Seven Tests for the Aspiring Acquirer

Preamble: Acquisitions have been good news for pretty much everyone except the stockholders of the acquiring firm. Acquiring firms seem to over estimate the value that they can create in synergies and over pay for these synergies. To see why this happens…

Warm up exercise: The target firm has the following income statement:

Revenues	$ 100 million
- Operating Exp	$ 80 million
Operating Income	$ 20 million
Taxes `	$ 8 million
After-tax Oper Inc	$ 12 million

Assume that this firm will generate this operating income forever (with no growth) and that the cost of equity for this firm is 20%. The firm has no debt outstanding. What is the value of this firm?

Test 1: Assume that as an acquiring firm, you are in a much safer business and have a cost of equity of 10%. What is the value of the target firm to you?

Test 2: Assume as an acquirer that you have access to cheap debt (at 4%) and that you plan to fund half the acquisition with debt. How much would you be willing to pay for the target firm?

Test 3: Assume that you are now told that it is conventional to pay a 20% premium for control in acquisitions (backed up by Mergerstat).

a. How much would you be willing to pay for the target firm?

b. Would your answer change if I told you that you can run the target firm better and that if you do, you will be able to generate a 30% pre-tax operating margin (rather than the 20% margin that is currently being earned).

c. What if the target firm were perfectly run?

Test 4: Assume that you are told that the combined firm will be less risky than the two individual firms and that it should have a lower cost of capital (and a higher value).

a. Is this likely?

b. Assume now that you are told that there are potential growth and cost savings synergies in the acquisition. Would that increase the value of the target firm?

c. Should you pay this as a premium?

Test 5: Now assume that you are told that an analysis of other acquisitions reveals that acquirers have been willing to pay 5 times EBIT.

a. Given that your target firm has EBIT of $ 20 million, would you be willing to pay $ 100 million for the acquisition?

b. What if I estimate the terminal value using an exit multiple of 5 times EBIT?
c. As an additional input, your investment banker tells you that the acquisition is accretive. (Your PE ratio is 20 whereas the PE ratio of the target is only 10… Therefore, you will get a jump in earnings per share after the acquisition…)

Test 6: Now assume that you know that the CEO of the acquiring firm really, really wants to do this acquisition and that the investment bankers on both sides have produced fairness opinions that indicate that the firm is worth $ 100 million. Would you be willing to go along?

Test 7: The odds seem to be clearly weighted against success in acquisitions. If you were to create a strategy to grow, based upon acquisitions, which of the following offers your best chance of success?

This	Or this
Public target	Private target
Pay with cash	Pay with stock
Small target	Large target
Cost synergies	Growth synergies