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Strategic Value Determination

The value of a business will differ among buyers with different outlooks.

by Mark D. Working

The first steps in the process of a corporate acquisition are to conclude that the target makes strategic sense and that adequate capital and organizational bandwidth exists to close and integrate the acquired company. Once confirmed, an important question remains to be answered before an offer should be made. What is the target company worth?

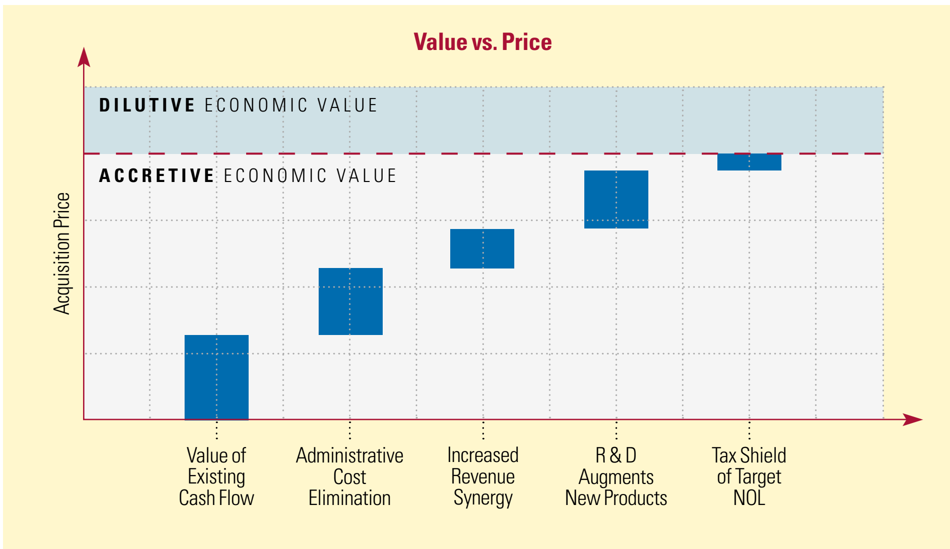
The answer to this question is not as simple as it might seem. The fact is that businesses can, and do represent different values to different acquirers.

Although knowing what value a business might have to its current owners is worthwhile, when considering an offer strategy, the question a buyer should be asking is what value might accrue as a result of the unique combination between itself and the target company.

Fundamentally, the value of any asset, a business being a collection of assets, is worth the present value of the future stream of the after-tax cash flows it generates. Any shortcut assessment of value, such as the value of assets, multiples of earnings derived from comparisons to other transactions or public companies, or metrics related to market share or various operating statistics (e.g., production volumes, customer counts) are very imprecise estimates of value and provide almost no information about the value of the target business in combination with the specific buyer.

Although knowing what value a business might have to its current owners is worthwhile when considering an offer strategy, the question a buyer should be asking is what value might accrue as a result of the unique combination between itself and the target company.

For example, if the buyer is a private equity firm, there might not be much difference in the projected trajectory of revenues and profits than if the company were to remain independent. However, a strategic buyer may be able to consolidate market positions, eliminate duplicate administrative functions, and rationalize production assets. The two buyers' views of the future might show decidedly different revenue opportunities and cost structures and thereby different bottom lines and values. The nearby chart illustrates the potential categories that contribute value in a business combination.



THE ACQUISITION BUSINESS PLAN

An acquiring company should begin by developing a business plan for what will happen with the acquired business after the transaction. It is a plan for how the combined businesses will be operated once they become "one." The plan should yield a detailed projection of the incremental operating cash flow and capital requirements that result from the combination. Although the final articulation of the plan is in financial terms, it is not a task to be left solely to financial analysts. The plan of action is driven by an assessment of customer demand, market strategy, and functional operations. This planning must be done by a multi-functional team, comprised of a project leader, a corporate development specialist, and experts in each functional area.

The business plan will follow from the strategic purpose and objectives of the acquisition. The nature of the opportunity might be broadening a product line, cross selling existing products in different markets, adding specialized production capacity, technology, or workforce capabilities, and/or cost reductions available through organizational or capacity rationalization.

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All of the operational considerations,

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actions, timetables, and financial consequences need to be quantified. The end product is a detailed income statement, cash flow, and balance sheet that reflects all of the operating assumptions relating to how the acquiring company plans to operate the combined businesses.

Among the biggest mistakes made by acquiring companies is over optimism about sales increases, cost reductions, or the time required to execute the plan. Experienced acquirers tie the critical operating assumptions relating to the acquisition to the performance goals of the business unit managers involved in post-transaction operations.

A proper analysis compares the expected future results of combined businesses to no deal, considering two important perspectives:

- the possibility that the business would be combined with a competitor ("do or lose" analysis), wherein there could be strategic negative consequences; and
- building a competitive business organically, commonly referred to as the "buy vs. build" analysis.

In all of its different possibilities, the competitive landscape could change as a result of a business combination and value to the acquirer is properly measured as the difference in value gained or lost as a result of a transaction.

MECHANICS AND ARITHMETIC

It is impossible to address all corporate finance mechanics in a single article, other than to say the details matter and that an improper analysis can lead to a flawed investment conclusion and potential destruction of value.

At the root of all acquisition analyses is the following relationship where the Enterprise Value ("EV") is the sum of all future operating cash flows discounted to the present.

$$\textbf{EV} = \left[\frac{\text{(After-Tax Operating Profits)} + \text{Depreciation} - \text{CAPX} - \text{WCI}}{(1+\text{K})}\right]^{*} + \text{Excess Assets}$$

**in periods over time*

Operating cash flow is the base economic driver, with its components being operating profit (adjusted for cash taxes), the difference between economic vs. accounting depreciation, and investments in working capital.

Since value represents all future cash flows, projections usually can only reliably be made for several years. The period beyond the forecast is usually incorporated by use of a "terminal value, often in the form of a perpetuity.

Excess assets include any assets that are not required to generate the operating cash flow of the business (including cash).

A complicating factor of the tax calculation is the measurement of the value of tax shields (e.g., goodwill amortization, asset revaluations), and the ability to use NOLs.

A discount rate (K) which, as discussed in the accompanying article ("Capital and Uncertainty"), is used to combine all future period cash flows into a single current number. Because estimating K is not an exact science, sensitivity of value to different discount rates within a relevant range should be considered.

Done properly, the results of this analysis will allow the business analyst to determine the value of the acquisition target in combination with the acquirer. Once that information has been developed and digested, the effort should turn to crafting an offer and preparing for negotiations as described in the following article. ❖