Premiums Paid in M&A Transactions

Premiums paid in M&A transactions are typically justified with future expected synergies. In most cases, however, these eventually never materialize to the extent anticipated.

The majority of acquisitions don't create value for the shareholders of the acquiring company: Whilst often an overly aggressive purchase price for the target is made responsible, the actual underlying reasons are rather lack of strategic fit, underestimated deal complexities or insufficient focus on handling the post-merger integration of operations.

Empirical research and observations indicate that in most acquisition attempts involving publicly listed companies, the target´s share price tends upwards with the one of the acquirer coming under pressure. Hence, market participants anticipate a wealth transfer from the shareholders of the acquirer to the ones of the target. They assume that the premium offered for the target is not justified, that anticipated synergies will not be realized, at least not to full extent, and that the overall net impact will be value-destructive from their point of view.

Also, it can be observed that by times managers of an acquiring company get caught up in the excitement of a race for a target, offering more than they should, or what may fundamentally be justified. Research indicates, though, that the actual premium paid is not necessarily an indicator whether a deal eventually creates value or not. Instead, the question rather is whether an acquirer has paid more than the acquisition was worth to that particular company (including realistically achievable synergies). Hence, the key to success in buying another company is knowing the maximum price one can pay - and then having the discipline to stick to this.

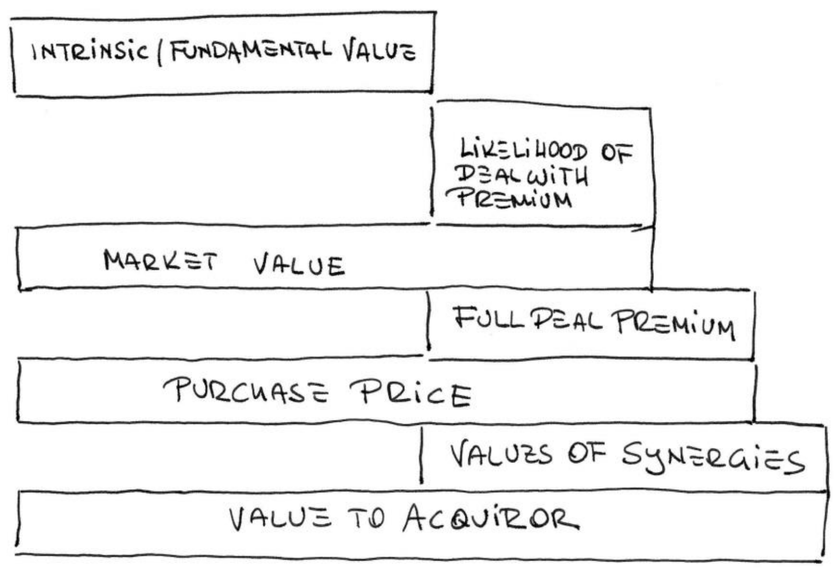
There are several distinct concepts of value: The most basic value of a company - its intrinsic value - is based on the net present value of future expected cash flows. Here, the target is assessed on a stand-alone basis. - On top of the intrinsic value, the market may add a premium to signal the likelihood of an offer for the target - or an even higher offer than currently on the table. Such is reflected in the share price trading at a premium to a firm´s fundamental value. – Eventually, the purchase price is what a bidder has to pay so that this is accepted and agreed to by the target shareholders.

The difference between the intrinsic value and the purchase price (i.e. value gap) should be justified by the net present value of the cash flows from improvements made once the companies have been combined: The combined value of anticipated synergies.

Such may include cost savings, revenue enhancements, process improvements, financial engineering or tax benefits. Cost savings, for instance, usually come from eliminating jobs, facilities, and related expenses that are no longer required when functions are consolidated, or they come from economies of scale in purchasing. However, acquirers often underestimate how long it takes to realize such savings.

Revenue enhancements are notoriously hard to estimate, not least because they typically involve external parameters beyond management's control. For instance, post-transaction, a combined customer base may be hesitant in relying too much on a (now much larger) single supplier. Or, competitors may react and lower their prices in response to an acquisition.

Also, implementing financial synergies are not easily achieved: At first sight, a combined, larger entity post-transaction may reduce a lender´s risk due to the borrower´s more diversified business portfolio. With business risk reduced, banks may be willing to acknowledge this in offering better loan terms (e.g. lower interest rates). Some lenders may be more cautious, though, as the newly established entity may pose a considerably larger risk of exposure as well as be more systemic relevant in its respective industry.


INTRINSIC / FUNDAMENTAL VALUE
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FULL DEAL PREMIUM
PURCHASE PRICE
VALUES OF SYNERGIES
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