

**DO MERGERS & ACQUISITIONS
CREATE SUSTAINABLE ENTERPRISE VALUE?
TEN REASONS WHY THE ANSWER IS NOT MULTIPLE CHOICE!**

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INTRODUCTION

The business press regularly showcases examples of mergers and acquisitions that failed to create shareholder value. Indeed, over the past ten years nearly \$2 trillion has been invested in merger and acquisitions and sadly, too many have resulted in a loss of shareholder value. Why? Where were the advisors to these companies, how did they perform their fiduciary responsibilities, and how could these losses have been avoided?

We hope and believe this recent value destruction phenomenon will not be repeated in the future. The creation of sustainable shareholder value can be achieved through thoughtful business transactions.

How can we, as professional advisors, be a resource to clients who wish to participate in value creating transactions that meet the expectations of all parties? The experience and research of The Bigelow Company suggests that when properly crafted, mergers and acquisitions do create sustainable enterprise value, add to the wealth of a society, meet the expectations of sellers seeking liquidity, and meet the expectations of acquirers seeking growth and an enhanced return on capital.

There are, in our experience, as many as ten critical factors to be considered when advising a client on a business acquisition or divestiture. As sell-side advisors, the bankers of The Bigelow Company understand well the emotions and thought patterns of buyers and fully appreciate the needs, wants, and expectations of sellers. Experience strongly suggests that the drivers of valuations are

more a function of the buyer's unique experiences, skills, resources, motivations, and behaviors, and less a function of some pre-determined average multiple of sales, earnings, or mystical "synergy."

The application of the majority of these critical understandings and practices provides a level of assurance that the desired outcome will be reached, shareholder value will be created for the buyer, and premium value and liquidity will be generated for the selling shareholders.

**TEN CRITICAL FACTORS TO VALUE
CREATING TRANSACTIONS**

First, the WHY of the Transaction. The business transaction that has been contemplated must be championed by all parties to the transaction, especially the respective CEO's, CFO's, and their advisors. Both the buyer and the seller should fully embrace and understand the specific market and business model reasons for the transaction and be able to clearly articulate the qualitative and quantitative benefits of the proposed business deal. Advisors to the decision, be they accountants, lawyers, or bankers, must also know the 'whys', if together they are to succeed in meeting the expectations of the parties they are representing.

Second, The Board(s) of Directors are Onboard. The acquirer's Board of Directors should, ideally, have agreed in advance on a "growth through acquisition" strategy before the target acquisition or combination is presented to the Board for initial approval.

Unlike the recent past, today's more aggressive Board governance practices do not

allow a “rubber stamp” on investments the CEO wants to make. When the buyer or seller is a privately held or family owned company, all of the shareholders and critical stakeholders must be in agreement with the reasons for the transaction and understand the implications of legacy, liquidity, and life after the transaction. Without this understanding, there is a risk the deal will not close and the opportunity for a value creating combination may never reoccur for either the buyer or seller. Time alone does not assure a business will become more valuable in the future.

Third, On or Off the Team’s Agenda. The acquirer’s operating team must embrace that “growth through acquisition” is the company’s chosen plan for growth and that the goal is equal to or greater than possible internal growth. Proposing a transaction that is off-agenda is unlikely to gain support in execution and value will be lost to passive aggressive behavior. Advisors and company Board of Directors will want to advance this kind of strategic questioning of management on the topic of growth or value alternatives and seek consensus before starting on a course of acquisition or sale.

Fourth, Don’t Bet the Bank. The net worth or market capitalization of the acquiring entity should ideally be no more than 20% of the investment required to complete the acquisition; short of that there is a risk the transaction will not close, will not earn the cost of capital, and will be severely hampered in execution. Even common industry mergers that have limited operating risk are vulnerable when the ratio of market cap to investment is breached. For example, Fairpoint Communications’ investment in Verizon’s (VZ) New England telephone business was 4x their net worth. Fairpoint filed for Chapter 11 in 2009. The relationship of investment to net worth is especially important when selling

shareholders are taking an earn-out or when they retain some investment in the selling entity.

Fifth, Buyer Behavior Drives Value. Before the seller’s advisors approach any potential acquirer, an understanding of the buyer’s past practices, behaviors, and decision making processes must be known first. The acquirer must have made several premium value acquisitions in the past where each combination was successful upon integration. Past implementation success provides a high level of confidence that the transaction will close and that the value for the seller will be at a premium. Buyers with the experience and skill to integrate have confidence in their ability to create incremental value and as a result are willing to provide a significantly higher value to the sellers. First time acquirers or those with limited implementation success will always assign a lower value to a transaction due to their lack of confidence in the outcome. Sellers and their advisors should avoid first time buyers or buyers without a track record of value creating integration. Exxon’s (XOM) acquisition of Mobil at 12x EBITDA was a significant premium over Exxon’s market multiple and premium over any other bidders. Happily, XOM’s ability to extract value and create capital returns out of the transaction was far greater than the premium paid. XOM’s return on capital has since improved from 20% to over 30%. By contrast, Chesapeake Energy’s (CHK) low multiple purchases have fared less well with their return on capital dropping to 5% or less than the cost of capital. And yet, the multiples CHK paid were only 4x EBITDA. Execution experience translates into a greater willingness to pay a premium price to sellers. Behavior drives value creation.

Sixth, Cash is More than Money. The seller's advisors must determine if likely acquirers have sufficient cash resources on the balance sheet to close the transaction without borrowing any funds.

Sellers need to be mindful that acquirers without readily available resources cannot assign a premium to the combination and cannot control closing. Investors requiring external financing will assign a value more as a function of the bank's willingness to lend versus the true value the opportunity represents. Those who are advising sellers want to be aware that confidentiality may become unnecessarily breached if the seller's intentions are shared with buyers unable to consummate the transaction with available cash resources. Contrary to popular belief and practices, an auction process with seller books and multiple buyers often depresses value and compromises confidentiality. The "best" buyers may opt out of the process leaving the least able to participate.

Seventh, Accretive Without the Hockey Stick. The combination proposed must have an expected high degree of future financial success in order to assure a closing and a premium value to sellers. Given the high level of scrutiny from Wall Street, the merger must be shown to be accretive within three years without questionable assumptions. Advisors who understand the need for an accretive transaction are best able to assist the parties to work together on information sharing.

Eighth, Valuation 2.2. The chances for a timely closing and a premium value for the sellers are greatly improved when the combination creates true sustainable enterprise value and the return on capital for each entity is improved.

A prime example is eBay's acquisition of PayPal in 2002. While the street did not

believe the acquisition would be value creating, it is worth noting that most of the value creating factors suggested here were in fact present. The purchase price of \$1.5 billion was nearly 40x EBITDA and yet it became accretive in three years and for 2009 PayPal's growth and return on capital exceeds that of eBay's! And then, there was the recent acquisition of PNC Financial Services' back office operations by BNY Mellon at a valuation of 35x EBITDA! What do they know? Another example of a high value multiple (12x) was Proctor & Gamble's acquisition of Gillette. For several years, P&G's return on capital averaged 23% but for the three years following the merger, Gillette's average return on capital has dropped to 12%; growth versus profitability trade-off?

Ninth, Culture Counts. The cultural fit of the combination has become increasingly important, especially in service organizations. Advisors, bankers, and Boards must determine if there is a cultural fit and this determination must take place early in the discussion stage. Few behaviors will impede execution and destroy value more than a clash of cultures. This is critical when there are seller earn-outs, large escrow contingencies, or stock or debt take backs in the transaction. There are several conspicuous examples of culture clashes within the service sector, namely banking, insurance, and wealth management arenas. Remember when Bank of America acquired Charles Schwab only to have a major culture clash that resulted in Charles Schwab being sold back to Mr. Schwab at a fraction of the original purchase value within a few years? Northwest Mutual Insurance (NML) acquired Robert W. Baird brokerage firm as a means to become "full service," or so it was stated at the time. The business press stated that NML solved a problem they didn't have! The staid actuarial culture that has made NML the greatest insurance company in the world clashed with the "banker's bonus culture." The

affiliation ended when Baird partners purchased the company back at a fraction of the original valuation. And then there was the famous Snapple beverages culture clash. Quaker Oats purchased Snapple for \$1.7 billion and sold it for \$300 million a few years later. The clash of the entrepreneurial Snapple culture with the button-down bureaucracy of Quaker Oats was too great. The loss of shareholder value when Snapple was sold exceeded \$1.4 billion.

Tenth, Value Creating Strategies Trump Negotiating Tactics. Most often, successful high value transactions close in keeping with the original terms and conditions because both sides wish this to be and only limited negotiation on key points needs to take place. Bidding contests, intimidation, mock auctions, and briefcase slamming tactics are a relic of past legal and investment banking practices. Successful mergers that create sustainable value are driven by mutual agreements, common expectations, pre-determined outcomes, and limited negotiations. Experienced acquirers seek to add value for their shareholders not by low multiple acquisitions done with bare knuckle negotiations, but by creating strategic value. Oddly enough, issues of impairment occur more often on “bargain” purchases than on “high value” purchases. Transactions succeed or fail less because of the price paid and more because of the timely execution of the value creating opportunity the transaction represents. Buyers in the past often said to sellers “we are not about to pay for the value we bring to the seller.” Today’s investors expect to pay for the value they bring and it is the skill of the seller’s advisors to understand the value creating process. The world has changed and it’s not about the multiples!

LESSONS LEARNED

There are many examples of successful transactions that embraced the kinds of value creating suggestions referenced here. Unfortunately, there are too many examples of failed transactions. The most conspicuous example of value destruction is the Time Warner-AOL combination. As best we can determine, nearly every one of the ten critical success factors detailed here was violated. And were there consequences of bad behavior? The value of Time Warner before the transaction was \$63 billion. After merging with AOL for \$94 billion, the combined net worth was \$157 billion. Just nine years later in 2009, the value of the enterprise was \$36 billion; \$121 billion in enterprise value was lost. Where were the professional advisors, the Board of Directors, and the executives who championed the transaction? Did this need to happen? The answer to this question is not multiple choice.

ABOUT THE BIGELOW COMPANY

Originally established in 1935, The Bigelow Company focuses exclusively on working with the most successful market leading owner-managed companies in North America. Bigelow provides objective advice to its clients on matters of business strategy and ownership succession, leading to the successful outcomes of value creation, and someday, capturing the value they have worked so passionately to build.

As we look together at the current landscape of uncertainty, perhaps only a few things are clear: once-successful behavior patterns will not be sufficient to survive, let alone flourish in uncertain future economic scenarios. Embracing change as a means to create increased enterprise value for all stakeholders is always important, but critical in times of uncertainty and turbulence. Bringing about that change in entrepreneurial organizations, where ownership and management control is frequently concentrated, can be daunting for advisors who are inexperienced in that domain.

Senior Members of the Bigelow Team have been active participants in successfully advising companies in dozens of industries over multiple business cycles. Clients tell us that this transferable “scar tissue” has provided them with invaluable insight on behaviors and strategies that enable enterprises to earn superior returns and to exit at a premium enterprise value.

Bigelow’s proprietary tools are based upon the artful query of entrepreneurs, their stakeholders, and their advisors. These tools illuminate ways for CEO’s, Boards, and other expert advisors to systematically understand the trusted leadership and the techniques needed for the allocation of resources which drive successful change within entrepreneurial cultures.

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