



## Discipline Leads to Acquisition Success

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

by William S. 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 make incremental investments or adjust the investment strategy along the way to im-

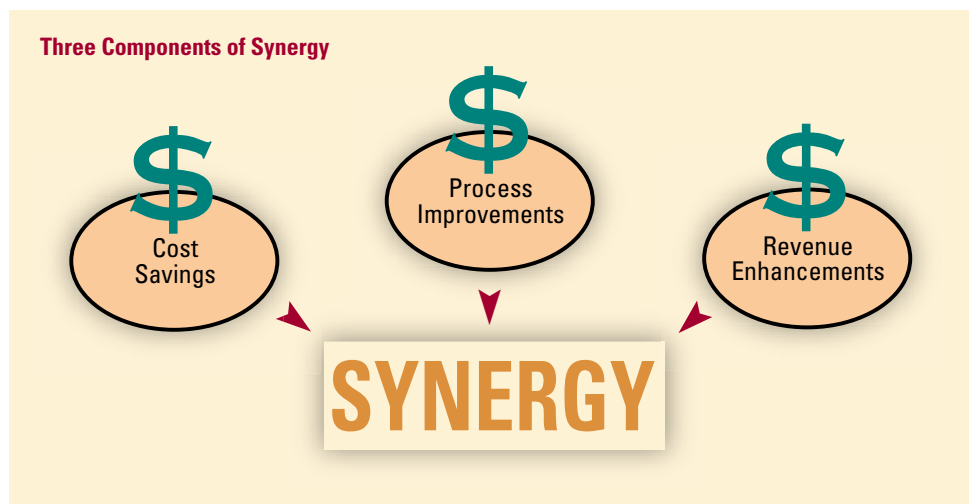
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prove the end result. Second, the costs of integration can be extremely high and difficult to predict. Once integration begins, there is no turning back. The success of an investment depends on the ability to anticipate many highly variable outcomes, both good and bad, and account for them at the outset.

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tulates 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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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.” ♦



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