Valuation in M&A Transactions

Valuation in M&A Transactions

- M&A transactions normally involve a range of valuation methods
- These are often presented in the "Football Field" style of presentation

Valuation in M&A Transactions

- The additional dimension is the impact of the "deal" on the valuation
  - Different perspective of buyer and seller
  - Strategies, synergies and premiums
  - Accretion or dilution
  - Impact of deal on Terminal Value assumptions
  - Financing - Debt or Equity
  - Comparable transactions?

Valuation in M&A Transactions

- M&A transactions can involve complex financing, particularly if its a sizeable deal being run by a PE Firm
- VC houses also use preference share structures to protect their downside

Valuation in M&A Transactions

- Consideration can include
  - Cash
  - Shares
  - Preference or Convertible stock
  - Debt - in more than one tranche, including Mezzanine, Junior and Senior
- These structures need to be modelled and their impact assessed on the valuation and the outcome of the deal - Accretion/Dilution

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- Putting that aside, the fundamentals of the analysis are very similar
- You have to keep your eye on the basics

Valuation in M&A Transactions

- Management
- Strategy
- Life Cycle Stage
- Historic Financial Performance and Balance Sheet structures

Valuation in M&A Transactions

- At the heart of every deal we are still looking at the value of cash flow which is connected to the risk associated with that cash flow
  - Rate of Return
  - Growth
  - Cost of Capital

Valuation in M&A Transactions

- Focus on whether the target has a low return on investment AND there is room/scope for increasing that return through the deal, particularly synergies to make the target more efficient and profitable, grow faster and/or reduce its cost of capital.

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- Lets take a look at Synergies
  - Benefits of the deal =
  - Value of Synergies -
  - Value of Premium

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- Synergies might include:
  - Overhead cost reduction
  - Capacity saving or improved utilisation
  - Growth through investment (capex)
  - New sales from improved strategy, customer mix or new customer base
- Cannot apply the same discount rate to all synergies - some may have greater risk

Valuation in M&A Transactions

- The assumptions underlying the results
- Accretion or Dilution must be challenged
  - Management changes
  - Forex rates of exchange
  - Strategic adjustments and changes

Valuation in M&A Transactions

- Valuation multiples are commonly used in M&A
- Comparable Companies and Precedent Transactions make this straightforward
- As we have seen, the selection of the Peer group is critical to the outcome
- Adjustments for outliers can further distort results
- EV / EBITDA most common
- Investment Bankers in Public Transactions use PE ratios

Valuation in M&A Transactions

- Prepare to remain critical of multiples
  - EV/EBITDA multiple depends on
    - Changing ROIC
    - Asset Life and Asset Replacement (Depreciation and Capex)
    - Tax Rate
    - Changing Growth rates
    - Working Capital investment
    - Weighted Average Cost of Capital

Valuation in M&A Transactions

- Your EV/EBITDA check list should include the peer group and the target having similar
  - Trends in ROIC
  - Growth rates and consistency with ROIC
  - Asset lives
  - Working Capital investment relative to EBITDA
  - Tax Rates
  - Cost of Capital
  - Capital Structures

Valuation in M&A Transactions

- You should also keep a close eye on the Entry EV / EBITDA and the Exit EV / EBITDA to ensure that there is no arbitrage between the two

Valuation in M&A Transactions

- A DCF valuation nearly always is part of the M&A modelling
- Bewary of using this for negotiation
- You will end up focusing and arguing about assumptions rather than the actual deal consideration
- The potential wide valuation range will only make this argument more complicated not more straightforward

Valuation in M&A Transactions

- Taxation can become very complex in M&A deals and modelling
- Purchase accounting might be used for book purposes but for tax purposes the transaction may be treated as a tax free exchange
- This means that tax depreciation will be different from book depreciation and deferred taxes will arise.

Valuation in M&A Transactions

- Another popular technique, particularly used by PE/VC houses is to make adjustments to the cost of capital (upwards) to reflect the value of smaller private companies or overseas companies (downwards)
- They are less liquid, higher risk and have financial statements prepared to lower standards are typical reasons for this.

Valuation in M&A Transactions

- A final word should go to the Work Capital Adjustment argument which always takes place between a buyer and a seller
- The Seller wants to take all the spare cash out of the business prior to the sale
- The Buyer will always argue that there is no "spare" working capital and a capital injection is required.
- This has nothing to do with valuation and everything to do with cash and deal value for both sides.
- You have been warned.

Valuation in M&A Transactions

- The purpose of this lecture has been to open your eyes to an additional level complexity when it comes to valuation in M&A transactions
- You need to be constantly questioning assumptions and avoid over simplifying conclusions without a clear understanding of why the answer make sense.

Valuation in M&A Transactions