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WINNING WITH BETTER FORECASTS

A guest article from Duff & Phelps identifies how improved projections can help buyers succeed

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GETTING THE DEAL DONE is only the initial part of the equation when it comes to making successful acquisitions. Of even greater importance is the question of whether acquisitions will beat the odds and grow a company profitably. Given the competitive environment and limited time typically available to propose a purchase price, well thought out forecasts of the acquired business are essential.

Although many companies have clear business objectives for an acquisition, detailed financial projections don't always provide as complete a basis as they should to value an acquisition target. Too little time may be devoted to vetting the key commercial assumptions behind the projections. Too much time may be spent on assumptions with little impact on deal viability. Synergies and the outcome of losing the bid may not be quantified properly. Risk assessment may be focused only on the downside, ignoring the potential for better than expected performance. Risk may be incorporated into the valuation only via a discount rate that is chosen on the basis of "rules of thumb," without a solid tie to the rationales for why cash flows could be higher or lower than expected.

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Start with the forecast basics

The first step is to identify all of the underlying assumptions — including what is taken for granted. Acquiring companies should be clear about assumptions regarding everything from the scope of the accessible market to the growth rates and sustainability of trends driving that growth; from unit sales and pricing to market share; from new product launch schedules to the evolution of the competitive landscape; and from capital investments to taxes.

In our experience, it's the hidden assumptions that usually cause problems. To ferret out the hidden assumptions, buyers should ask the question: "What if profits were twice what you thought they would be?" And then ask, "How did this happen?" The next question buyers need to probe is: "What if profits were half what you thought they would be?"

The second step is to test the credibility of the assumptions for both internal and external consistency. Typical internal consistency testing includes investigating the consistency of market share assumptions with pricing; of gross margins and selling expenses with the business model; and of top-down projections with bottom-up projections. In addition, internal consistency requires that the assumptions used by different business functions are the same and that planned costs, capacity and staffing are sufficient to support planned sales growth.

External testing of assumptions includes assessing whether the market share projections are reasonable given the projected competitive positioning and likely future competitive moves. Consideration must also be given to the evolution of prices and costs and the impact of new competitors, distribution channels and technologies, in accordance with industry trends. Finally, external consistency requires that assumptions regarding e.g., margins, revenue/customer, productivity/sales person, and growth rates, lie within the range of benchmarks for comparable companies in similar markets at a similar lifecycle stage.

Understand the elusive synergies

Synergy is frequently the justification for the premiums paid for control of the target company. Common pitfalls in identifying and valuing synergies include projecting the impact of only immediate and tangible synergies, ignoring negative synergies, failing to realize that synergies may be difficult or slow to achieve, and/or simply using the discount rate as a catch all adjustment to reflect the risk of achieving synergies.

Typical sources of business synergies include: cross-selling to a combined customer set, broadening of the product portfolio, elimination of duplicate functions and the use of tax credits. Synergies can also be found in the ability to build scale across the production line and leverage distribution channels, strong brands and innovations in production processes. On the other hand, each of these aspects can involve dissynergies. For example, some deals may lead to product cannibalization, increased costs associated with merging different cultures, tax code limitations, channel conflicts and brand dilution. Also, some customers may wish to maintain multiple sources.

After identification, the key synergies/dissynergies should be valued by projecting their impact, timing and potential for delay.

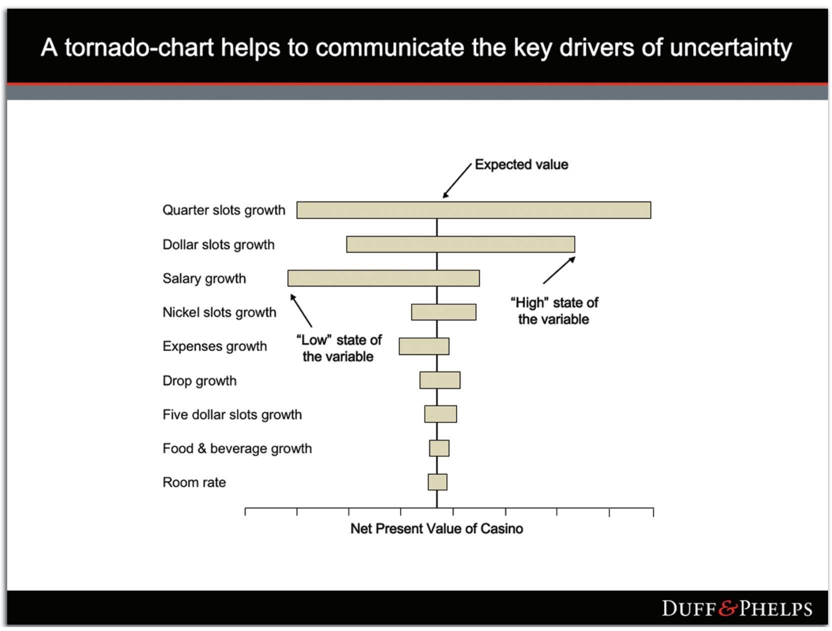
Of course, acquirers should not make the common mistake of including, in the offer price, synergies brought only by the individual buyer. While they may need to bid more than the standalone value in a competitive situation, or to close a deal with a reluctant seller, any such decision should be a conscious choice, recognizing that the buyer is giving away some of the value that they bring to the table.

Make risk work for you

Substantial risk of achieving the anticipated cash flows may exist. Traditional valuations often account for risk via a high discount rate, or by developing two or three alternative scenarios.

The difference in value between using a high discount rate to reflect risk versus explicitly incorporating risk in the cash flows can be substantial. A good example is provided by a deal where the target had near-term sales in one market together with a planned launch a year later into a second, larger market. The acquirer had previously valued the acquisition using a somewhat arbitrarily high discount rate to reflect the risk of the product still in development. Identifying the risks, probability-adjusting the cash flows, and using an appropriate discount rate for the industry nearly doubled the value as compared with the use of that high discount rate.

To properly incorporate risk in the transaction valuation, the key is to identify, quantify and communicate uncertainty about important financial parameters, such as the size and growth of the markets, pricing, degree of competition, costs and timing.



A Tornado Chart can help buyers rank key risk factors before submitting a bid.

Communicating about risk can be challenging, however. We often provide the expected cash flows and a range around those cash flows that profiles the overall risk. Another valuable communication tool is the "tornado chart," which ranks key risk factors by the range of variation in value driven by that single factor on its own. The tornado chart helps the deal team to focus on the key issues.

Leverage learning opportunities to increase value

With a deep understanding of the uncertainties, acquirers can better manage the risks they accept. They can design deal structures with appropriate milestone payments, earnouts, collars, tiered royalties, Ebitda claw backs, working capital adjustments and/or warrants.

In addition, management may be able to identify contingent strategies to increase value, taking advantage of upsides or mitigating downsides. Traditional discounted cash flow models may underestimate the value of investments, if strategic options are embedded in the investments. Examples of these strategic options include the opportunity to defer investments, alter manufacturing or expand into new markets based on early results.

Such a "real" option gives the holder the ability to make a decision related to an operating business asset, contingent on how the world evolves. Examples of real options include executing a deal with contingent deal terms (milestones, earnouts, claw backs, etc.); entering into a joint venture with options to change scope, increase ownership, or exit; acquiring a brand with options to expand to additional markets; building infrastructure or capacity in increments; and investing in phased product development.

Real options can have an enormous impact on value, and in some cases can quadruple the value of an investment.

To the extent that real options are uniquely available or recognized by a company and not by competing bidders, they can provide an element of value that supports a winning bid for an acquisition target.

What can be done to be ready

It is possible to provide a firmer foundation for valuations of acquisition candidates, increasing the likelihood that investments will provide a cash flow return on the purchase price greater than the cost of capital. To achieve this objective, investors can take some steps before becoming enmeshed in the compressed timeframe of a transaction process.

First, form a multidisciplinary team with a well developed view of the markets and competitive dynamics in which acquisitions will be made. Next, prepare a flexible transaction valuation model before the deal negotiation starts. Set consistent assumptions for market growth rates, achievable market shares, cost reductions and timing, tax rates, investment assumptions and terminal value. Finally, develop a protocol for the team to identify key assumptions, rank their relative importance, quantify synergies, develop a balanced risk assessment and identify real options.

Companies who follow these practices will be more confident of a successful transaction, will have better information about value and risk to support their negotiations of price and deal terms, and will be positioned to execute a value-maximizing contingent strategy post-transaction. M&A