



# INSIGHT

## Discipline Leads to Acquisition Success

*Creating shareholder value from an acquisition requires restraint in consideration of synergies.*

by William Hanneman

Completing an acquisition is simple relative to the challenge of creating shareholder value from that acquisition. The sad truth is that most major acquisitions are dead on arrival. Studies of public M&A transactions over many years have concluded that nearly two-thirds of major acquisitions fail to create shareholder value. In other words, post-transaction equity values do not reach the level required to justify the investment.

While there is little data to measure the success of acquisitions in the private markets, a similar bias toward optimism seems to prevail when managers of privately held companies are weighing the potential benefits of an acquisition.

### A UNIQUE GAMBLE

On the surface, the evaluation of a business acquisition would appear to be a straightforward capital budgeting decision. However, the allocation of resources to an acquisition has several unique attributes. First, all of the money is paid up front; there is no ability to

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make incremental investments or adjust the investment strategy along the way to improve the end result. Second, the costs of integration can be extremely high and difficult to predict. Once integration begins there is no turning back. The success of an invest-

### HELP NEEDED?

Business people often hesitate to engage outside help with regard to important financing or strategic transactions. Some reticence to call in consultants is natural as this advice represents an added expense. Nevertheless, there can be compelling reasons to expand your team.

**Access to Unfamiliar Markets.** Business owners or managers do not routinely arrange capital, other than from senior lenders. The syndicated, institutional, mezzanine debt, and private equity markets are best accessed with the assistance of an intermediary who has a clear understanding of market terms and practices, and can organize a process that delivers the most favorable mix of capital cost and flexibility.

**Presentation of Business Strategy and Economics.** Think of it this way, you speak Spanish and capital providers speak Portuguese. Many of the words sound the same, but both parties have trouble understanding each other. An advisor that can clearly articulate the client’s business strategy and economics in a manner that the market understands adds significant value.

**Allocation of Corporate Resources.** Most firms do not have the luxury of significant excess management capacity. An experienced outside team of advisors can help complete the transaction without sacrificing attention on the business. An outside advisor may also remove emotion from the negotiation. A bit of space between the frontline and the ultimate decision-maker is invariably beneficial.

A major transaction represents a change in the business environment. Consider outside assistance to ease the transition. ❖

ment depends on the ability to anticipate many highly variable outcomes, both good and bad, and account for them at the outset.

Within business academia, the concept “hubris hypothesis” is well known. It postulates that there is a bias toward over confidence by acquirers, which evidences itself in optimism regarding future economic performance. Future financial performance more often than not falls short of that required to justify the investment. While difficult to prove quantitatively, our own ability to play to a buyer’s optimism has been at the root of some of our greatest sell-side successes.

### SYNERGY VALUE

The primary culprit in over-pricing an acquisition is the estimation of the increase in performance of the combined firm over what the individual businesses would expect to accomplish independently. This is known as “synergy” and, in unsuccessful acquisitions, often proves to be the elusive element needed to justify the investment.

Acquirers often pay a premium over the stand-alone value of acquisition targets. The reason for the premium is that there are business initiatives that can be pursued successfully by the combined firm that could not be accomplished by either independently. “Two plus two equals five” is the synergy value equation. Generally, the obstacle to creating value is not the quality of the business ideas, but the difficulty in executing joint initiatives. Combining two profitable, well-managed, or even related businesses does not ensure value creation. Genuine gains in competitive advantage must be realized.

Acquirers often base their calculations on three categories of synergies:

- *Cost savings* are easy to estimate on paper, but much more difficult to achieve in practice. Managers routinely overestimate cost cuts; it is easier to cut positions on paper than to eliminate the people that fill them. Because people and organizations are resistant to change, it always takes longer to implement cost reductions than expected.
- *Revenue enhancements* are notoriously difficult to pin down as they involve external factors that are beyond management’s control. It is easy to imagine the possibilities to

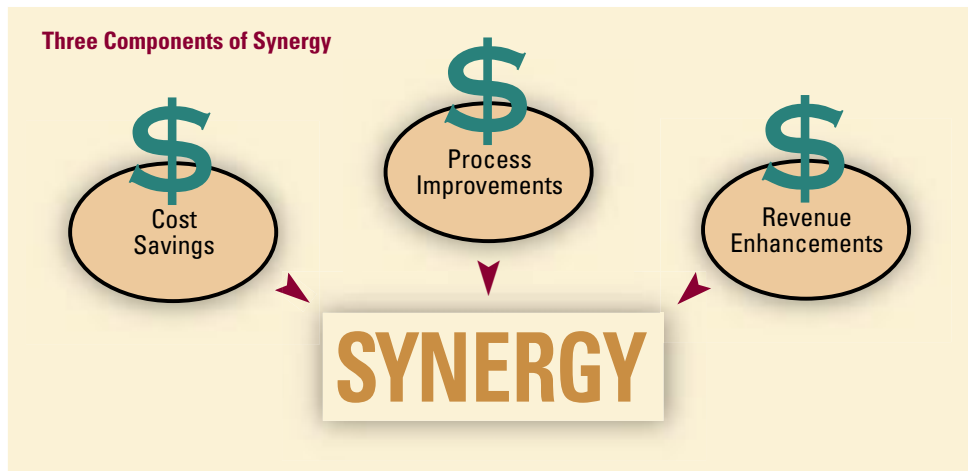
accelerate revenue growth, but in reality the business is more likely to lose rather than gain customers while management is focused on integrating an acquisition. Few, if any, corporate resource decisions can alter the value of a company as dramatically as a major acquisition. It is hard to estimate the effect of taking management's eyes off the market or competitors when it is neck deep in the process of integrating an acquisition. As a result, some disciplined acquirers refuse to even consider revenue enhancements in calculating acquisition values.

▪ *Process improvements* are either cost savings or revenue enhancements derived from adoption of the best practices of each organization. Improvements require changes in culture, capabilities, practices and/or personnel that are invariably more difficult to achieve than imagined.

Free cash flow valuation models are quite sensitive to changes in deal specific synergies. A minor tweak in growth rates or operating margins can drive a wide range of values. Because each prospective suitor can influence these variables differently, it is quite reasonable that there can be a broad value range for any acquisition target based on the attributes of the prospective buyers. This is why justification of value based upon "comparable transaction multiples," is dangerous. How synergies are evaluated in another acquisition (a "comparable transaction") usually has little bearing on the situation at hand.

**KNOW THY LIMITS**

Value is best determined by a thorough evaluation of the expected free cash flows from the acquisition with a conservative eye toward the realization of benefits from working together. If the preponderance of value expected from an acquisition is tied to the realization of synergies, it is a warning sign that the expectations for the future may be too robust. It is absolutely essential to focus only



on improvements that can be reasonably expected, not those that might be possible.

Corporate executives commonly rationalize an acquisition based on an improvement

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**There are two keys to success in pricing an acquisition. First, make sure that the investment analysis is rigorous and predicated on realistic assumptions. Second, pay no more than the quantifiable economic benefits imply. Resist the temptation to incorporate unquantifiable benefits in the valuation conclusion.**

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in strategic position. We cringe when we hear this tripe. In fact, the strategic rationale for virtually any deal boils down to revenue enhancements or cost savings that can and should be reflected in the numbers. If it can't

be nailed down, don't pay for it. There are two keys to success in pricing an acquisition. First, make sure that the investment analysis is rigorous and predicated on realistic assumptions. Second, pay no more than the quantifiable economic benefits imply. Resist the temptation to incorporate unquantifiable benefits in the valuation conclusion.

Most acquirers do not begin with a detailed integration plan and only move incrementally once a deal is inked. If you do the math, the higher the premium paid, the more critical it is that any expected performance gains from realization of synergies commence immediately. Value creation is predicated on what can be accomplished operationally. Acquisition success depends upon detailed post acquisition operational execution.

Remember, an acquisition is not an end, but merely a means to an end – the creation of shareholder value. Analytical rigor and strict process discipline are the cornerstones of acquisition success. Our advice to clients considering an acquisition is "don't dare to be great, dare to be disciplined." ♦

## Fundamentals of Leasing

*How best to finance the equipment your company needs usually centers around the question of leasing or conventional debt. Unfortunately, leases are often misunderstood.*

by Michael Newsome

It is a routine challenge for a financial officer to arrange the most flexible and affordable financing for the equipment a business needs to produce its products or services. Equipment leasing is perennially one of the more important sources of funding for the capital investment needs of U.S. businesses. According to the Equipment Leasing and Financing Foundation, over the past five years, equipment leasing financed nearly one-third of business fixed investment. Essentially, there are three basic equipment-

financing alternatives:

- Rent
- Rent with an option to purchase
- Buy and finance with conventional debt

Because lease structures are flexible, each of these alternatives can be accomplished with a lease. Decisions to lease or buy are typically veiled in complexities associated with tax attributes, options and risk shifting. Leasing, particularly tax oriented leasing, is a product that never seems to be well understood even

by the people that market it. So what exactly is a lease? Simplistically, it is a customized debt financing with potentially unique tax features and either a fixed or fair market value residual. There are two considerations that are fundamental to most lease contracts:

- Who has the right to use the tax shields (depreciation and investment credits), the lessor (owner) or the lessee (user).
- When, and if, title to the equipment changes hands.

In the absence of these tax and ownership concerns, a lease is essentially a secured term loan. Lease contracts are commonly defined by both the tax and accounting treatments.

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not identical. In practice, most, but not all, operating leases are true leases. Only a small percentage of capital leases actually qualify as true leases; most are financing leases. These four tax and accounting categories encompass an enormous variety of lease structures that are customized to the needs of individual equipment users. Contracts for the use of equipment are written for periods as short as a few hours to as long as 20 to 30 years.

**WHY LEASE?**

When reality is separated from marketing hype, the benefits of leasing fall into the following categories:

TAX TREATMENT	TAX-ORIENTED LEASE	NON-TAX ORIENTED
Classification	"True" or "Direct" lease	"Conditional Sales Contract" or "Financing" lease
Use of Tax Shields	Lessor	Lessee
Equipment Ownership and Residual Value	Lessor owns, lessee may have a fair-market-value ("FMV") purchase option	Lessor or lessee may own. Lessee may have a fixed price purchase option
Key Characteristics	Meets all of the following criteria: <ul style="list-style-type: none"> <li>■ Lessor's asset investment and residual value ≥ 20%.</li> <li>■ Lease term ≤ 80% of asset's economic life.</li> <li>■ Lessee's purchase option ≥ FMV.</li> </ul>	Does not meet all true lease criteria.

ACCOUNTING TREATMENT	OFF BALANCE SHEET	ON BALANCE SHEET
Classification	"Operating" lease	"Capital" lease
Accounting	Disclosed in financial statement footnotes.	Present value of lease rentals is treated as an asset and a liability.
Key Characteristics	Does not meet any capital lease criteria	Meets any of the following criteria: <ul style="list-style-type: none"> <li>■ Ownership transferred to lessee prior to lease expiration</li> <li>■ Bargain purchase option</li> <li>■ Lease term &gt; 75% of asset's estimated economic life</li> <li>■ Present value of rentals ≥ 90% of asset's fair market value</li> </ul>

**Tax Savings:** Leasing is an efficient mechanism for transferring tax shields from equipment users to lessors (equipment owners). If the difference between the expected marginal tax rates (“MTR”) of the lessor and lessee is significant, savings can be realized for both parties at the expense of government tax revenues. The lessor profits from lower

taxes and the lessee enjoys a lower rental expense. As a consequence, low tax paying firms tend to favor leases and high tax paying firms gravitate towards debt financing.

**Capital Access and Affordability:** Although rarely touted by leasing companies, a key benefit is the manner in which leases are treated in default and/or bankruptcy as

(continued p.4)

**Lease vs. Loan After-Tax Cash Flow Analysis**

GENERAL INFORMATION							
Closing Date	7/1/04						
Equipment Cost	\$ 1,000,000						
Depreciation	3 Yrs MACRS						
Fed Tax Rate	35.00%						

LEASE INFORMATION		YEAR	RENTAL	RESIDUAL	DEPRECIATION	TAX SHIELD	ATCF
Lease Factor(s)	1.59599%	1	111,719	-	-	(39,102)	72,618
Estimated Residual	20.00%	2	191,519	-	-	(67,032)	124,487
Payment Method	advance	3	191,519	-	-	(67,032)	124,487
		4	191,519	-	-	(67,032)	124,487
		5	191,519	-	-	(67,032)	124,487
		6	79,800	200,000	(66,660)	(51,261)	228,539
		7	-	-	(88,900)	(31,115)	(31,115)
		8	-	-	(29,620)	(10,367)	(10,367)
		9	-	-	14,820)	(5,187)	(5,187)
			\$ 957,595	\$ 200,000	\$ (200,000)	\$ (405,158)	\$ 752,437

LOAN INFORMATION		YEAR	DEBT SERVICE	INTEREST	DEPRECIATION	TAX SHIELD	ATCF
Monthly Payment Amount	\$ 20,038	1	120,227	(36,197)	(333,300)	(129,324)	(9,097)
Payment Method	arrear	2	240,455	(62,669)	(444,500)	(177,509)	62,946
Interest Rate	7.50%	3	240,455	(48,867)	(148,100)	(68,938)	171,516
Balloon Payment	0.00%	4	240,455	(33,993)	(74,100)	(37,833)	202,622
		5	240,455	(17,965)	-	(6,288)	234,167
		6	120,227	(2,587)	-	(905)	119,322
			\$ 1,202,274	\$ (202,278)	\$ (1,000,000)	\$ (420,797)	\$ 781,477

NET PRESENT VALUE OF AFTER-TAX CASH FLOWS	
Discount Rate	7.50%
Cost FMV Lease	576,222
Cost of Loan	576,222
Benefit (Lease) Loan	\$ 0

**Fundamentals of Leasing** *continued from p.3*

compared to debt. If leased assets are to be used while in bankruptcy, the lessee must continue to make scheduled lease payments. In contrast, payment of most other financial obligations, including most secured debt payments, is suspended until the bankruptcy is resolved. Lease obligations effectively enjoy priority in bankruptcy on par with administrative expenses. The bottom line is that it is generally cheaper and easier to recover on a lease default than a loan default. That advantage is manifested in better access to lease credit for financially volatile businesses and lower leasing costs. This is a principal reason why small companies can often lease when they cannot borrow and why leasing is consistently a major component of small business finance.

**Cost of Capital:** One of the most widely promoted advantages of equipment leasing is 100 percent financing, which is purported to preserve capital for other uses. Economists would argue that this benefit is illusory. It is reasoned that if a firm can arrange 100 percent lease financing, it can also find 100 percent debt financing at a market deter-

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mined price (perhaps not all from a single source). Nevertheless, experience suggests that leasing is a lower cost source of 100 percent financing than conventional debt alternatives. The disparity between real world lending and leasing practices seems to be an example of the fabled economic “free lunch.”

Another well-known justification for leasing is the off-balance sheet treatment of operating leases. By keeping the obligation off the balance sheet and relegated to the financial footnotes, it is presumed that capital providers will be inclined to view the lessee as financially stronger. In the post-Enron era of financial transparency, it seems unlikely that sophisticated analysts and capital providers will fail to account for operating leases in their assessment of financial leverage. However, even today, borrowers are frequently not restricted from incurring significant operating lease obligations by routine bank covenants, such as fixed charge coverage and leverage ratios, or capital expenditure limits. Lenders are often adamant

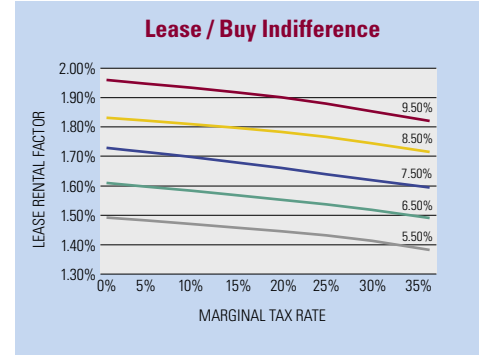
that borrowers generate sufficient cash flow to cover their annual debt service obligations by a ratio of 1.25:1 or greater. Yet the treatment of fixed lease rentals as a deduct to cash flow in these covenant calculations means that these obligations need only be covered on a 1:1 basis.

One situation where off-balance sheet lease financing can be an imperative is when capital investments have been financed by the issuance of tax-exempt industrial development bonds. These bond issues limit capital investment to \$10 million (including the bond financed investment) within a three-year window. Off-balance sheet leasing is a standard way to exceed these capital investment limitations without jeopardizing the tax-exempt status of the bonds.

**Risk Sharing:** One of the most compelling arguments for leasing is that it helps to avoid many of the risks of ownership, particularly the risk of equipment obsolescence. A well tailored lease allows the lessee to pay for the asset value that is actually used and provides an option at, or in some cases prior to, the end of the contract to buy the asset, return it to the lessor, or extend the rental. How the lessee uses these options depends in large measure on the economic value of the equipment to the business at that time. For example, equipment with predictable replacement cycles (e.g. forklifts, trucks, or computers) is commonly leased for a period that closely matches its useful life. If the equipment is worn out or technically obsolete at the end of the lease, it is frequently cost effective to return it to the lessor and replace it with new equipment. Often a lessor with superior equipment knowledge and better access to secondary markets than the lessee can maximize the equipment’s residual value when it comes off lease. The disparity between the residual value to the lessor and the lessee can be reflected in more favorable rental rates for the lessee.

**LEASE OR CONVENTIONAL DEBT?**

The basic lease or buy decision is a comparison of discounted after-tax cash flows over the term of the loan and lease based on



the expected marginal tax rate. The table on the previous page compares the after-tax cash flows (“ATCF”) of a \$1.0 million five-year lease contract to a five-year term loan at 7.5%. It is assumed the lessee will acquire the equipment at the end of the lease for 20% of original cost. Assuming a marginal tax rate of 35%, the lease is more attractive if the lease factor (monthly rent as a percent of equipment cost) is 1.596% or less. The loan is more attractive if the lease factor is greater than 1.596%. The curves on the adjacent chart reflect the points of indifference between a lease and a loan based on marginal tax rates between 0% and 35% and loan rates between 5.5% and 9.5%. A lower MTR favors leasing and a higher MTR favors conventional debt financing.

**CONCLUSION**

In the pursuit of an efficient and flexible capital structure, it is paramount that business managers carefully consider the tax impacts and corresponding economic and qualitative benefits of leasing relative to buying. The key benefits of leasing—affordability based on the use of tax shields and default treatment and the sharing of obsolescence risk—ensure that it will remain a flexible and attractive alternative to conventional debt financing. ❖

**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, go to ZacharyScott.com.

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