



May 2015

Ron Stacey

Founder & Managing Director, Legacy Advisors

The Key to M&A Success: Validate the Value of the Acquisition to the Buyer

For an M&A transaction to close successfully, the seller should be able to show that the investment value to a specific buyer, or special-interest purchaser (with cash-flow-enhancing synergies), is greater than the value to the seller of keeping the business (without synergies). We call this difference in value an acquisition premium. In many cases, this premium can exceed 30% of the value without synergies. It is incumbent upon the seller to demonstrate to the buyer the business case necessary to justify the acquisition premium. Failure to do so results in a failure to close.

In this article, I will address the critical importance of validating the value of the acquisition to the buyer, and identify some generic best-buyer advantages and the most attractive acquisition strategies.

Find the Best Buyer

A properly-conceived strategic marketing plan clearly identifies the "best buyers," enabling the sell-side deal team to articulate a compelling business case for the acquisition to potential buyers. Best buyers are those to whom the acquisition will add the most value, for specific reasons. Ultimately the process culminates in the best buyer paying the highest price available in the marketplace for the business, because the best buyer can generate the highest cash flows in operating the business.

Price negotiations generally revolve around how the value of the synergies (incremental additional cash flow) is divided between buyer and seller.

If the seller cannot communicate a compelling business case to the buyer, at some point the deal fails. Put differently, the buyer must be able to clearly point out the synergies (revenue and/or cost) that justify the premium. Buyer discomfort with the deal can occur at any point in the M&A process. Once this tipping point is breached, there is no second chance; the seller needs to get the price justification (validation) right the first time and every time. To be a successful seller, think like a buyer.

Identify Best Buyer Advantages

The best buyer possesses some distinct advantages for owning the business. These may include cross-linkages to other buyer-owned business, unique skill sets, and better operational governance, among others. Not on this advantages list are size, scale, strategic diversification, or new business model.

Synergistic links to other businesses in a business portfolio are powerful means to add value. For example, take a waste collection business – yes, garbage. A seller has a collection contract for a number of cities, but no landfill close to the pickup routes. The buyer has a landfill near the seller's collection routes, making it the best buyer for the seller's collection business because it has the shortest route to the landfill. More common examples include the ability to leverage large company sales forces with

acquisitions involving new and innovative products developed at smaller companies without the distribution infrastructure.

Value can be created through the application of unique skill sets in the value drivers of a particular business. In manufacturing, for example, companies like GE bring world-class manufacturing capability through Lean Six Sigma and best practices. The application of these skills to an acquired business produces better cash flows (higher value) from efficiency and cost reduction. Depending on the circumstances, these improvements can be dramatic. Similarly, in consumer product businesses, Procter & Gamble has distinct advantages in brand development both from acquisitions and startups.

Private equity generates value by being better operators. Private equity investors partner with operating management to create an incentivized performance culture. Odyssey Partners' 1998 buy-and-build acquisition of TransDigm Group in the aerospace industry is a case in point. With a well conceived strategy of acquiring niche manufacturing operations in businesses with high proprietary engineering content, Odyssey invariably included the management teams in the ownership structure. It worked. In 2003, Odyssey sold the combined \$300-million-revenue company to Warburg Pincus for just over \$1 billion. Everyone did quite well, including Warburg Pincus, which later took the company public. As of this writing, TransDigm's market capitalization is \$6.34 billion, and in 2012 it ranked first in operating margin (45 percent) and first in operating profit per employee (\$151,000) in its sector.

Attractive Deal Structures

The investment thesis or acquisition strategy underpinning any transaction is a powerful determinant of deal success. The best deals typically involve improving the seller's existing cash flow performance, impacting return on invested capital (ROIC) through cost reduction and/or revenue enhancement; acquiring seller skill sets specific to the value drivers in the business, sooner and cheaper; weeding out excess industry capacity; gaining access to new markets or consolidate existing markets.

The ability to substantially improve the seller's performance through increased cash flow and ROIC is clearly the most common method to create sufficient value to justify the acquisition price. A good example is General Mills' purchase of Pillsbury from Diageo in 2001 for \$10.4 billion. Both General Mills and Pillsbury are in the packaged food business, while Diageo is primarily in the alcoholic beverages business and ran Pillsbury as a stand-alone operation. General Mills was able to integrate Pillsbury into its packaged food operations, leveraging purchasing, manufacturing, distribution, and marketing. To boost revenues, General Mills introduced Pillsbury products to the school lunch market where the company already had a strong presence. Lastly, General Mills distributed newly introduced Pillsbury refrigerated products on its fleet of refrigerated trucks. All in all, General Mills boosted Pillsbury's operating profits by 70 percent. The price General Mills paid, including the premium, was less than the value to General Mills but more than the value to Diageo to continue to operate the business. Hence the deal got done. (See End Note 1).

The opportunity to acquire skill sets or technologies sooner and at lower cost is a formidable framework for successful acquisitions. This deal attribute is particularly important at information technology companies, where it can take years and cost millions to develop code and acquire customers. Cisco Systems is a good example of a company built through acquisitions from a single product line to a broad-based internet equipment provider. Since its first acquisition in 1993, shortly after going public, through May 2012, Cisco Systems acquired 152 companies and reached sales of \$45.6 billion with a market capitalization of \$88 billion. Google is another great example of an internet technology company built through acquisitions. Since 2001, Google has acquired 110 companies with announced prices exceeding

\$21.4 billion. Its recent acquisition of Motorola Mobility is the largest in its history, at \$12.5 billion. While Google's sales at \$40 billion are in line with Cisco Systems, Google's market capitalization is a whopping \$192 billion.

In high-volume, capital-intensive, and cyclical industries, an acquisition strategy aimed at taking capacity out of the market can be highly successful. Representative industries include chemicals, foundries, refineries, paper mills, pulp mills, and packaging manufactures. These businesses typically have high fixed costs with the concomitant high operating leverage. During soft demand (excess capacity), the high fixed costs force competitors to lower prices to the point where the marginal contribution to overhead is minimized. Rationalizing capacity through acquisitions leads to higher prices and, more importantly, higher capacity utilization from the remaining plants. Once the utilization reaches fixed-cost break-even, the profit curve becomes very steep. These two factors (big losses versus big profits) combined can create compelling scenarios involving the acquisition and shut-down of excess capacity. Wayzata Investment Partners has employed this strategy very successfully in the U.S. foundry business by buying up foundry assets at the bottom of the cycle (many times out of bankruptcy), then rationalizing the capacity by keeping only the best parts of each acquired facility. A specific example is the 2010 Wayzata acquisition of Grede Foundries, which was then merged into Citation Corporation to form a highly diversified foundry business with 14 foundries and two machining centers.

Market access for new and innovative products, usually developed at smaller companies, can drive successful acquisition scenarios. The format is simply taking the products and driving them through the big-company sales force and distribution capability. IBM employs this strategy quite successfully. Since the beginning of 2000, IBM has acquired 130 companies in strategic areas including analytics, cloud, security, and Smarter Commerce. IBM expects to spend \$20 billion in acquisitions over the 2015 Road Map period to support growth initiatives. (See End Note 2). In a 2010 IBM investor briefing, it estimated that revenues in the acquired companies increased by 50 percent in the two years immediately following the acquisition, and by 10 percent in each of the three years thereafter.

Case Study

Joe Grover, the owner of refuse collector West Maine Disposal, is nearing retirement. Joe knows that crosstown rival East Maine Waste Services is the perfect buyer for the business. East Maine's landfill is 14 miles closer to the customers than West Maine's is. Moreover, Joe believes that with some rerouting, better efficiencies and higher productivity is achievable. Joe wisely hires an investment banker to approach East Maine about the possibility of an acquisition with some meaningful synergies.

Meetings are arranged and soon Joe and his counterpart at East Maine, Jeff Lyons, are discussing what synergies are achievable in a combined business. The shorter distance to landfill reduces travel time and increases equipment utilization, and saves on fuel cost while reducing labor costs. Some of the routes can be redrawn to gain further savings. Joe confirms what Jeff believes to be the synergies. Jeff does the math and determines that \$2.1 million can be saved at the gross margin level. Jeff also determines that the headcount reduction from combining the sales and administration functions produces another \$2.45 million in savings. Total synergies are \$4.55 million. Jeff works up the spreadsheet shown in Figure 1.

Figure 1: Best Buyer's Synergy Worksheet

	East Maine	West Maine	Combined	Synergies Value
Revenue	85,000	35,000	120,000	
COGS	<u>56,100</u>	<u>25,200</u>	<u>79,200</u>	2,100
Gross Profit	28,900	9,800	40,800	
%	34.00%	28.00%	34.00%	
SG&A	<u>15,300</u>	<u>4,900</u>	<u>17,750</u>	2,450
Operating Profit	13,600	4,900	23,050	
%	16.00%	14.00%	19.21%	
Multiple: 5	<u>68,000</u>	<u>24,500</u>	<u>115,250</u>	22,750

In the first column, Jeff calculates East Maine's value *sans* synergies, for simplicity's sake, at five times operating profit, or \$68 million. He does the same calculation in column two for West Maine, a smaller company with lower margins, and derives a value of \$24.5 million. The combined company, however, has an investment value to Jeff of \$115.25 million, \$68 million for East Maine plus \$24.5 million for West Maine, plus the added value of the \$4.55 million in synergies: \$22.75 million at a five multiple.

Jeff offers \$32.5 million for West Maine. That is an approximate 33 percent, or \$8 million, premium to the \$24.5 million value and a 6.6 multiple of operating profit. Of the \$22.75 million in synergies value, Jeff is giving up about 35 percent of the synergies with the \$8 million premium. On his investment banker's advice, Joe accepts. Now Jeff has to go out and realize those synergies!

Summary

The price dynamics of healthy M&A transactions dictate that for a sale to occur, typically an acquisition premium must be paid. It's the seller's duty to know and understand the relative advantages of the best buyers, and to demonstrate to those buyers the business case that justifies the purchase price. Buyers with synergistic links to other portfolio business, unique skill sets, and better operators are all good candidates to be the best buyer. Attractive acquisition strategies that create value include improving performance, acquiring special skill sets sooner and cheaper, squeezing out excess industry capacity, gaining access to new markets, and consolidating existing markets. To quote Warren Buffet, "Price is what you pay, value is what you get." The seller needs to ensure that the necessary value to justify the price is clearly visible to the buyer.

End Notes

Tim Koller, Richard Dobbs, and Bill Huyett, *The Four Cornerstones of Corporate Finance*, John Wiley & Sons, Hoboken, NJ, 2011.

IBM website, May 29, 2012: www.ibm.com/annualreport/2011/ghv/#five.