MODULE 5: Merger Valuation.

M&A valuation*:* is very complex because it involves two companies and issues like synergy and control.

- *Synergy:* sourced from the combination of two companies (1 + 1 > 2). Dissynergy has opposite effect.
- *Control premium:* the value improvement of the target that stems from policy alteration.
    - This is generated through improving the efficiency of the target.

Important valuation questions include:

- When should you consider synergy? Can synergy be valued?
- Where does the method of payment enter the process?
- What is the value of control? How can this be estimated?

Steps in M&A*:*

1. Establish a *motive* for the acquisition.
2. Choose a *target*.
3. *Value* the target with the acquisition motive built in.
4. Decide the *method of payment* (cash vs stock; debt vs equity).

Step 1: M&A motives. The most common motives are:

- *Undervaluation:* in financial markets relative to true value (capitalise on mispricings).
- *Diversification:* with the intent of stabilising earnings and reducing risk.
- *Synergy:* potential additional value from combining two companies (operational, financial).
    - Operating synergies: sourced from higher growth and/or lower costs.
        - Economies of scale and scope.
    - Financial synergies: sourced from tax savings, increased debt capacity, cash slack.
        - E.g. if the target has high debt levels, interest expense will increase (offsets tax).
- *Management efficiency:* poorly managed companies are taken over and restructured.
- *Managerial self-interest:* e.g. managerial hubris, empire building, agency problems.

Step 2: Target selection.

Motive	Target characteristics
Undervaluation	Trades at a price below the estimated intrinsic value.
Diversification	A business which is different from the acquirer's.
Operating synergy	Similar business (economies of scale); high growth potential.
Financial synergy	Tax benefit to acquirer; unable to borrow (debt capacity); great projects (cash slack).
Control premium	Badly managed; stock has underperformed the market.
Managerial interest	Aligns with CEO's ego and power objectives.

Step 3: Value target with motive built in.

Motive	Valuation technique
Undervaluation	Value target as a stand-alone entity (no premium).
Diversification	Value target as a stand-alone entity (no premium). *Why?* Empirical evidence indicates diversification often destroys shareholder value. Thus, including financial synergy in the form of a premium is too optimistic.
Operating synergy	1. Value companies independently. 2. Value the combined firm with the operating synergy. 3. Target value = independent value + synergy.
Financial synergy	Tax benefits: value of target + PV of tax benefits. Debt capacity: value of target + increase in value from debt. Cash slack: value of target + NPV of projects. <u>Note</u>: Measuring different synergies in a single deal is complex (discount rate arbitrary).
Control premium	Value of target if run optimally.
Managerial interest	Value target as a stand-alone entity (no premium).

Valuing an acquisition:

Component	Valuation guidelines	Should you pay?
Synergy	Value the combined company with *synergy built in*. This may include: – Higher *revenue growth rate:* growth synergy. – Higher *margins:* economies of scale. – Lower effective *tax rates:* tax benefits. – Lower *costs of debt:* financing synergy. – Higher *debt ratio* (lower risk): debt capacity. Subtract value of target (with control premium) AND value of acquirer (pre-acquisition).	Q: Which firm is indispensable for the synergy? A: If it's the *target*, acquirer should be willing to pay for the synergy. A: If it's the *acquirer*, they should not pay for the synergy. <u>Maximum</u> value = standalone valuation + control premium + synergy (to ensure NPV > 0).
Control premium	Value the target if *optimally managed* (by altering the investment, financing and dividend policies). – *Investment:* higher returns on great projects; divesting unattractive projects. – *Financing:* move to a better financing structure (e.g. optimal capital structure, tax shields). o The result of market imperfections. o Minimisation of transaction costs. – *Dividend:* return unused cash practically.	If motive is *control*, this is the <u>maximum</u> the acquirer should pay.

	◦ The result of agency issues. ◦ Look an industry averages (if lazy). ◦ Do a company financial analysis.	
Status quo valuation	Value the target *as is*, with existing inputs for investment, financing and dividend policy.	If motive is *undervaluation, diversification, managerial self-interest*, this is the <u>maximum</u> price.