Valuation of Synergies - Applied

Weighted Average Cost of Capital (WACC): Subsequent to a major acquisition (or merger) the combined firm will likely be a significantly different one compared to the acquirer on a stand-alone basis pre-deal, as in respect to size, operations or balance sheet structure. For instance, an acquisition pursued with the goal to catch up in a fiercely competitive market may result in an acquirer rather looking like any of its peers. In particular, this may be the case as far as its capital structure is concerned, converging towards one broadly in line with that of its competitors. Now, working on this assumption seems fair when valuing a combined entity´s anticipated synergies - at a point in time when a final capital structure can not yet be determined. Therefore, in order to narrow down the number of possible capital structure-related alternatives to be assessed and to reduce the noise inherit in single-firm estimates, industry-specific parameters can be used: In a simplified approach, the WACC applied for determining the value of expected synergies may be based on the required return of (industry-specific) assets less an adjustment for interest expense-driven tax shields.

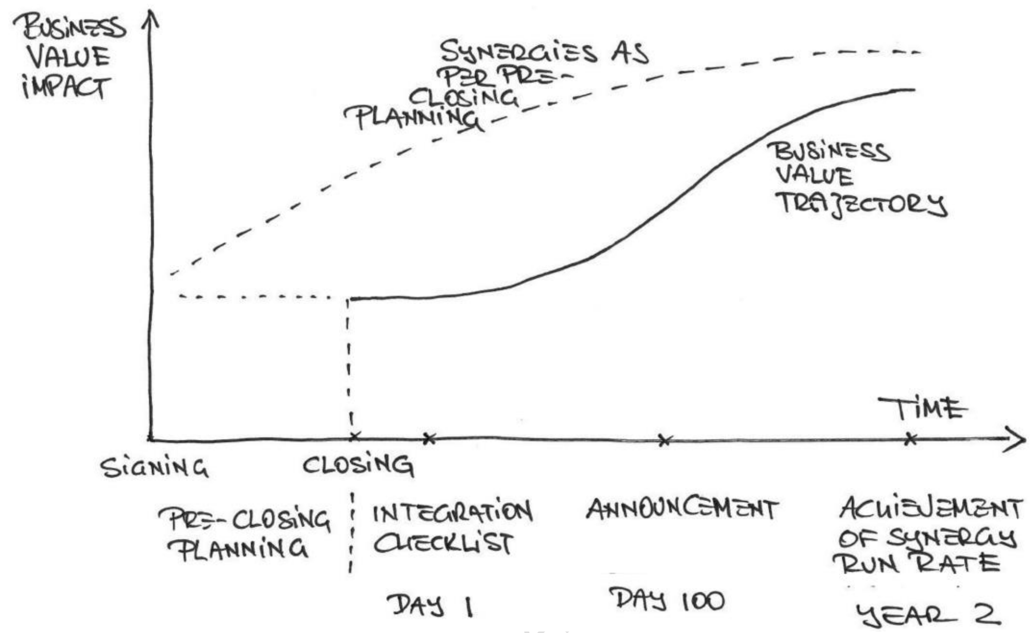
Timing and Realisation of Synergies: In regards to timing, the most "valuable" synergies are operational improvements, and ideally those which can be implemented immediately (even pre-closing). As a matter of fact, these sort of improvements could (actually: should) already have been identified and implemented by the target´s current management – and: on a stand-alone basis. Activist shareholders do focus on these potentials of efficiency enhancements which can be implemented swiftly, and along with them shareholder value enhanced swiftly, as well. Besides, communicating such (perhaps: hidden) improvement potentials is a core element when defending a target in the course of a hostile takeover attempt.

To start with, any valuation approach of merger benefits focuses on the anticipated increase of earnings (before interest and taxes) once a deal is closed: in essence, efficiency improvements in the combined firm´s revenue and cost structure. When processing these in the context of a standard discounted cash flow valuation approach, a fair assessment of such synergies´ long-term impact is critical. Hence, when determining the terminal value of such benefits then usually no further, future (perpetual) growth is assumed: Instead, it may be (fairly) assumed that synergies tend to erode over time, not keeping pace with general price-wage increases in the economy. - Tax benefits derived from the redomiciliation of the combined company post-closing, by the way, can be assessed by estimating future cash flow savings and discounting them with the cost of debt (and not with the WACC).

Divergence of Calculated Synergies from Share Price Dynamics: In most cases, during the rumour / pre-merger phase a target´s share price tends to increase, whilst that of the acquirer to decrease. Not least, this is due to the majority of mergers or acquisitions not creating, instead rather destroying shareholder value, in particular on the acquirer´s side. At the same time tough, a premium - on top of a target´s recent share price - has to be offered to motivate shareholders to sell: By all means, such should be capped by the value of anticipated synergies under optimal circumstances. If the subsequent implementation of synergies fails, however, then a transaction resulted in nothing else than a value and wealth transfer from acquiring to selling shareholders.

In some instances, upon the announcement of an intended transaction, a target´s share price may actually trail below the offered purchase price: This is the case when the market is yet uncertain whether the intended acquisition will happen at all. - If, on the other hand, the target´s share price exceeds that offered by the acquirer, then a higher (perhaps: competitive) bid is anticipated by the market. – Only prior closing will a target´s share price trade along the actual price offered by the bidder.

DELIVERY OF SYNERGIES - WINDOW OF OPPORTUNITY



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