Lesson 10

THE MERGERS AND ACQUISITION MARKET. AN OVERVIEW.

INTRODUCTION TO COMPANY'S VALUE AND VALUATION TECHNIQUES.

DCF AND COMPARABLES

Internal growth vs. External growth

Internal growth ⇒ investments plants, equipments

investments technologies

investments human resources

External growth ⇒ **acquisitions**

mergers

alliances

joint ventures

External Growth

ACQUISITION: one company taking over controlling interests in another company

MERGER: combination of two or more companies into one

PURCHASE: the amount paid over and above the acquired company's book value is carried on the books of the purchaser

$$\cancel{A} \longrightarrow \mathbf{B}$$

CONSOLIDATION: a new company is formed to acquire the net assets of the combining companies

$$\cancel{A} \searrow \mathbf{C} \swarrow \cancel{B}$$

External Growth (cont'd)

MERGER

- **horizontal:** takes place between two firms in the same line of business
- **vertical:** involves companies at different stages of production
- **conglomerate:** involves companies in unrelated lines of business

External vs internal growth (benefits and costs)

<u>some benefits</u>

- ✓ timing
- ✓ control over expenses
- ✓ control over results

<u>some costs</u>

- ✓ difficult to maintain the equilibrium (and performance) within the company
- ✓ human resources
- ✓ different cultures
- ✓ an acquisition is never tailored

External growth: characteristics

- ✓ **High failure risk**
- ✓ **Difficulties in evaluating a company**
- ✓ **Difficulties in obtaining guarantees**
- ✓ **Synergies**

Some reasons to merge

- ✓ economies of scale
- ✓ economies of vertical integration
- ✓ surplus of funds
- ✓ complementary resources
- ✓ tax shields

Some reasons to acquire

- ✓ entrepreneur’s ambition
- ✓ to increase market share
- ✓ to enter in a new market, in a new industry
- ✓ to obtain a royalty, know-how, trade mark
- ✓ to eliminate a competitor

Keys to succeed

Only by gaining a clear understanding of *what* and *where* value can be obtained from a deal, can companies hope to avoid 'bad' deals and be in a position to work out *how* this value extraction will be achieved.

Hard keys

- **synergy evaluation**: in terms of revenue benefits, indirect and overhead cost reductions, direct operational cost reductions
- **integration project planning**
- **due diligence**

Soft keys

- **resolving cultural issues**
- **selecting the management team**
- **communications**

Business valuation: definition of value

- **Market value:** is a general estimate of what a business would sell for in the open market. It is independent of a particular investor

- **Investment value:** is the value of the business to a specific investor. It would reflect synergies, a tax rate specific to the investor, and policies the investor is likely to implement

- **Fair value**: is used in certain legal cases and the method is defined by statute

How to realize an acquisition

- ✓ **Analysis and definition of the industry and the target co.**
- ✓ **General screening of the co.s**
- ✓ **Specific analysis of the most interesting co.s**
- ✓ **Priority in contacts**
- ✓ **Way of contacting**
- ✓ **First approach**

Methods

- Assets
- Revenues
- **Comparables** ⟶ **Market approach**
- **Discounted Cash Flow (DCF)** ⟶ **Income approach**

Each approach has advantages and disadvantages

Generally there is no right answer to a valuation problem.
More an art than a science!

Comparables (Multiples)

- Multiple = Enterprise value / *most important element to value (EBIT, EBITDA, Sales)*

- Compute the average of the multiple of the companies of the sample

- Multiply the average multiple obtained for EBIT, EBITDA or Sales of your company

Discounted Cash Flow (DCF)

DCF capitalizes the cash flows the firm is expected to generate

Strenght: reflects actual benefits that investors care about better than other methods

Weakness: relies heavily on projections. Valuations are only as good as these projections

Discounted Cash Flow (DCF) (cont'd)

$$W_f = \sum_{t=1}^{n} \frac{F_t}{(1+k)^t} + TV$$

W company's value

F_t Cash Flows

k discount rate

n number of periods considered

TV terminal value of the company

Cash Flows

Cash Flows

Cash Flows to Firm

Cash Flows to Equity

Cash Flows to Firm

The FCF are the expected cashflows to the firm, i.e., the residual cashflows after meeting all operating expenses and taxes, but prior to debt payments, discounted at the WACC.

EBIT

-/+ Change in Net Working Capital

\+ Depreciation, amortization

\- Investments

\+ Divestments

\- Taxes

Free Cash Flow to Firm

Cash Flows to Equity

The CF to Equity are the expected cashflows, i.e., the residual cashflows after meeting operating expenses, tax obligations and interest and principal debt payments and reinvestments needs, at the cost of equity (k_e), i.e., the rate of return required by equity investors in the firm.

EBIT

+/- Change in Net Working Capital

\+ Depreciation, amortization

\- Investments

\+ Divestments

\- Interests Expenses

\- Principal payments

\- Taxes

Free Cash Flows to Equity

Terminal value

$$TV = \frac{F_n \,/\, (k-g)}{(1+k)^{n+1}}$$

Because businesses are typically long-lived assets and detailed cashflows forecasts beyond 5 yrs tend to be more fiction than fact, most analysts project cashflows for a finite period and then assume some normal terminal value at the end of that period

g = sustainable growth rate (usually: long-term expected rate of inflation)