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## *11th M&A VALUATION FOR CFOs*

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# VALUING ACQUISITION TARGETS ON A STAND-ALONE BASIS


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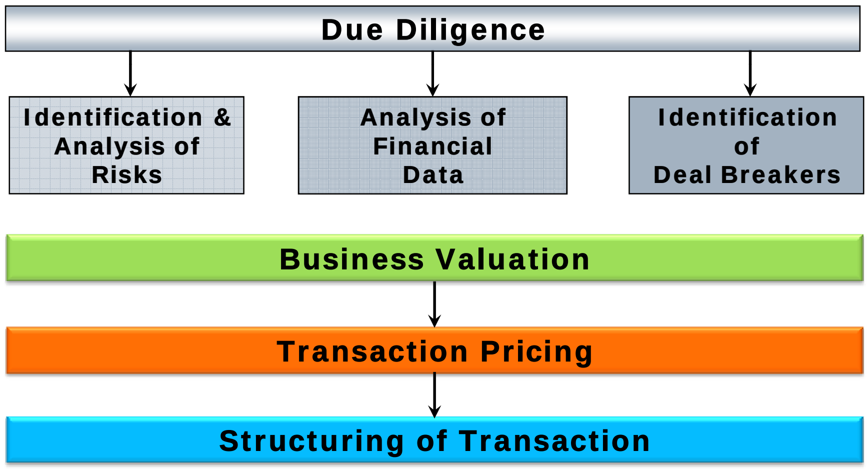
# STEPS IN THE ACQUISITION PROCESS






# THREE POSSIBLE COMPONENTS OF TRANSACTION PRICE

1. Intrinsic Value ("Stand-Alone Value") of Target
2. Net Economic Value Created by the Acquisition
3. Value of any "Redundant Assets"

# SYNERGY

**"The increase in performance of combined firm over what the two businesses are already expected or required to accomplish as independent, stand-alone businesses."**



# POST-ACQUISITION SYNERGIES

**Increase in value of combined business beyond sum of its components by:**

- increasing amount of combined prospective discretionary cash flows
- reducing risk of buyer, seller, or both
- creating growth opportunities and strategic advantage not otherwise available to either buyer or seller

## SPECIAL-PURCHASER SYNERGIES

- FINANCIAL
  - Size and lower financing costs
  - Leverage
  - Capital structure
- OPERATING — INTANGIBLE
  - Ongoing source of supply
  - Technology
  - Growth opportunities
- OPERATING — TANGIBLE
  - Economies of scale / purchasing advantages
  - Product diversification
  - Utilization of excess capacity



## ASSESSMENT OF SYNERGIES

### QUANTUM OF SYNERGISTIC BENEFITS

- Forecast and analysis of increased cash flows, net of working capital and fixed-asset investments and related financing
- Probability of achievement
- Best-case, most-likely-case and worse-case scenarios, using sensitivity analysis

# ASSESSMENT OF SYNERGIES
(CONT'D)

## TIMING OF SYNERGISTIC BENEFITS

- As forecasts made further into the future, more risk in being on target
- Synergies in shorter term can be forecasted more reliably



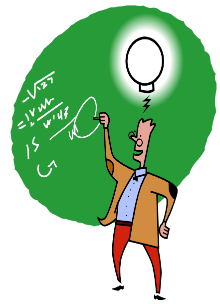
# VALUATION/PRICING WILL CONSIDER:

- Standard valuation approaches:
  - Cost
  - Income
  - Market
- Perspectives of possible buyers/sellers
- Attributes of property being valued
- Industry and economic environment

# VALUATION / PRICING CONSIDERATIONS

## Valuation formula components

- ❑ **Numerator: economic benefits, cash flow**
- ❑ **Denominator: cap rate (rate of return)**





# PRE-TAX vs. AFTER-TAX CAPITALIZATION RATE — EXAMPLE

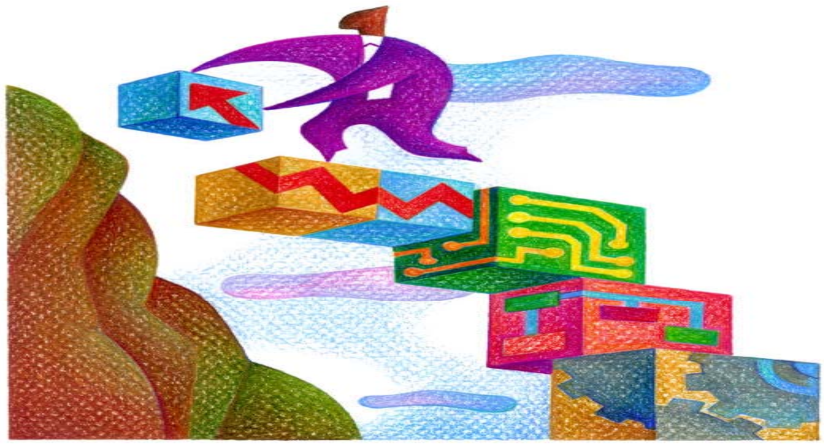
**Assumptions:**

- ❑ Appropriate after-tax capitalization rate is 15%
- ❑ Corporate income tax rate is 30%

∴ equivalent pre-tax capitalization rate is
[15% / (1 - 30%)] = 21.4%

| | | Pre-Tax | After-Tax |
|---|---|---|---|
| Cash flow | (a) | $100 | $70 |
| Multiple (1 / Capitalization Rate) | (b) | 1 / 21.4% = 4.67 | 1 / 15% = 6.67 |
| Capitalized value | (a) x (b) | $467 | $467 |

## RATE OF RETURN: DISCOUNT RATE OR CAPITALIZATION RATE
## BUILD-UP METHOD



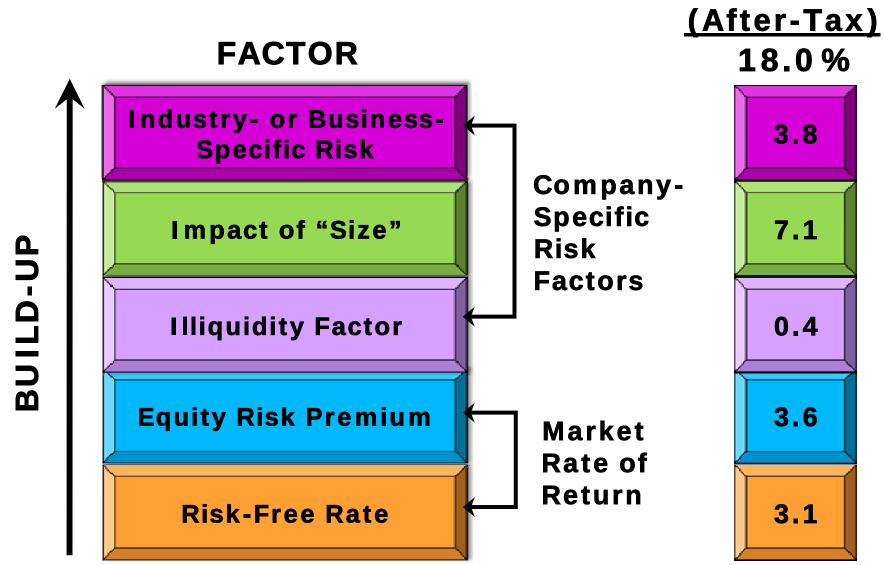


## EQUITY CAPITALIZATION RATE OR DISCOUNT RATE SEGREGATED INTO FOLLOWING COMPONENTS

a. Risk-free rate
b. Equity risk
c. Size
d. Liquidity
e. Company-specific risk
f. Lack of control and/or lack-of-marketability

## DEVELOPING DISCOUNT RATE OR CAPITALIZATION RATE

**BUILD-UP METHOD — EXAMPLE**




# DISCOUNT RATE

**Discount rates must be adjusted to exclude any risks unrelated to asset's estimated cash flows, or for which estimated cash flows have already been adjusted.**

## DISCOUNT RATE —
## WEIGHTED AVERAGE COST OF CAPITAL

- Capital Structure
  - Comparable companies
- Cost-of-Equity Component
  - Capital Asset Pricing Model
  - Build-Up Approach
- Cost-of-Debt Component



## CAPITALIZATION RATE —
## INTERNAL FACTORS

- Financial condition of business
- Tangible asset backing
- Management depth and continuity
- Products and services offered
- Research and development
- Condition of plant facilities
- Marketing ability

# CAPITALIZATION RATE — INTERNAL FACTORS (CONT'D)

- Labour force
- Contracts, leases, etc.
- Customer dependence
- Supplier dependence
- Ability to cope with, and react to, change
- Patent, copyright, etc. protection



# CAPITALIZATION RATE — EXTERNAL FACTORS

- Industry conditions
- Economic conditions, including cyclicality
- Money and stock market conditions
- Foreign exchange rate fluctuations
- Political environment
- Social environment

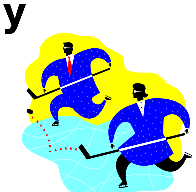
## CAPITALIZATION RATE — EXTERNAL FACTORS (CONT'D)

- Competition
- Ease of entry by others
- Presence of identifiable prospective purchasers and their strategic objectives at given point in time
- Sources of raw material supply
- Market psychology

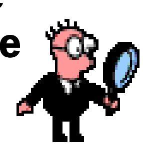


## SELLER'S PROJECTIONS

- Often optimistic; can be unrealistic ("hockey stick" projections)



- Assumptions must be scrutinized (and some challenged)



# REVIEWING SELLER'S SIGNIFICANT ASSUMPTIONS

- Assumptions go to heart of projections
- Evaluate whether "significant assumptions" used by seller / management, taken individually and as a whole, are reasonable
- Are assumptions consistent with market information (such as that used by market participants)?



# REVIEWING SELLER'S SIGNIFICANT ASSUMPTIONS
(CONT'D)

- General economic environment and entity's economic circumstances
- Existing market information
- Entity's plans, including management's expectations of outcome of specific objectives and strategies

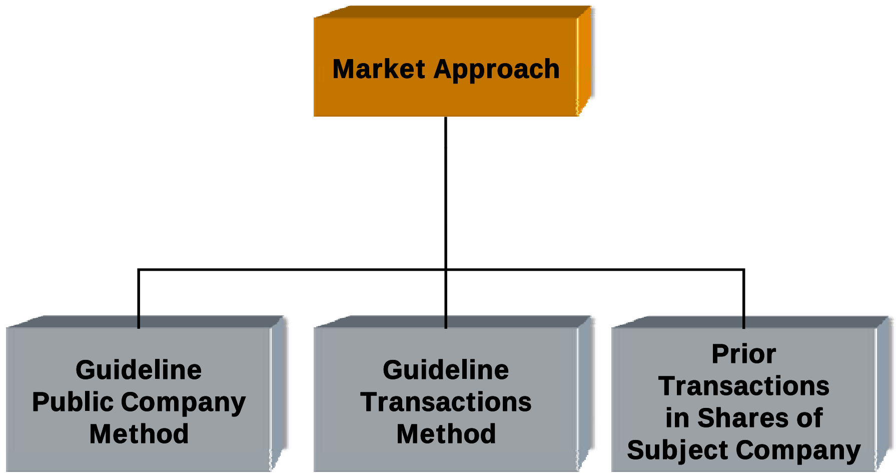
## REVIEWING SELLER'S SIGNIFICANT ASSUMPTIONS
**(CONT'D)**

- Past experience of, or previous conditions experienced by, entity if currently applicable
- Assumptions used by management in accounting estimates for financial statement accounts (auditor-reviewed?)
- Any risks associated with cash flows, including potential variability thereof and related effect on discount rate



## WAS THERE IMPAIRMENT TESTING FOR GAAP?
**CHECK BASIS FOR ESTIMATE OF FUTURE CASH FLOWS**

- Management's estimates of future cash flows should be based on most recent budgets/forecasts for <u>maximum of 5 years</u>
- May use cash flow projections for period longer than 5 years <u>if confident that projections are reliable and can demonstrate management's ability, based on past experience</u>, to forecast cash flows <u>accurately</u> over that longer period
- Objectively support growth rate






# EXAMPLES OF MARKETS

- ***Example 1*:**

  **Parking lot operation on ABC land**

  **vs**

  **Apartment building / condo development on ABC land**

- ***Example 2*:**

  **Summer camp on XYZ land**

  **vs**

  **Condos or resort hotel on XYZ land**

# EXAMPLES OF MARKETS
(CONT'D)

## THE MARKET FOR

**Control of public companies**
**and**
**Control of private companies**

**vs**

## THE MARKET FOR

**Minority interests in public companies**
**and**
**Minority interests in private companies**



# IF RELYING ON ("GUIDELINE") TRANSACTIONAL PRICING DATA, YOU MUST KNOW ABOUT

- Seller's motives
- Buyer's motives
- Whether distress or duress situation
- Special / strategic buyers vs financial / ordinary buyers
- Any redundant assets included in price
- Tax structuring

## IF RELYING ON ("GUIDELINE") TRANSACTIONAL PRICING DATA, YOU MUST KNOW ABOUT (CONT'D)

- Other "consideration" included in transaction "price":
  - Consulting agreement with seller
  - Non-compete covenant with vendor
  - Earn-out provision
  - Retirement allowance



## AOL TIME WARNER INC. YEAR ENDED DECEMBER 31, 2002

| Reduction in Carrying Value of | Billions (U.S.) |
|---|---|
| Goodwill (AOL) | $33.5 |
| Cable segment | 10.6 |
| Music segment | 0.6 |
| Brands and trademarks at Music segment | 0.9 |
| Impairment charge (to operating income) | $45.5 |

# AOL MANAGEMENT EXPLANATION OF WRITE-DOWNS

**"The $33.489 billion charge at the AOL segment reflects the AOL segment's lower than expected performance, including the continued decline in the online advertising market. The $10.550 billion charge at the Cable segment reflects current market conditions in the cable television industry, as evidenced by the decline in the stock prices of comparable cable television companies. The $1.499 billion charge at the Music segment reflects declining valuations in the music industry, primarily due to the negative effects of piracy.**

**"The impairment charges are non-cash in nature and do not affect the company's liquidity … ".**



# QUESTIONS?

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