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Don't Count on Strategic Value

Strategic value is only realizable under specific circumstances.

by Mark D. Working

How often have you heard declarations along the following lines: "When I sell my business, I fully expect to be paid for strategic value, just like my competitor," or "My advice to the client is to hold out for strategic value, given the company's long-term industry position?" Both statements are imprecise at best, if not completely incorrect, as they imply that strategic value is a constant reality, and that the seller has a choice in the matter. A fundamental misunderstanding of the nature of strategic value often tempts sellers into the erroneous belief that lackluster business performance will not hinder them from receiving a high value for their businesses. The four simple truths about strategic value are that it can be created only as a result of a business combination, the buyer must successfully execute the plan of consolidation to realize it, a seller can be compensated for it only if a buyer can be compelled to pay for what the buyer expects to create, and its existence is situational and transitory.

DEFINING STRATEGIC VALUE

The definition of business value, be it financial (intrinsic) or strategic, originates from the classic corporate finance theory of business valuation that equates current value to the sum of all expected after-tax cash flows from future operations and investment discounted to the present. Financial value reflects the expectations of the current plan and strategy of an existing business. Strategic value represents anticipated changes in the economics of the business in combination with another that lead to expectations for accelerated sales, increased margins, and/or reductions in capital employed. These economic improvements are commonly referred to as "synergies." In concept, it is as simple and straightforward as 1+1 = 2.5, but, in practice, it is decidedly more difficult to capture the fruits of a business combination. While the buyer might have the opportunity to reap the benefits of synergies, there is no assurance that the seller will be paid for them. Only in a competitive process might the buyer be coaxed to pay for some, but rarely all, of the value created by acquisition synergies.

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The potential for strategic value requires the existence of meaningful industry inefficiencies. These are often a function of demand and capacity imbalances, particularly in mature industries. In these situations, the economics of consolidation provide impetus for rationalization of resources. New business models may emerge with improved cash flow generation capabilities based on economies of

PERFORMANCE:	ACE	ACME	ACME / ACE COMBINED	AAA		
Situation	Inefficient production; Substantial excess capacity	Inefficient production; Operating at capacity	Substantial operating leverage at higher plant utilization	Inefficient production with substantial excess capacity		
Widget Production (units)	75,000	125,000	200,000	100,000		
Sales (thousands)	$ 95,000	$ 155,000	$ 250,000	$ 150,000		
Operating Earnings (thousands)	$ 5,000 5.3%	$ 25,000 16.1%	$ 75,000 30.0%	$ 18,750 15.0%		
VALUATIONS:						
Intrinsic Value (6X multiple)	30,000	150,000	450,000	112,500	112,500	112,500
Implied Strategic Value	170,000	100,000	-	150,658	637,500	157,500
Total Value (thousands)	$ 200,000	$ 250,000	$ 450,000	$ 263,158	$ 750,000	$ 270,000
VALUATION METRICS:						
Sales Multiple	2.1	1.6	1.8	2.1		
Operating Earnings Multiple	40.0	10.0	6.0		40.0	
Production Multiple ($/1000 widgets)	2.7	2.0	2.3			2.7

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scale in production, customer service, delivery efficiency, or geographic coverage. These forces drive the restructuring of the industry, hamstringing competitors that do not or cannot adapt to the changing competitive dynamic.

CAPTURING SYNERGIES

Once companies consolidate to capture synergies and realize higher levels of performance, all worth in the industry reverts to the collective intrinsic value of the individual firms. The difference between the aggregate pre- and post-rationalization cash flows of the industry, less transaction costs, is the maximum amount of strategic value available for industry participants. After the buyer keeps some portion of this strategic value for taking the challenges and risks of consolidation, the remainder represents the limit of the premium available to pay sellers.

To illustrate the arithmetic of a business combination that results in strategic value, consider the admittedly simplistic example of two companies, Ace and AAA, both of which have substantial excess capacity relative to the demand for their products, and their competitor, Acme, which is bursting at the seams with customer demand. To cope, Acme is forced to inefficiently spread its production among multiple locations. Due to poor capacity utilization, all three companies perform well below par. For the sake of discussion, it is assumed that a discounted cash flow analysis for each of these businesses would result in an intrinsic value equal to a multiple of 6x current operating income.

The owners of Acme astutely see the potential of acquiring either Ace or AAA, in order to consolidate all production in under-

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used plant capacity. After being rebuffed by AAA, Acme is able to come to terms with Ace and, as illustrated in the accompanying table, the consequential economies of scale vastly improve profitability and, therefore, the value of the combined businesses. To put the two businesses together, Acme agrees to pay Ace's owners the fantastic sum of $200 million, a premium of $170 million over the value justified by the company's stand-alone performance. Most importantly, it's a bargain for Acme, which pays $200 million to acquire $300 million in value. Break out the champagne; it's a red-letter day in both camps.

Naturally, when AAA learns the particulars of the Ace transaction through the omnipresent widget industry grapevine, its owners will take a keen interest in the transaction. They might apply the resulting transaction metrics to their business as an appropriate benchmark of value, no matter how outlandish in relation to their business performance. In this case, the owners of AAA might wrongly conclude that their business has substantial strategic value. These transaction metrics (e.g., multiples of sales, operating income or widgets) suggest a wide value range, perhaps in excess of $600 million. Beware! The music always stops. At the point that industry efficiency has been reset, little or no strategic value remains, and the owners waiting on the sidelines for an ever-higher valuation are left standing.

DON'T BE MISLED

The implication of wringing out strategic value through business rationalization is that business owners cannot afford to be mesmerized or misled by the lofty transaction values they hear about in their industry. It is not reasonable to conclude that valuation metrics achieved in strategic transactions can be applied across an entire industry. There is specific economic reasoning that applies to an individual transaction, not a "new valuation paradigm." The logic underlying one deal may or may not extend to other situations or businesses. Moreover, even if strategic value now exists, it will not last forever. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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