Eyes on the Price

Four finance executives reveal how they avoid overpaying for an acquisition.

By Vincent Ryan

If Silver Lake Partners and Michael Dell pull off their leveraged buyout of Dell at a 25% premium, they will be getting a bargain, at least as merger-and-acquisition premiums go. In merger deals involving nonfinancial public companies in 2012, the average premium paid was nearly 41%, according to data from S&P Capital IQ. (Only deals above $50 million were counted.)

Dig down, though, and maybe the Dell deal is not the steal it appears to be. In that S&P Capital IQ data set, only 89 companies (out of 1,016) paid a premium of 25% or more, down from 108 in 2011 and 122 in 2007, prior to the financial crisis.

Dell aside, many companies are still paying a healthy amount above a target's intrinsic value, even in a tepid climate for M&A. And because M&A is cyclical, in a more vigorous global economic recovery premiums could swell, experts say. That's because when banks lend more and executives brim with confidence, companies tend to pay too much for acquisitions, hurting their return on investment. "The best returns from M&A come from transactions during recessionary periods, the worst when the economy is very strong," says Andy Rose, CFO of metals manufacturer Worthington Industries.

But companies can develop competencies in M&A that tamp down the impulse to overpay. "Where you differentiate yourself is in the discipline you use in negotiating the price and not overpaying," says Rose, who has spent years in private equity and orchestrated $500 million in deals at Worthington the past three years.

What rules and principles do CFOs and M&A advisers live by when valuing prospective deals? Here, a group of experienced finance executives share five tips from their M&A playbook.

1 CURB YOUR ENTHUSIASM.

No hunter wants to come home without bagging the prize. Similarly, an executive's desire to acquire a trophy business can overwhelm reasonable thinking about price. As Aaron Gilcreast of PricewaterhouseCoopers's transaction-services practice points out, "Bankers are not motivated by doing deals; they are motivated by closing them."

Indeed, the bias to get a deal done can obscure red flags. In one of the worst large M&A deals in recent history, Royal Bank of Scotland executives pursued the takeover of ABN AMRO through a long, competitive battle without having conducted due diligence on the Dutch bank's balance sheets or risk-management practices. The board rubber-stamped the disastrous $97 billion deal even though it was told that execution risk was high and integration would be more difficult than with RBS's past deals.

When enthusiasm builds for a transaction, the CFO often has to be the objective voice in the room. "Chief executives have big visions, which sometimes result in narrow consideration of alternate views," wrote Gilcreast in a 2012 paper on deal valuation. CFOs can make it easier for executive management and a board of directors to walk away from an expensive transaction by making sure the company is not banking its future on one deal, says Rose. "If I have a pipeline of 20 opportunities, I can walk away and go to the next deal on the list," he says. Worthington Industries has an executive who flies around the world to identify companies, meet owners of businesses, and fill its funnel with opportunities.

2 DON'T PAY FOR SYNERGIES (MOSTLY).

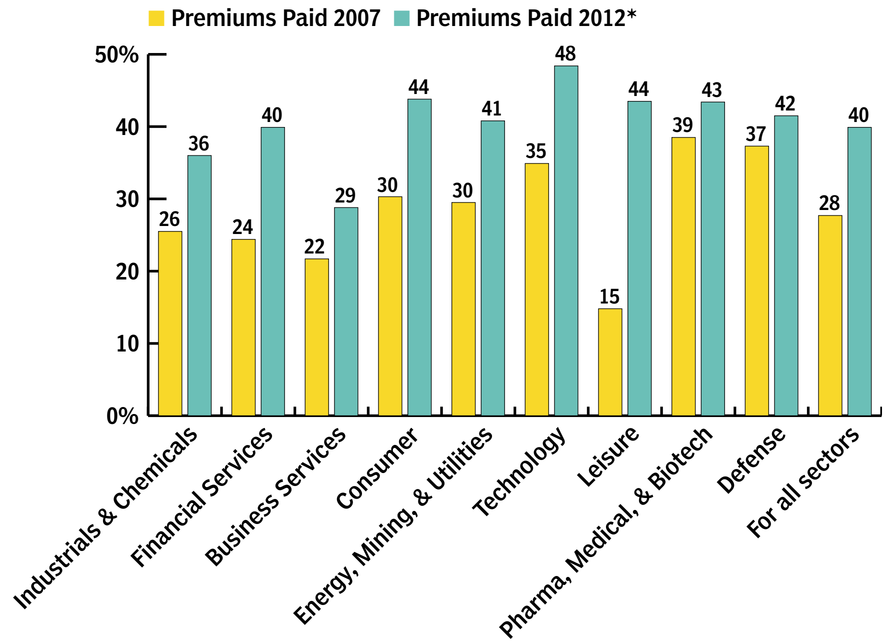
Many M&A advisers counsel against paying for synergies, the notion that two businesses combined can be greater than the sum of their parts. Baking synergies into the target's valuation is particularly dangerous, because then the seller, not the buyer's shareholders, reaps the value of the synergies. But some CFOs think it's okay to figure in certain kinds of synergies.

Cypress Semiconductor bought Ramtron International in 2012 in a $116 million tuck-in deal (the acquisition of a company made for the sole purpose of merging it with a division of the acquirer). In buying a small public company in a similar business, Cypress CFO Brad Buss included in his calculations the cost savings from eliminating parts of the

Paying Up

Compared with five years ago, just prior to the worst of the financial crisis, acquirers paid higher premiums for merger targets in 2012.

(Deal premiums paid in North America for transactions above $50 million)



*Premium based on target public company's share price one month prior to the transaction. Construction, media, transportation, agriculture, and real estate sectors were excluded due to small sample size.

Source: Mergermarket

management team, the board of directors, and other expenses that go with being a public firm, as well as some manufacturing efficiencies.

But, as a rule, Buss would not pay for other synergies, he says. For instance, buyers often assume that they will be able to cross-sell their products to the target customer's base, but they can't count on that synergy's realization. "It could take years, and the first year or two you're so involved with the sales team just bringing this pig in the door that you have no time to focus on these alleged synergies," Buss says.

If a company plans to pay for any kind of synergy, it needs to consider the probability of achieving it, experts say. Because Worthington is one of the largest buyers of steel in the country, a firm it acquires can lower its steel costs immediately, and "that automatically drops to the bottom line," says Rose.

On the other hand, if Worthington projected that a larger, merged sales force would increase its market penetration by 10%, says Rose, it might pay only a percentage of the value the synergy could create. "One of the things we emphasize around here is, 'You show me the list of synergies, and I also want to see your confidence level on achieving those synergies,'" he says.

If a firm includes synergies in its calculation of a deal's value, it also must account for the other side: the costs of the acquisition process itself. Cypress's Buss says it is critical to know the fully loaded cost of any transaction. The semiconductor company's deal with Ramtron was a hostile takeover, which means Cypress and Ramtron spent a lot of money on lawyers and bankers that could have gone to shareholders. But with any deal, Buss advises, things like management layoffs, severance packages, and stay bonuses have to be factored into the target price.

3 KEEP FINANCIAL MODELS HONEST.

Most acquirers value targets using roughly the same financial models, but CFOs can't assume such models are bulletproof. "A decent number of spreadsheets contain errors," says Gilcreast. What's more, errors in logic are more common than the math kind, and "they're harder to find: it's something you have to see in the formulas."

The assumptions that go into a model are even more important than the model itself. When calculating how much of a premium above intrinsic value to pay, for example, some M&A teams compare what other acquirers in similar deals have paid and use the average of those premiums as a floor. But Gilcreast says the buyer shouldn't assume it needs to pay the average premium or above.

Two big drivers of a target's valuation are sales and margin growth. But Rose indicates caution is warranted here, too. "A lot of times when investment banks put the books together, sales are going up and margins are going up. But something has to be a catalyst to drive the margin growth: most customers don't get excited when you raise a [product's] price," he says.

Finally, sticking to a model's output might be the toughest part of valuation. But companies that are highly acquisitive often excel at drawing that line in the sand. CBIZ, a tax and accounting services and employee-benefits firm, did 10 M&A deals last year. CFO Ware Grove goes into every potential transaction with a price target of 6 to 7 times earnings before interest, taxes, depreciation, and amortization. While Grove admits that some competitors are willing to pay 8 to 10 times EBITDA, he says

CBIZ has found sufficient opportunities in its value range.

Similarly, Cypress has "a very finite price that we won't cross, no matter what," says Buss. "We all agree on that up front, the board agrees, so we go into [negotiations] very disciplined."

4 HEDGE THE DEAL.

Assigning a value to a target's future performance is perhaps the most difficult part of calculating a takeover price. The vast majority of acquirers hedge the risk, however, by making contingent payments, or earnouts, part of a takeover's consideration.

Delaying part of a payment and tying it to the target's postdeal performance is a smart move, especially since so many M&A deals fail. In a study of 342 acquisitions last year totaling $55.3 billion, about $7.7 billion of the total deal value was part of an earnout consideration, according to Shareholder Representative Services.

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> ›› Anthony Vigorito, CFO, Billtrust

Anthony Vigorito, finance chief at Billtrust, a billing-process outsourcer, uses a contingent payment in every transaction. "Any time we talk to sellers, they talk about what the business will become, so the contingent payment puts their money where their mouth is," he says. Even better for Billtrust, the businesses it has acquired in electronic billing and invoicing and other markets have all been profitable, so Vigorito uses the cash flow from the seller's business to fund the future contingent payments. "It's sort of like seller financing," he says.

Likewise, CBIZ makes half of the purchase price contingent on the seller's hitting milestones over two to three years. The contingent payment is usually at least 10% in CBIZ stock, says Grove. "If the seller doesn't hit the targets, we pay less," he says. "So that protects our shareholders and gives the target a clear incentive to work hard."

5 TRACK PERFORMANCE.

Contingent payments assume that the buyer can track the performance of a merged entity cleanly. That's tough to do, but it can be invaluable in estimating a deal's actual return after a few years. Indeed, it is part of the finance religion at Cypress Semiconductor.

An $800 million company, Cypress treats every product division as a stand-alone unit, with separate profit-and-loss statements. In takeovers in which it uses debt, like the Ramtron deal, it assumes that the acquired business must pay back all the debt with its own cash flow. The length of time that will take factors into the return on the deal. Separating out the acquired business also comes in handy if the business does not succeed and Cypress decides to sell it.

Even with precise tracking, however, it can be hard to tell if you could have landed a company for a lower price. One reason is that most businesses contain intangible value that doesn't fit into a financial model, so acquirers may end up paying more than the valuation model says a target is worth.

Also, as Gilcreast points out, deal success doesn't always mean earning an outsized return, which he defines as "paying for nothing and getting something in exchange or paying less than the fair value of the target." If companies are always expecting such a large return, they may walk away from acquisitions that could add value.

Price and value, then, are two different things. In the gap, says Gilcreast, is where CFOs become expert dealmakers. CFO

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