VALUATION

Premiums Paid in M&A Transactions

Premiums paid in M&A transactions are often justified with future expected synergies. However, these often do not materialize.

Most acquisitions don't create value for the shareholders of the acquiring company: Whilst often a too aggressive purchase price for the target is made responsible, the actual reasons are rather different, such as lack of strategic fit, underestimation of the deal complexities or insufficient focus on handling the post-merger integration of operations.

Empirical research indicates that in most acquisition approaches involving publicly listed companies, the share price of the target tends upwards whilst the one of the acquirer comes under pressure: Hence, market participants anticipate a wealth transfer from the shareholders of the acquirer to the ones of the target, because the premium to be offered for the target appears not to be justified, as anticipated synergies are not expected to be realized, or at least not fully.

By times managers of the acquiring company get caught up in the excitement of a race for a target, offering more than they should. Research indicates, though, the actual premium paid is not necessarily an indicator upon whether a deal is eventually creating value or not. The question is much more whether an acquirer has paid more than the acquisition was worth to that particular company. Hence, the key to success in buying another company is therefore knowing the maximum price the acquirer can pay - and then having also the discipline not to pay more.

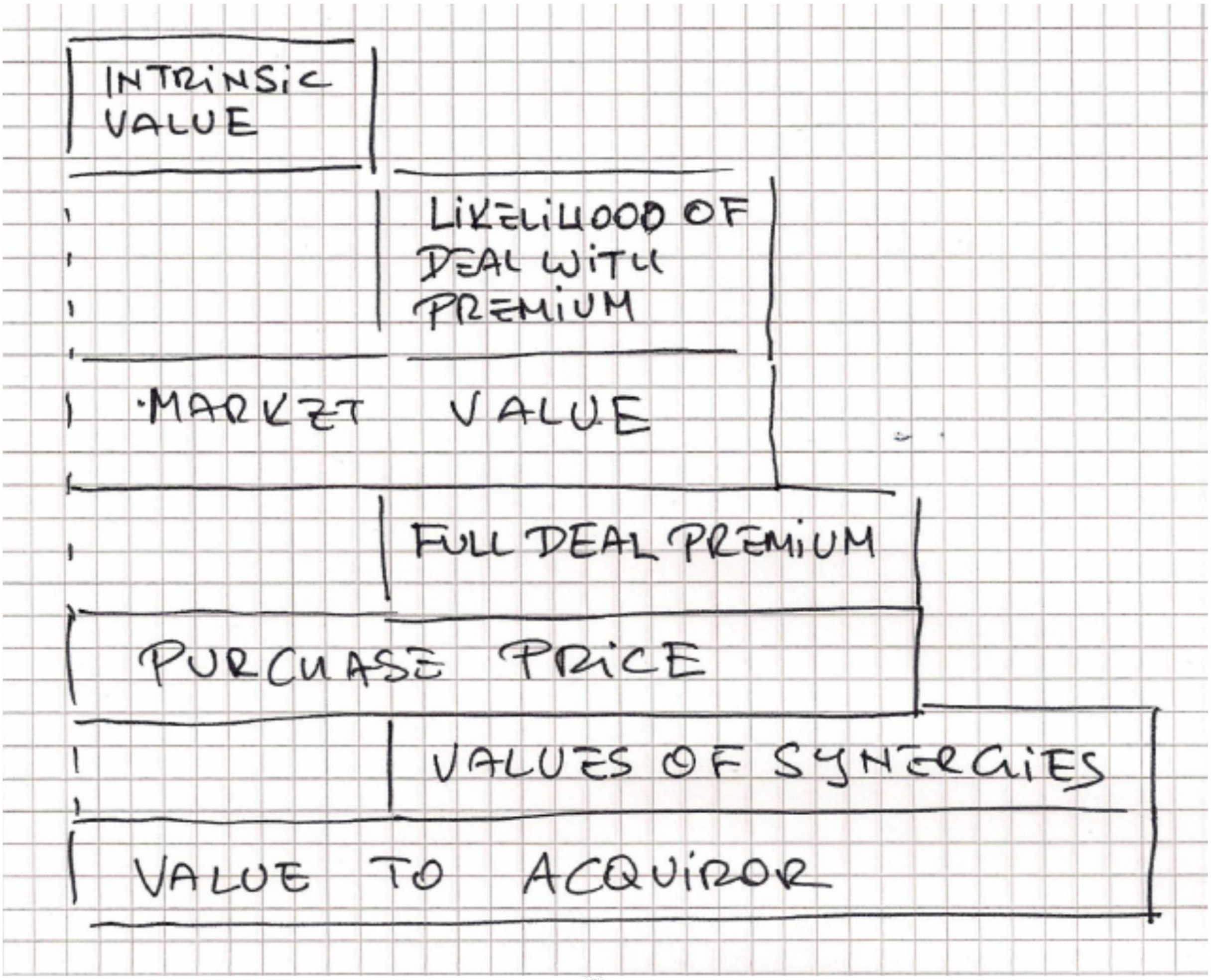
There are several distinct concepts of value: The most basic value of a company - its intrinsic value - is based on the net present value of future expected cash flows, entirely independent of any acquisition. The target is assessed on a stand-alone basis. - On top of the intrinsic value, the market may add a premium to reflect the likelihood that an offer for the target will be made - or that a higher offer will be tendered than the one currently on the table. This is reflected in a relatively higher share price. – And, finally, the purchase price is what a bidder has to pay to be accepted by the target shareholders.

Now, the difference between the intrinsic value and the purchase price can be described as the value gap. And, this premium which the buyer is willing to pay for the target should be justified by the net present value of the cash flows from improvements made once the companies have been combined: This value of anticipated synergies is the justification for paying a premium for the target.

Calculating the expected synergy value can be based on various types of synergies: cost savings, revenue enhancements, process improvements, financial engineering or tax benefits. The value of each type of synergy will depend on the particular skills and circumstances of the acquirer.

Cost savings come usually from eliminating jobs, facilities, and related expenses that are no longer needed when functions are consolidated, or they come from economies of scale in purchasing. However, acquirers often underestimate how long it will take to realize cost savings. - Revenue enhancements are notoriously hard to estimate, not least because they usually involve external parameters beyond management's control. A combined customer base may hesitate at making too many purchases from a single supplier. And competitors may lower their prices in response to an acquisition. - Acquirers often think that if they borrow cash to finance a transaction, they'll reduce the weighted average cost of capital. Usually that actually doesn't really work and does not seem to be a good reason to do a deal. If either the acquirer or the target company could afford to take on more debt, each could have borrowed it on its own.

Therefore, should figures not work out then the most disciplined thing to do is to walk away from a deal. But this seems sometimes easier said than done.


INTRINSIC VALUE
LIKELIHOOD OF DEAL WITH PREMIUM
MARKET VALUE
FULL DEAL PREMIUM
PURCHASE PRICE
VALUES OF SYNERGIES
VALUE TO ACQUIROR