Building better bids

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How can managers eager to complete an acquisition know when the premium being asked is too much to pay? By following a careful analytic approach that uses free cash flows to estimate the true value of the main potential "synergies" of joining together: scale and scope, exploitable opportunities, and asset restructuring. Each is worth a different amount to different owners. Some can be captured by a range of owners; others not.

When companies make acquisitions they often pay substantial premiums; increments of 40 percent or more above previous stock market valuations are not uncommon. Are they overpaying? If the acquisition was made in an auction, could they have succeeded with a lower bid?

There is no simple formula for answering these questions. The price that one company should offer for another is not a function of the readily calculated ratios that are often bandied about (such as p/e ratios, multiples of sales, and so forth). Instead, it is, or ought to be, a function of the cash flows – specifically, the net present value of the cash flows – that those two particular companies can be expected to generate in combination.

The increments to value that can arise from the joining of two firms, that is, the amount by which the whole is greater than the sum of the parts, are synergies. This definition is deliberately broader than the typical description of synergies as cost savings, as there are many more ways to create value in a business combination. Effective bidding requires a thorough understanding of all the potential synergies, a systematic assessment of their distinctive availability, and a predefined bidding strategy.

Identifying synergies

There are, broadly speaking, three kinds of synergies: economies of scale and scope, exploitable opportunities, and asset restructuring.

Their value is the net present value of the incremental cash that they produce, minus the net present value of the costs of attaining those incremental cash flows.

Economies of scale and scope are the rewards of being bigger and broader. They include savings in corporate overheads, reductions in duplicate staff, combined service departments and leveraged sales forces. Less evident synergies of this type include cross-selling of products and access to new markets.

Exploitable opportunities are the benefits of being stronger and doing things more efficiently. These include market, operational and financial opportunities. Examples would be rationalizing manufacturing capacity, capturing value added from vertical integration and capitalizing on brand names.

Asset restructuring is the maximization of the value of assets or reserves. This category includes asset redeployment (such as divestitures), the realization of hidden value (such as overfunded pension plans) and the use of alternative financing mechanisms (such as sale/leasebacks).

The point of this analysis is that synergies need to be identified and assessed systematically; they involve much more than the simple elimination of redundancies. But this is the beginning, not the end, of building the bidding strategy.

The next step is to recognize that because synergies can be distinctive to particular combinations of companies, the value of a potential acquisition will be as much dependent on the buyer as the seller. That is why target company X may be worth more to acquirer A than it is to acquirer B. Only by carefully examining specific synergies can we really address how much X could be worth to A (or B) – and how much either should consider bidding for X.

Evaluating synergies

It is not uncommon for buyers to pay for part or all of the synergies that they hope to attain. This is the primary reason for acquisition premiums – and, not incidentally, the overpayments that make so many acquisitions failures. In this context, a failure occurs when an acquiring company does not achieve a return at least equal to its cost of capital: for although buyers bear the costs and risks of realizing synergies, they do not always harvest the rewards of achieving them.

Paying for too many potential synergies is akin to buying a house and then offering to add to the purchase price an amount reflecting the travel savings that you will get from being closer to work. While there is some logic in this if every potential buyer works where you do and would get the same savings, you are clearly overbidding (and overpaying) if you are alone in being able to attain these savings. Thus, synergies should be categorized as to how distinctive they are to any given potential buyer.

Degrees of distinctiveness

The most basic category of synergies, which can be termed *universal,* are those that are generally available to any logical acquirer with a capable management team. Examples of universal synergies would be most economies of scale (such as leveraging the fixed costs of an MIS department), and some exploitable opportunities (such as raising prices).

Endemic synergies are those available to only a few acquirers, typically those in the same industry as the seller. These would include most economies of scope (such as broadened geographic coverage), and most of the exploitable opportunities (for example, redundant sales forces in a same-industry acquisition).

Unique synergies are those that are distinctive to a particular buyer. These include some exploitable opportunities or asset restructurings, and are usually tied to a unique skill that the buyer has. For example, some companies are extremely good at cost reduction, while others are masters at creative financing arrangements.

Against this template, a firm can methodically assess the value of potential acquisitions and develop a realistic bidding strategy specific to any firm that is interested in purchasing. It is to the latter subject that we now turn.

The strategy in action

Especially in a competitive bidding situation, knowing the distinctiveness of potential synergies can help a firm set a bidding range that will not unnecessarily reward a seller for synergies distinctive to the buyer. The present value of universal synergies is often paid to the seller, which is generally appropriate because the seller and the competitive bidders are aware that this value exists and feel that they can probably capture it as well.

Endemic synergy values may have to be split between the buyer and the seller. The seller is often less aware of the nature and the value of these opportunities. However, many bidders in the same industry will see the same opportunities. For example, in many industries it is easy to determine how much can be saved by combining two underutilized sales forces. But the valuation becomes more complex when there are two bidders from different industries. In such cases, the potential buyers may have totally different endemic synergy opportunities.

Finally, the buyer should strive to keep unique synergies. Going back to our house example, assume that you were the only building contractor in a given geographic area. Paying for unique synergies would be a bit like buying an old house that you were going to refurbish and then resell, and paying the seller the amount that you were going to sell the house for, less your costs. Since the refurbishing skill is distinctive to you, it would be unnecessary and wasteful to pay someone else for the value that only you can derive from the skill.

The bidding process

Let us examine some of the ramifications of this way of approaching the bidding process. First, the failure to recognize competitors' universal and endemic opportunities may invite competing bids. Generally, the lower the initial bid, the greater the likelihood of another bidder. This can happen because the range of total values (i.e., the intrinsic value of the target plus the acquirer's synergies) is often great enough to provide latitude on what the opening bid might be, especially in a hostile takeover.

Second, a potential bidder may have unique synergies that are higher than another bidder's endemic synergies. Consider the case of a national hotel chain buying a smaller regional hotel chain. Let us suppose that the hotel buyer estimates its endemic synergies and adds some of them into its bid price, knowing that most other large hotel chains could achieve them as well (savings from a centralized computerized reservation system, for example).

But then another bidder emerges. This one is a much smaller regional hotel chain without a reservation system. But it has a remarkable skill in real estate management. Its managers know where to put in new hotels, which ones should be modernized, and so on. They see in the acquisition a chance to create more value with their real estate skills than the national chain can create by consolidating and saving. In this case, the smaller buyer would place a higher value on the acquisition.

The difficulty here, however, is that it may have to pay the seller for some of these unique synergies to win the battle. It should do so only if it is confident that it can attain the added value. Its decision should turn on the magnitude and expected achievability of its unique synergies relative to the endemic synergies available to others; if the former are smaller than the latter, it should pass the potential acquisition by.

When to walk away

In any event, it should be prepared to pass, as any bidder should be, if the price goes above a pre-calculated prudent level. In bidding wars, an auction mentality sometimes takes over; would-be buyers forget the rationale for the acquisition in their zest for winning.

It is important that any potential buyer have a "walk away" price determined before the bidding, and stick to it, because the value of the target does not change once the bidding starts. Just because another company bids above your walk away price does not mean that the target is worth more to you. It may be that the other bidder has greater synergy opportunities, or is just overbidding.

The ideal bid, then, is one that includes most or all of the universal synergies and perhaps some of the endemic synergies. A walk away price should be set below the sum of universal and endemic synergies. As the certainty of achieving the synergies decreases, the walk away price should be adjusted accordingly.

The foregoing is intended as a basic framework for assessing synergies and setting bid prices. Many other permutations exist, but the central point is this: only by understanding synergies and their distinctiveness to particular bidders can a potential acquirer develop a reasonable bidding strategy that will generate value for its shareholders.

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Bill Pursche has been advising companies and senior executives for over 25 years. He has been involved in over 300 M&A and PMI efforts in a variety of industries and geographies, including numerous cross border deals. He is regarded as one of most knowledgeable experts in the world on synergies and Post Merger Integration.

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