

Creating Synergies

Realizing the Strategic Value of Acquisitions

By Howard E. Johnson

A strategic buyer is defined as one that believes it can generate incremental value following an acquisition by combining the acquired firm with its existing operations. In an open market transaction, expected post-acquisition quantifiable synergies combined with perceived strategic value are often important factors affecting the negotiations between buyer and seller. There are various types of synergies that strategic buyers frequently anticipate will be realized, and different ways in which those synergies are quantified.

Components of value and price

There can be, and often is, a significant difference between the "value" (normally defined as fair market value or some other value term) of the shares or net assets of a particular business and the price that is paid for those shares or net assets.

In a notional market context, the "value" of the shares or net assets of a going concern business on a stand-alone basis frequently is determined based on the intrinsic discretionary (after tax) cash flows the target business prospectively will generate, and the associated risks. In this context, value generally is referred to as "intrinsic value" (or "stand-alone" value), and normally is comprised of:

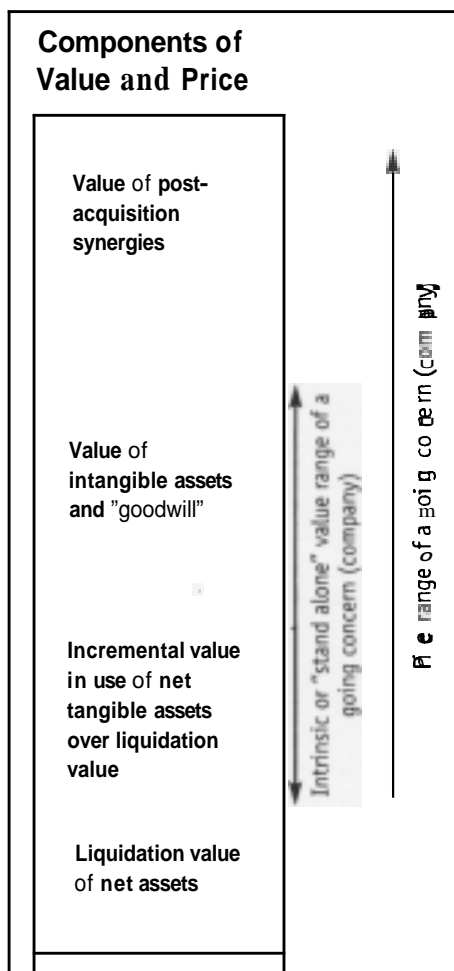
- the value in use of the underlying pool of net tangible assets of the

business (which in itself typically incorporates subjective elements); and

- in many cases, commercial goodwill – the amount by which the estimated stand-alone value of the shares of the business determined pursuant to a cash flow-based valuation methodology exceeds the value in

use of the underlying net tangible assets. Commercial goodwill may include both identifiable intangible assets ("brands," for example) and intangible value that cannot be specifically attributed, and that is therefore simply referred to by the catch-all term "goodwill."

In theory, intrinsic value should not be less than the net after-tax proceeds that would be obtained on the liquidation of the net assets of the business. Conversely, the price paid for the shares or net assets of a business in an open market transaction generally is influenced by (among other things) the buyer's and seller's perception of the post-acquisition synergies that will arise following an acquisition. In most cases, buyers are in a better position to identify and quantify expected post-acquisition synergies, and a vendor can only speculate as to what those benefits may be and the level of importance to a particular buyer. Synergies may affect price to the extent that the purchaser believes that the potential benefits are realizable and will negotiate to pay for some or all of them. Accordingly, price, as negotiated between the buyer and seller, in an open market transaction,



may be equal to or greater than (and in some cases, possibly less than) intrinsic value, and typically will vary (often significantly) among possible buyers. The components of value and price can be summarized as follows:

Types of synergies

Post-acquisition synergies are defined as those that increase the value of the combined business beyond the sum of its components (i.e. the intrinsic value of the acquirer and target company) by way of:

- increasing the quantum of prospective discretionary cash flows;
- reducing the risk of achieving prospective discretionary cash flows; and
- creating growth opportunities and strategic advantage not specifically quantified.

These benefits may accrue to the acquirer (including its existing affiliates), the acquired business or a combination of both.

In most transactions, each potential buyer has a unique expectation as to the type and value of synergies that will arise from a particular acquisition. Empirical data accumulated in 1998 by Toronto-based Campbell Valuation Partners Limited found that over 80% of corporate

Synergies may affect price to the extent that the purchaser believes that the potential benefits are realizable and will negotiate to pay for some or all of them.

acquirers typically consider post-acquisition synergies in assessing the value of an acquisition target. Of those 80%-plus acquirers who consider synergies, more than one-half indicated that they normally incorporate 50% or less of the value of anticipated synergies in their-acquisition pricing analysis.

The following are examples of the types of synergies commonly anticipated. Although these benefits have been categorized as marketing, operating, financial and strategic, these classifications sometimes overlap.

Marketing

- benefits associated with increased market share, such as savings in advertising costs or increased corporate awareness;
- the elimination of a competitor, thereby reducing

Over 80% of corporate acquirers typically consider post-acquisition synergies in assessing the value of an acquisition target.

price competition and the threat of new products being introduced by that competitor;

- improved market coverage resulting from the integration of product lines;
- access to new customers to whom the acquirers' existing products can be sold; and
- improved distribution of products from better utilization of the marketing organization and distribution channels of the combined entities.

Operating

- the ability to immediately transfer technology of the purchaser's business to the vendor's business (or vice versa), thereby increasing profitability and eliminating the time that the vendor would otherwise require to develop the same capabilities internally;
- higher capacity utilization leading to incremental throughput, utilization of engineering and design services, and overall operating efficiencies;
- increased purchasing power; and
- headcount reductions.

Financial

- accelerated growth potential for the vendor's business through access to lower cost and/or more varied financial resources enjoyed by the purchaser;
- benefits associated with a more efficient capital structure for the combined firm arising from its greater consolidated asset base, and improved cash flow generation capability following the transaction; and
- where the acquirer is a publicly held company, greater size may lead to increased investor interest and stock analyst coverage, thereby reducing the acquirers' cost of raising equity capital.

Strategic

- acquisition of additional capacity and/or existing know-how and market presence on a 'buy' rather than 'build' basis;
- potential risk reduction resulting from upstream/downstream integration opportunities;
- entry into a new strategically important market, from either a product or geographic standpoint;
- a reduction in risk through greater diversification of products and/or markets; and
- so-called 'scarcity value' related to the unusual or unique attributes of the target company as viewed by acquirers.

Costs of realizing synergies

While corporate acquirers frequently emphasize the antici-

pated benefits from an acquisition, they often do not give adequate pre-acquisition consideration to the costs of integration, the timing of the anticipated proceeds, and the probability factors related to the actual realization of the perceived benefits. This may occur because synergy assessments are overly optimistic as a result of inadequate analysis, overly optimistic to rationalize the price that is perceived necessary to secure the acquisition, or do not adequately consider post-acquisition competitor strategies and activities.

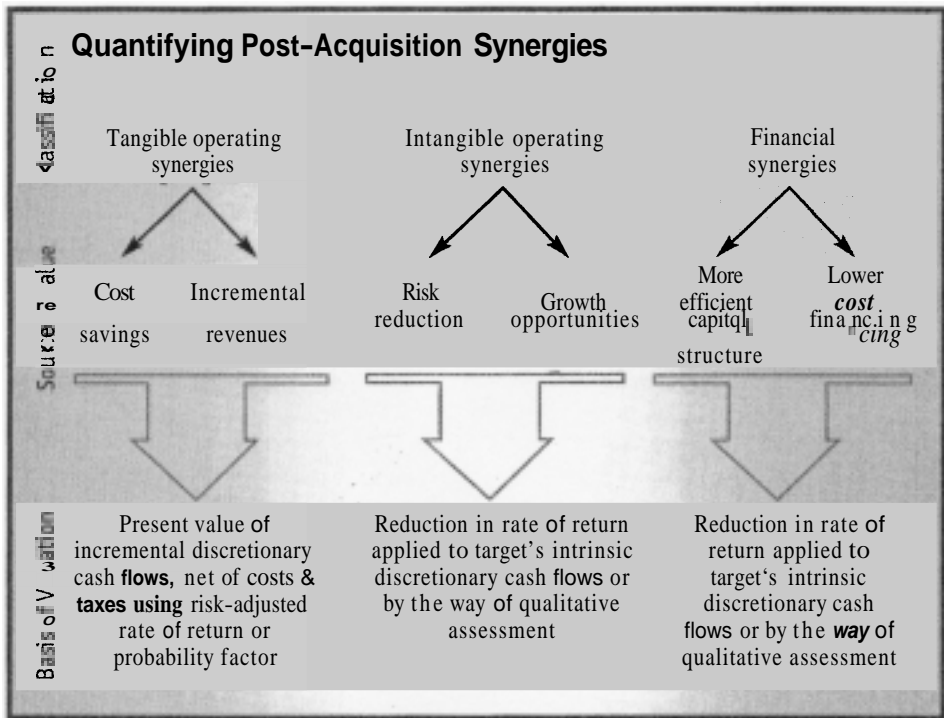
Examples of incremental expenditures that may be required to obtain anticipated synergies include the following:

- severance costs associated with headcount reductions;
- lease termination payments and facilities disposition costs, including relocation expenses;
- general integration and monitoring costs related to the implementation of policies and procedures, quality standards, computer system integration, and so on;
- turnover of key personnel in the acquired business due to uncertainty, differing management philosophies, or those who seek other career opportunities;
- deferred costs, where the vendor has deferred certain expenses (such as equipment maintenance, research and development, and advertising) in the months (or years) prior to sale in order to improve its financial results;
- contingent or inadequately accrued liabilities, including pending litigation, post-retirement benefits, warranty reserves, environmental and cleanup costs, for example; and
- capital expenditures and working capital requirements needed to finance anticipated revenue growth.

Quantifying synergies

The quantification of post-acquisition synergies should be a separate and distinct component of any business valuation exercise. Therefore, the intrinsic value of the business should be estimated as the "base value" and the value of synergies added to that base. This segregation not only assists in evaluating the reasonableness of the components, but in an open market transaction, the acquirer's pricing and negotiating strategy should consider the portion of expected synergies it wants to "pay for." Where a purchaser does not pay for it, expected synergies serve to compensate for unanticipated shortfalls from expected post-acquisition discretionary cash flows. *No acquisition review can be so complete as to eliminate all post-acquisition surprises.* In many instances, a lower level of post-acquisition benefits and a higher level of costs materialize following acquisition than were anticipated during negotiations. Consequently, if the value-added component is fully paid for, the purchaser has eliminated all downside protection and the likelihood of acquisition success is reduced.

A proper quantification of post-acquisition synergies requires a balanced, realistic perspective of the perceived benefits that will arise following an acquisition, as well as an assessment of the likely timing and incremental costs to be incurred in their realization. For the purpose of analysis,



rate of return to the discretionary cash flows of the target business than would otherwise be applied in valuing the target business on an intrinsic basis. In practice, corporate acquirers frequently adjust their price upward in recognition of strategic importance and other intangible operating synergies expected to arise from an acquisition. However, the quantification of such benefits often is more influenced by an acquirer's qualitative assessment of the level of importance and amount of competition for an acquisition candidate than it is by a purely mathematical exercise.

Financial synergies are those benefits associated with a more efficient capital structure and/or lower cost financing available either to the vendor, the acquirer, or the combined firm because of the acquisition.

post-acquisition synergies generally can be segregated into tangible operating synergies, intangible operating synergies and financial synergies, as indicated in the chart above.

Tangible operating synergies are those benefits that can be readily isolated and quantified in terms of incremental prospective discretionary cash flows, such as specific revenue opportunities and cost reductions. The quantification of tangible operating synergies generally involves determining the incremental discretionary cash flows expected to accrue to the purchaser, net of the costs of realizing expected synergies, and related income taxes.

The net incremental discretionary cash flows should be projected on an annual basis and discounted at a rate of return that appropriately reflects the risk in achieving the benefits. Alternatively, expected synergies can be expressed net of a "probability factor" to reflect the risk of their realization, which is the approach more frequently used in practice. In this case, the probabilized synergies typically are discounted at more moderate "market driven" rates of return, commonly the rate of return used in estimating the value of the target business on an intrinsic basis. A discounted cash flow methodology generally is the preferred approach to quantifying tangible operating synergies since it explicitly considers the expected timing of the anticipated benefits and all of the related costs, including incremental capital expenditure and working capital requirements.

Intangible operating synergies are those benefits that cannot readily be segregated and analyzed on an individual basis. Intangible operating synergies typically relate to incremental growth opportunities, a reduction in business risk of the combined firm, or other strategic advantages that have not been included as part of post-acquisition incremental discretionary cash flow. Although the value of intangible operating synergies generally is very subjective, in theory these benefits may be quantified by applying a lower

Financial synergies can be quantified as the increase in the intrinsic value of the target business (or acquirer or combined firm, where applicable) based on a lower rate of return due to a more efficient capital structure or lower cost financing arising from the acquisition. In practice, corporate acquirers sometimes assess financial synergies on a qualitative basis.

An example of synergy valuation

Buyerco is considering the acquisition of Targetco and has estimated the intrinsic value of the shares of Targetco to be \$23 million, based on Targetco's annual prospective discretionary cash flows of \$2.5 million and an 11% rate of return (i.e. capitalization rate), which Buyerco considers appropriate in this case. In addition, Buyerco anticipates that the following post-acquisition synergies will arise through the purchase of Targetco:

- staff reductions resulting in savings of \$400,000 per annum. Severance costs are expected to be \$200,000, and Buyerco's income tax rate is 40%;
- incremental revenues of \$1 million in the first year following acquisition, \$2 million in the second year and \$3 million in the third year and thereafter. Targetco's contribution margin on incremental sales is estimated at 30%. Due to excess operating capacity at Targetco, it will not incur any incremental fixed costs or additional capital expenditures. Working capital requirements are estimated at 10% of revenues;
- due to Buyerco's ability to utilize a more efficient capital structure in its consolidated operations, the required rate of return for Targetco will decline from 11% to 10%; and
- Buyerco views the acquisition of Targetco as strategically important because it will allow Buyerco access to an important new market that would have been difficult to enter without this acquisition. Buyerco estimates the val-

A proper quantification of post-acquisition synergies requires a balanced, realistic perspective of the perceived benefits that will arise following an acquisition, as well as an assessment of the likely timing and incremental costs to be incurred in their realization.

ue of this benefit to be \$5 million.

Assuming that Buyerco applies a 50% probability factor to anticipated post-acquisition synergies and that a 10% rate of return is considered appropriate, the price Buyerco may be prepared to offer for the shares of Targetco is estimated as follows:

The quantification of perceived post-acquisition synergies is a subjective and fact-specific exercise. However, in any open market transaction it is important for both the buyer and seller to consider what anticipated synergies might arise and to attempt to quantify their value. From the seller's standpoint, this will assist in determining which potential purchasers to solicit and the estimated price that each might pay. For the purchaser, an assessment of synergies is important from the perspective of determining all the potential value components of the acquisition candidate, and in estimating the price that competitors might pay. In most cases, both the prospective buyer and seller in an open market transaction improve their respective negotiating position through a detailed and objective assessment of anticipated post-acquisition synergies, the expected timing of those benefits, the related costs, and the likelihood of their ultimate realization.

Howard E. Johnson (hjohnson@cvol.com), CMA, is a partner with Toronto-based Campbell Valuation Partners Limited, a consulting firm specializing in business valuations, acquisitions, divestitures and financial litigation.

Bid price analysis for the shares of Targetco (\$000)

Estimated value of post-acquisition operating synergies

	Year 1	Year2	Year3	Thereafter
Contribution on incremental revenues at 30%	300	600	900	900
Cost savings on staff reductions	400	400	400	400
Less severance costs	(200)			
Incremental operating cash flow	500	1,000	1,300	1,300
Less: income taxes at 40%	(200)	(400)	(520)	(520)
Net operating cash flow	300	600	780	780
Less: working capital at 10% of incremental sales	(100)	(100)	(100)	
Incremental discretionary cash flow	200	500	680	780
Terminal value at a 10% capitalization rate				7,800
Discounted at 10% rate of return	182	413	511	5,860
Net present value of operating synergies (rounded)	7,000			

Estimated value of financial synergies

Intrinsic discretionary cash flows of Targetco	2,500
Rate of return given Buyerco's capital structure	10%
Modified stand-alone value of Targetco	25,000
Less: original estimate of stand-alone value	(23,000)
Estimated value of financial synergies	2,000

Summary of estimated synergy value

Net present value of tangible operating synergies	7,000
Estimated value of more efficient capital structure	2,000
Estimated strategic value not otherwise quantified (given)	5,000
Gross value of synergies	14,000

Pricing estimate for shares of Targetco

Estimated intrinsic value	23,000
Probabilized synergies at 50%	7,000
Estimated bid price	30,000