach to business valuation.

Applying several different valuation approaches and methods allows the analyst to:

1. develop a multi-faceted perspective of the target company value,
2. triangulate a pricing conclusion within a range of values,
3. consider factors and variables that are not emphasized in the DCF method,
4. identify aberrational value indications from within a normal range of prices, and
5. quantify the sensitivity of price indications to small changes in valuation model inputs.

### PROCEDURE 2. CONSIDER THE APPLICATION OF ASSET-BASED APPROACH VALUATION METHODS

Many M&A analysts are not particularly experienced with asset-based approach business valuation methods. In the asset-based approach, the target business value is the sum of the current values of (1) financial assets (e.g., receivables, invento-

ry, investments), (2) tangible assets (e.g., real estate and personal property), (3) discrete intangible assets (e.g., patents, copyrights, trademarks, workforce), and (4) goodwill—less the current values of (1) short-term liabilities (to estimate enterprise value) and (2) long-term liabilities (to estimate equity value).

Typically, the most difficult aspects of asset-based approach methods are the (1) identification and (2) valuation of the target company's off-balance-sheet, discrete intangible assets.

The asset-based approach methods may require more analytical time and effort than income approach or market approach valuation methods. And, asset-based approach methods may require a more rigorous acquisition due diligence investigation of the target company than other valuation methods. However, the additional due diligence effort invested in performing an asset-based approach valuation analysis not only provides an additional value indication in the final pricing synthesis and conclusion. The additional due diligence effort also increases the reliability and documentation of all other valuation pricing analyses.

Since the asset-based approach requires the analyst to value all of the target company tangible and intangible assets, the valuation effectively creates a preliminary transaction purchase price allocation. This purchase price allocation can be used:

1. to consider the pro forma effect of the transaction on the acquirer financial statements and
2. to model the income tax implications of alternative transaction prices/structures.

The discrete asset valuations can be used for purposes of (1) analyzing proposed transaction financing terms and (2) identifying sale/leaseback and other creative financial structures. And, asset-based approach procedures help the M&A analyst identify/quantify contingent liabilities (e.g., taxation, litigation, regulatory, environmental, etc.) that are not explicitly considered in other business valuation approaches.

### PROCEDURE 3. QUANTIFY BOTH THE STAND-ALONE FAIR MARKET VALUE AND THE BUYER-SPECIFIC ACQUISITION VALUE OF THE TARGET

Fair market value is generally defined as the price a typically motivated willing buyer would pay and a typically motivated willing seller would accept for the subject business enterprise. This definition of value generally considers only the target economic benefits that would be available to the typical willing buyer.

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Unique buyer-specific synergies and post-merger economic benefits should be excluded from a fair market value analysis. This definition of value generally considers only the assets that the target has available to sell on a stand-alone basis. In other words, intangible assets that are created (or enhanced) only as a result of buyer actions/attributes should be excluded from a fair market value analysis.

Acquisition value (also called investment value) is generally defined as the highest price a specific buyer would be willing to pay to a specific seller for the subject business enterprise, given a buyer-specific set of investment criteria. This definition of value generally considers the total expected economic benefits of the combined acquirer/target entity.

Buyer-specific synergies and post-merger economic benefits could be included in an acquisition value analysis. Similarly, target intangible assets that are created or enhanced by the acquirer's financial/operational attributes would be included in the acquisition value analysis.

In addition, the valuation analyses would be based on buyer-specific investment criteria—for example, discount rate, direct capitalization rate, and payback period. This is true even if these buyer-specific investment criteria are not consistent with market-derived valuation pricing variables.

Typically, the buyer's acquisition value is greater than the target's stand-alone fair market value. Of course, this outcome is not a forgone conclusion. For a particular buyer (with an unusually high cost of capital, for example), its acquisition value for a target may be lower than the target company's fair market value.

Of course, in a competitive bidding situation, that buyer would never be the successful acquirer of the target. In a competitive market, that buyer could be easily outbid by the "typical" willing buyer. Accordingly, it is unlikely that a target company would ever sell for less than its stand-alone fair market value. And, rational sellers will typically sell the target company to the specific buyer that can realize unique post-merger financial, operational, or strategic synergies.

There are two reasons why M&A analysts should quantify both the fair market value and the acquisition value of the target. First, such an analysis requires the analyst to (1) identify and (2) quantify the expected merger-specific economic benefits. Second, such an analysis should help the analyst in negotiating the pricing for the transaction.

There are several reasons why an M&A analyst would want to identify/quantify specific post-merger benefits.

First, this procedure gives the analyst the opportunity to assess whether the expected post-merger benefits are reasonable. This reasonableness assessment should consider both (1)

the type of expected benefits—that is, can that type of benefit actually be realized?—and (2) the magnitude of expected benefits—that is, can that level of benefit actually be realized?

Second, quantifying the expected post-merger benefits allows the acquirer to realize how much of the proposed purchase price relates to (1) planned changes in the target's current business model versus (2) ongoing business operations from the target's current business model.

Third, delineating the expected post-merger benefits often allows the buyer to seek target/acquirer managements' pre-merger commitment to achieving the projected benefits.

There are also several ways in which an M&A analyst would use the expected post-merger benefits in the deal price and structure negotiations.

First, by simply knowing the target's stand-alone fair market value (i.e., value without buyer-specific post-merger benefits), the analyst can negotiate a final deal price that is close to that stand-alone value.

Second, the buyer typically will not be willing to pay the seller for economic benefits that will be caused by attributes that the acquirer brings to the transaction. In other words, the buyer will not want to pay a price that encompasses expected benefits that the target company could not achieve on its own.

Third, if competitive bidding causes the analyst to offer a price that includes expected post-merger benefits, that price could be realized through an earn-out provision. In other words, the terms of the purchase agreement could allow the sellers to receive periodic payments of a stated percentage of actual post-merger benefits. Through this procedure, if post-merger benefits materialize, then the seller will be paid for them (over a, say, three year earn out period). If post-merger benefits do not materialize, then the acquirer will not have to pay for them (i.e., there will be low or no earn out payments).

*“And, rational sellers will typically sell the target company to the specific buyer that can realize unique post-merger financial, operational, or strategic synergies.”*

#### **PROCEDURE 4. PERFORM A SENSITIVITY ANALYSIS OF THE IMPORTANT VALUATION VARIABLES**

Among the sensitivity analysis scenarios, the analyst may consider: (1) a valuation without any expected post-merger synergies and (2) a valuation of the "worst case scenario" for the target company. There are several reasons why sensitivity analysis may be useful in the transaction pricing and structuring negotiations. These reasons are described below.

First, the sensitivity analysis can identify a range of possible values for the target company. This would indicate that the analyst should not negotiate a transaction price outside of this range of possible values. Depending on the procedures per-

formed, the sensitivity analysis may also identify probabilities associated with the possible value outcomes. This would allow the analyst to negotiate a price within the most likely range of possible values.

Second, the sensitivity analysis can identify the most sensitive valuation variables—that is, variables where a small change in the variable input causes a large change in the value indication. It is important to identify the most sensitive variables so that the acquirer analysts can subject those variables to a particularly robust due diligence investigation. It is also important to identify the most sensitive variables so that acquirer management can focus on those variables during the post-deal target company integration process.

Third, the sensitivity analysis can help quantify the risk of overpaying for the acquisition. This is particularly true when the sensitivity analysis quantifies the values associated with (1) the worst case target company scenario and (2) other pessimistic target company scenarios.

The sensitivity analysis should help the analyst develop a clear understanding of the value implications of unfavorable target company operating results. Based on such an understanding, the acquirer may be less likely to pay \$2X or \$3X for a target when there is an identifiable probability that the economic value of the target (based upon a pessimistic scenario) is only \$X.

**PROCEDURE 5. CAREFULLY CONSIDER THE VALUE IMPLICATIONS OF BUSINESS CYCLES WITH RESPECT TO THE TARGET COMPANY, THE TARGET INDUSTRY, AND THE GENERAL ECONOMY**

Considerations of the relevant business cycles may be grouped into two categories: (1) the length and shape of the typical business cycle and (2) where the target company is situated in the current business cycle as of the valuation date. Business cycle considerations may affect the acquisition valuation in several ways.

First, most target company financial projections indicate continuous increases in operating performance after the valuation date. The analyst should consider if such a projection is inconsistent with the historically cyclical nature of the target business. And, the analyst should consider the current operating results compared to where the target is in its current business cycle.

If the target is currently at the nadir of its business cycle and approaching an expansionary phase, then continuously increasing projections may not be unrealistic. However, if the target is currently at the zenith of its business cycle and

approaching a contractionary phase, then more conservative projections may be more reasonable. The analyst should consider the current stage of the target business cycle when assessing the reasonableness of any target company financial projections.

Second, an analysis of where the target industry currently sits on its industry business cycle can help identify the expected level of competition to the target company. The current stage of the industry business cycle could affect:

1. expected product pricing,
2. expected product innovation/new product introductions,
3. the number of companies expected to enter/leave the industry in the short term, and
4. the general level of supply and demand for products in the target industry.

*“The analyst should consider the current stage of the target business cycle when assessing the reasonableness of any target company financial projections.”*

Third, an analysis of where the regional/national economy sits in the general economic cycle can help identify expected changes in

the macroeconomic factors that influence the target company valuation. The current phase of the general economic cycle could affect:

1. expected interest rates,
2. the availability of capital for target company expansion plans,
3. the expected price inflation and cost inflation in the target industry,
4. the availability/price of labor in the target industry, and
5. the relative pricing (due to exchange rates) of foreign demand/competition for the target company products.

**PROCEDURE 6. STRUCTURE THE ACQUISITION TRANSACTION SO THAT THE SELLER HAS A CONTINUED INTEREST IN THE SUCCESS OF THE TARGET COMPANY**

This procedure involves structuring the target company asset/stock purchase. This procedure includes deal structure provisions such as: the use of seller contractual earn-out provisions, step-purchase transactions, and seller retention of some class of equity security. The objective of these contractual provisions is to have the target seller and/or target key employees continue to have an economic interest in the success of the target company.

There are two reasons to use contract provisions that continue the involvement of the seller and/or target key employees in the target company.

First, the seller (as an individual or corporate entity) and/or target key employees have an economic incentive to make the acquisition successful. It is in their economic self-interests to work hard to achieve the greatest subsequent payments in the earn-out/step-purchase/retained equity redemption phase of the transaction.

Second, such provisions reduce the downside risk to the acquirer. That is, if the financial performance goals or other contract provisions are not met, then the subsequent payments are not made. That means that the total consideration ultimately paid by the acquirer to the seller is less than it would have been if the acquisition was more successful.

There are two drawbacks associated with the use of contract provisions that continue the involvement of the seller and/or target key employees in the target company.

First, the use of such contract provisions adds a degree of complexity to the transaction. Obviously (and intentionally), the seller is not completely removed from the target at the time of the closing. Therefore, until the conclusion of the earn-out or other contract provisions, the acquirer may not:

1. obtain absolute control of the target or
2. be rid of all obligations to the seller.

Second, in the case of a successful acquisition, the buyer may have to make substantial post-closing payments to the seller. This may increase the total consideration paid for the target, when compared to an all-cash-at-closing price. Nonetheless, the larger total consideration does not mean that the buyer paid too much to the seller. This is because the subsequent payments are not made unless the target exceeds financial projections or other stated benchmarks.

#### **PROCEDURE 7. INCENTIVIZE TARGET COMPANY MANAGEMENT WITH CONTRACTS CONTAINING PERFORMANCE INCENTIVES, STOCK OPTIONS, OR DIRECT EQUITY INVESTMENTS**

The objective of this incentive compensation is to motivate target company management to (1) remain with the target after the acquisition and (2) implement the acquirer's post-merger goals. The attitude of target company management is often one of the most important elements in the post-merger integration process.

Target company management personnel who are committed to finding new jobs at new companies will not be dedicated to ensuring that the acquirer achieve the maximum return on its investment. Alternatively, target company management personnel who are appropriately motivated and compensated

will work assiduously to make the acquisition a financial/operational success.

There are numerous compensation methods that are available to (1) encourage target management to stay and (2) motivate target management to internalize the acquirer's integration plans. These methods include stock and/or cash bonus plans, incentive stock option plans, plans that allow management to retain/obtain direct ownership of equity securities, plans that compensate management with indirect ownership of synthetic equity securities, and others.

All of these plans have a common attribute: the target company management income and/or wealth increases if (1) the target achieves predetermined post-merger benchmarks or (2) the merger is deemed successful by reference to some other predetermined goals or benchmarks. In short, the

greater return the acquirer earns on the acquisition, the greater return target company management earns on the acquisition.

As with any procedure, there are several drawbacks to such special acquisition-related compensation plans.

First, if the acquisition is successful, target company executives may earn more than comparable acquirer executives. This may cause some discontent on the part of seasoned acquirer executives. They may believe that the target company "new guys" are being treated better than long-time acquirer managers.

Second, if the acquisition is successful, target company executives may earn much more in the short term than market-level compensation amounts. However, both of these drawbacks can be mitigated by:

1. managed expectations and
2. effective communication.

It is true that target managers may be highly compensated in the first few years following the transaction. However, they must earn that compensation by achieving predetermined goals. And, if the acquisition is successful, that will increase the long-term value of acquirer. Also, that will ultimately lead to greater rewards for all merged company executives. In other words, all managers will benefit from the successful integration achieved by the target company managers.

#### **PROCEDURE 8. MAKE YOUR FINAL OFFER THE FINAL OFFER**

There is typically a great deal of negotiation that occurs during the M&A process. This includes negotiation over both the price and the structure of the deal. And, that's just the beginning.

*“. . . all managers will benefit from the successful integration achieved by the target company managers.”*

After the price and structure are agreed to in principal, considerable negotiation occurs with regard to each of the terms and conditions of the asset/stock purchase agreement or merger agreement. However, this recommended procedure relates to the deal pricing negotiation.

After (1) the buyer has performed its valuation analyses and (2) the buyer and seller have participated in several iterations of price negotiations, the buyer should submit one best and final offer for the target. The seller should understand that this is the final offer. The price negotiation process has completed. If the seller accepts the buyer's final offer, the transaction will be consummated.

If the seller rejects the buyer's final offer, the transaction will be terminated. No additional negotiations will take place.

The buyer should offer the highest price it is willing to pay in this best and final offer. If the offer is accepted, the buyer will not pay too much. However, the buyer should be disciplined to ensure that it does not exceed its "final" offer in a succeeding round of negotiations.

*"Of course, the financial advisor trusted with this important task should be independent of the transaction."*

**PROCEDURE 9. BE PREPARED TO WALK AWAY FROM THE TRANSACTION IF THE SELLER DOES NOT ACCEPT THE FINAL OFFER**

Of course, this procedure relates to recommended procedure 8. If the seller does not accept the best and final offer, the buyer should be prepared to withdraw from the negotiations. The buyer may be disappointed in that outcome, because a great deal of time and effort was expended on the negotiations.

However, continued negotiation after the rejection of a final offer (1) causes the buyer to lose credibility as a negotiator and (2) almost ensures that the buyer will ultimately pay too much for the target.

If the final offer is not accepted, the buyer should resolve to pursue alternative investment opportunities. The continued pursuit of the current transaction will likely result in an imprudent investment decision. After the negotiations are terminated, the buyer should still accept communications from the seller. After all, the seller may ultimately accept the buyer's final offer, after a period of reconsideration.

**PROCEDURE 10. OBTAIN AN INDEPENDENT ASSESSMENT OF THE DEAL PRICE/STRUCTURE BEFORE COMMITTING TO THE TRANSACTION**

This procedure involves retaining (and listening to) the professional advice of an independent investment banker, financial advisor, or other financial intermediary. This independent

assessment does not necessarily have to result in a formal fairness opinion.

If a fairness opinion is needed to satisfy a particular investor or financing requirement, the independent financial advisor can provide such an opinion. But, with or without the requirement of a formal fairness opinion, the financial advisor can provide informed, objective advice to the buyer regarding the transaction price parameters.

Of course, the financial advisor trusted with this important task should be independent of the transaction. In other words, this financial advisor is not one of the investment bankers who brought the deal to the buyer/seller. Those financial intermediaries will likely be compensated based on a percentage of the ultimate transaction price. Accordingly, they are motivated to have a transaction close at any price—so that they will earn their performance fees.

The financial advisor selected for this independent assessment function should not be a participant in brokering the transaction. Rather, what the buyer needs at this point in the negotiation process is totally unbiased, objective, independent advice. This financial advisor should

not have any economic disincentive to tell the buyer "the price is getting too high; you should call the deal off."

**SUMMARY AND CONCLUSION**

It is fairly easy to identify situations where buyers overpaid for acquisitions after the fact. And, it is fairly easy to specify the criteria that determine when a buyer has paid too much in an M&A transaction. These criteria have been adequately discussed in the literature. However, what is important to corporate acquirer analysts, executives, and directors is to establish procedures that minimize the probability of paying too much for the next M&A transaction.

This discussion has presented ten relatively simple procedures to assist acquirers to not overpay for M&A transactions. This list of procedures is not comprehensive. There are certainly other procedures that acquirers can use to avoid overpaying in acquisition situations.

Even these procedures will not ensure that a particular acquirer will not overpay for a particular deal. However, these procedures will generally assist rational acquirers from getting caught in the M&A overpricing trap.

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