Cross-sector valuation: What entertainment, media & communications companies should consider when acquiring tech targets

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At a glance

As entertainment, media & communications (EMC) companies continue transforming themselves through technology-focused acquisitions, unique valuation issues can challenge deal success.

Analyzing the sources of competitive advantage can play a key role in informing M&A decisions and can help increase shareholder returns.

Using the most appropriate valuation method and avoiding common pitfalls and valuation errors can be the difference between a successful or failed transaction.

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Leaders in the entertainment, media and communications (EMC) space are adapting their legacy business models to embrace the changes being created by new technologies. As content and distribution continue to diverge, value chains are being disrupted, leading to questions as to how the economics of the traditional bundled model will be allocated between content and distribution providers. Meanwhile, an array of game-changing business, technology, and consumer trends continues to create challenges as well as opportunities for industry participants. In such a rapidly changing, dynamic, and disrupted market, EMC companies are making investments in new and emerging technologies to help maintain their relevance and secure their position in the market. Consider as examples Comcast buying FreeWheel, Verizon buying Intel Media, and European broadcaster RTL Group making an investment in SpotXchange, a marketplace for digital video advertising.

In such a frothy atmosphere, percolating with equal parts urgency and opportunity, a deal maker's judgment can be challenged by valuation issues. While earnings are routinely subject to scrupulous review prior to consummating a deal, is it always clear what drives those earnings? Companies may risk invoking the traditional assumptions in their playbooks without sufficiently "looking under the hood" to clarify those assumptions and the value drivers behind them.

With emerging tech companies, where valuation poses unique issues that require specialized analysis, overlooking this "blind spot" can be dangerous. Absent such analysis, the buyer may risk over-paying or, perhaps even worse, undervaluing the target and missing an opportunity.

Understanding the source of value creation

When an acquisition is made, a significant component of what is being bought may be anticipated excess return on invested capital. This excess return, in turn, is often principally the result of the target's competitive advantage.

In calculating the ultimate worth of a target, then, it is important to consider the sources and viability of the competitive advantage. This is particularly true for a transaction involving the acquisition of a target with an emerging or perhaps unfamiliar technology. Failure to thoroughly understand the nature and sustainability of a new technology's competitive advantage can lead to valuation errors.

Competitive advantage analysis not only clarifies strategic rationale within the M&A process but may also provide a basis for determining the appropriate valuation methodology. The nature of a target's competitive advantage may influence the approach used to determine a target's value as well as the kind of data required to measure performance.

In the case of early stage companies, the valuation framework may be centered around a **Buy vs. Build** analysis. A competitive advantage that is relatively easy to replicate, for example, may suggest that the target's value is primarily a function of those replication costs.

To help make an informed choice in this instance, both "Buy" and "Build" options could be de-constructed into their components to expose assumptions and complexities. In drilling down into the Build scenario, for example, consider examining certain relevant direct and indirect costs that are frequently overlooked.

For example, a long development cycle or the risks associated with developing the technology can pose significant opportunity costs of lost profit vis-à-vis the Buy scenario.

A similarly camouflaged cost on the Buy scenario is the time, effort, and expense required to integrate the acquired technology into the buyer's existing service offering.

When a competitive advantage is difficult to replicate, on the other hand, value may primarily be a function of **future cash flows**. In this case, where replication cost may be essentially irrelevant if the competitive advantage cannot be easily replicated, income-based valuation methodologies measuring excess return on capital may provide quantitative representation of the competitive advantage. In pursuing this approach, however, with relatively young technology companies lacking long histories of financial performance, informed projections of future cash flow are often difficult to prepare.

This leads to another major challenge in valuing early-stage technology companies.

Projecting cash flow

In income-based methodologies, value is a function of future cash flow – or, to be more precise, a function of *expected* future cash flow. Consider regarding expected cash flows as neither an optimistic nor pessimistic number, aggressive nor conservative, best-case scenario nor worst. Rather, expected cash flow should be calculated through a coldly rational probability-weighted average of a range of possible outcomes.

Expected cash flows should consider measurable company-specific risks. As such, they should be regarded as unconditional, which is to say not contingent on an event that is ignored in the forecasts.

This type of approach often benefits from crafting multiple situations, contingencies, and outcomes. It makes for an admittedly robust and perhaps challenging process and, in the case of mature, low-growth companies, many M&A practitioners may understandably feel it unnecessary to devote extensive time to the exercise.

With technology companies that are characterized as "early stage"' or "high growth," however, doing the analysis can help clarify relationships between price and value. When it comes to technology targets, failure to conduct extensive scenario analyses could lead to significant valuation errors.

At the core of leading practices in cash flow forecasting is the infusion of dynamic assumptions into the valuation model. Commercial diligence – focusing on the source and sustainability of competitive advantages – leads to the identification of requisite dynamic assumptions.

Analyzing competitive advantage

Value analysis of a technology company target could benefit from considering key drivers of competitive advantage, including:

- Does the target have a first mover advantage?
- Is there a technology protected by patents? Is the technology difficult to replicate?
- Does scale create a barrier to entry?
- Are customer relationships strong and sticky (if so, why)?
- Is the management team well regarded and an important factor in the company's performance?

It is equally important to scrutinize the sustainability of these competitive advantages. Areas to focus on might include:

- If patents are a factor, how long will they be valid?
- Are the buyer's capabilities aligned with those required to extract maximum value from the target's competitive advantage?
- Are there industry forces or changing relationships that may disrupt the target's business model?
- Are competitors likely to respond to the buyer's acquisition in a way that will significantly change the competitive landscape?
- Will an existing competitive advantage lead to other opportunities to extend value creation by way of an installed customer base?
- Will the management team be retained?

Key variables impacting cash flow forecasting

In forecasting technology company cash flows, several key commercial diligence factors leap out for special attention:

- *Strength of underlying technology/patents*: In cash flow modeling, as previously noted, competitive advantage translates into excess returns on capital. Perhaps the most powerful competitive advantage may be a technology that is difficult to replicate. In calculating future cash flows, then, consider giving particular attention to the strength of the target's technology compared to competing technologies and the extent to which it is protected. The answers may impact not only projected revenue and gross profit, but could also influence assumptions about expected research and development costs.
- *Variability in projected cash flows:* Technology companies, perhaps more so than many others, may be particularly exposed to cash flow variability. "Framing exercises" for developing technologies – ranging from the upside where the technology succeeds and generates positive cash flows, to the downside where it fails and generates negative cash flow – can help identify realistic valuation scenarios.
- *Technology life cycles:* A fundamental question may be whether the next generation technology will provide the same competitive advantage as the target's existing technology over the course of evolving technology life cycles. Shorter technology life cycles, given the risks associated with creating next generation platforms, may increase variability in projected cash flows.
- *Focus on the residual calculation:* In many valuations of early-stage technology companies, the value of cash flows at the end of a discrete forecast period could range from 50 percent to 100 percent or more of the total business value at acquisition. Consider looking closely at the assumptions underlying such long-term "residual value" calculations of such magnitude. Too often, M&A practitioners presume a consistent annual excess return on capital into perpetuity, without first establishing the long-term viability of the competitive advantage responsible for producing those returns. While this may be a reasonable approach in more mature industries, the volatility of the technology space can make it more problematic. Disaggregating residual value calculations into implied assumptions about returns on capital and growth, as well as the investments required to generate both, can help test their credibility.

The illusion of market multiples as an escape hatch

Given the complexities of early-stage cash flow forecasting, some M&A practitioners prefer to replace income-based valuations with a market-based evaluation of value expressed as multiples of revenue or other operating metrics such as EBITDA. This methodology, however, does not offer an "escape hatch" from the need to analyze core value drivers. Market multiples are outputs, not inputs. That is, multiples simply emerge from observed market values, which are driven by the same core drivers of value. Said differently, a market multiple is a compacted representation of these value drivers.

Therefore, to accurately evaluate the multiple(s) applicable to a target, it becomes critical to understand the core value drivers of the peer companies and how those value drives compare to those of the target. In other words, be careful about taking equivalence for granted. Moreover, when compared to public companies that are deeper into their operating life cycle and past their peek growth opportunities, market multiples may potentially *understate* the value of early-stage companies without supplemental analysis of the key value drivers.

Is there such a thing as "intrinsic value"?

In the end, "intrinsic value" may be an elusive concept. Instead, ultimate value may depend on the worth of the target to a suitor; different suitors are likely to attach different values to the same target, depending on how it fits the acquirer's strategy and capabilities.

In pursuing technology companies, EMC companies often find themselves competing with other technology companies whose capabilities better align with those of the target. These more logical buyers may be better able to realize value from the transaction through various synergies and thus be willing and able to pay more.

As part of a disciplined M&A process, EMC buyers may benefit from understanding the value of an identified target not just from their own and the seller's perspective, but also from the point of view of other likely buyers. Crafting a view of the value perspectives of multiple buyers can help inform deal strategy, the negotiation process, and, ultimately, decisions about when to withdraw from deal talks when prices exceed value creation opportunities.

Conclusion

We expect EMC companies to continue seeking M&A opportunities as industry trends foster heightened competition among legacy and emerging players. Technology targets may be particularly valued as sources of innovation and growth. But EMC companies can expect to face challenges in accurately valuing those technology targets. These challenges may arise in no small part because these early-stage, high growth entities typically operate so differently from the sector's traditional acquisitions with which they are familiar.

M&A activity can represent tremendous potential for growth and transformation. Given its challenges, though, dealmakers are well advised to invest sufficient time and effort in valuation on the front end of transactions to avoid unwelcome surprises on the back end. Robust valuation diligence that focuses on the source and sustainability of value creation, and effectively considers the relationship between price and the value perspectives of different buyers, may help improve the odds of success when EMC companies make technology-driven acquisitions.

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