## Valuation of Synergies - Approach

**In almost all cases, Mergers and Acquisitions (M&A) transactions are justified with creating synergies: the acquired firm becoming more valuable when combined with the acquirer. Therefore, shareholders of the target company are usually offered a premium on top of the current share price. When valuing anticipated synergies, then operating and financial synergies should be assessed separately, though.**

Operating synergies are typically generated by either:

- Horizontal integration: Creating economies of scale by reducing cost or strengthening market power, thereby increasing profit margins and sales,
- Vertical Integration: Cost savings from controlling the value chain, or
- Functional integration: Specialization in functional areas.

Capturing revenue synergies typically takes several years to implement and may come from enhanced cross-selling, reduced competition or the access to new markets. Cost synergies, on the other hand, are foremost created by strengthening marketing strategies and channels, by improved sharing of information and resources, lower staff costs (e.g. layoffs in areas of overlap) and – in general - streamlined processes (e.g. more efficient supply chains).

From a financial point of view, operational synergies are reflected in higher earnings before interest and taxes and improved operating cash flows. Over short-term, however, cost items related to restructurings or redundancies may negatively impact these parameters. Besides, higher investment and spending levels could impair the combined firm´s free cash flow after closing. - In valuing operating synergies, the standard discounted cash flow valuation approach can be applied: Additional unlevered free cash flows generated from improvements are discounted by the firm´s appropriate Weighted Average Cost of Capital (WACC). - As a quick, simple alternative and cross-check, enterprise value-related multiples could be applied, provided the anticipated annual US$-based improvement used as a basis is assumed to remain constant and sustainable (which rarely is the case, though).

Financial synergies, on the other hand, are driven by tax benefits, the optimisation of a combined firm´s capital structure, or are the result of a lower risk profile due to a firm´s broader diversification in products, services and operations. - As far as tax benefits are concerned, an acquirer may enjoy lower taxes on earnings due to higher depreciation claims or combined operating loss carryforwards. Alternatively, in implementing a deal the new entity of the merged business may be redomiciled in a more favourable tax environment.

As far as capital structure-related synergies are concerned, a combined – hence: also larger – firm may potentially increase its debt capacity. As a consequence, going forward it could not only assume more debt but also benefit from better credit terms and conditions. Actually, even its cost of capital may decrease, provided that the combined firm´s broader, more diversified product portfolio makes earnings less volatile (i.e. less risky).

Whilst tax and interest rates do have an impact on a firm´s cash flow generation, the majority of financial synergies will actually be driven by the WACC and each of its core components, such as capital mix, default spread, and volatility. – When assessing the approximate value of the tax benefits on a standalone basis only (i.e. moving to a more favourable tax environment), then, however, anticipated cash flow savings would have to be discounted specifically by the cost of debt (and not by the WACC).

Needless to say, in an M&A context an in-depth assessment of expected synergies should - next to a critical review of each component - also focus on the probability of achieving them, as well as on the time horizon required. History indicates that speeding up with the purpose of making an acquisition attractive frequently results in overestimating a transaction´s synergy value.

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## VALUE FROM SYNERGIES

| REVENUES | COSTS | CAPITAL | OTHER FINANCIAL |
| --- | --- | --- | --- |
| INCREASE VOLUME | DECREASE FIXED COSTS | REDUCE FIXED ASSETS | REDUCE TAXES |
| INCREASE PRICING | DECREASE VARIABLE COSTS | IMPROVE WORKING CAPITAL | INCREASE DEBT CAPACITY |

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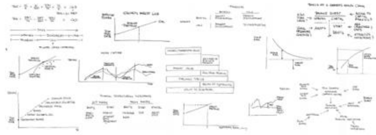
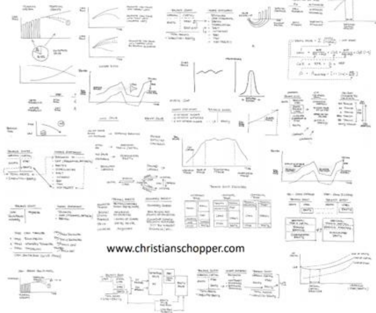


## Corporate Finance Concepts

**Christian Schopper**

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