

PROPER TARGET FIRM VALUATION: THE MUST DO ON M&A PROCESS

Abraham (Abi) Moskovicz

The Institute of Management Greater Manchester, University of Bolton, United Kingdom

abim@abimoskovicz.org

Abstract

Successful transactions should show a reasonable proportion between the return/gain likely to incur and the investment amount. M&A can be successful when the price to be paid by the acquiring company to the target firm is based on a realistic amount that is in viable proportion to the tangible and intangible returns as well. Overpayment has been reported as the main reason of merger failure. This has not been investigated enough and requires a more detailed study. Against this background, the current paper is focused on the strategy of mergers and acquisitions (M&A), at the stage of the target firm valuation.

Keywords: M&A, Target-firm valuation, Post-merger outcomes

INTRODUCTION TO M&A

For companies of every size, to not lag behind competitors through mergers or acquisitions has become increasingly important and has at least partly replaced organic growth. It is more necessary than ever before for companies to maintain and sustain a competitive advantage in today's dynamic, global market. In fact, business world is characterized by an increase of M&A.

Business evaluation is related to processes which would ensure efficient handling of the causes of M&A failures researched so far. This has not been investigated enough and requires a more detailed study, as argued by Haleblan (2009). This has also been substantiated on the basis of the conclusion that none of the variables (strategic or financial) are able to predict variance in post-acquisition performance, according to King (2004). Remarking the significance of business evaluation in the M&A transactions, Chase (1997) has also argued that well-evaluated mergers enhance the value of the firm and the value of the firm to society, where as

not properly planned mergers or undesired takeovers not only damage the acquiring firm but also the whole of society due to external costs not borne by the acquiring company. This also remarks the role of managers undertaking business evaluation and how they must be socially responsible and should consider the direct and collateral effects of the merger/acquisition on all stakeholders.

Studying the concept of evaluation of targeted business, Gande (2009) has analyzed that, just like for any other business proposition, successful transactions should show a reasonable proportion between the return/gain likely to incur and the investment amount. Mergers can be successful when the price to be paid by the acquiring company to the target firm is based on a realistic amount that is in viable proportion to the tangible and intangible returns as well.

Child (2001) wrote that significant part of the literature explains failures as the result of paying excessive premiums or unavoidable problems associated with post-acquisition integration. Hayward (2002) argues that companies can learn from small mistakes which are defined by the size of paid premium.

Overpayment has been reported as the main reason of merger failure, while less quantifiable causes such as strategy and merger execution have been downplayed. Without clarity, the discussions has led to uninformative case studies, as per Epstein's (2005) opinion.

Astrachan (2008) argued that business evaluation, is normally conceived as a calculations exercise based on a method which suitable to the cases, involving a large number of intangible factors. Reuer (2003) sustains that in most of the cases it is not being carried out in a way that would deliver reliable results, varying from a case to case basis due to the fact that either the sphere of valuation process is not clearly defined or it's not in accordance with the merger's objectives, or the factors involved are not given their required weight. As per Basu's (2008) argument, the process should, however, start from the stage of selection of a business.

VALUATION METHODS

As it was well described by Kennet Ferris and Barbara Petit (2013), there are several valuation methods available. They have been classified into four categories, based on two dimensions. The first dimension distinguishes between direct (or absolute) and indirect (or relative). The second dimension separates models that rely on cash flow from those that rely on another variable, such as revenues, earnings or book value.

Direct methods provide a direct estimate of a company's fundamental value, whilst relative valuation methods only indicate if it is fairly priced relative to some benchmark or peer group.

By using the direct valuation method, it is possible to compare the company's fundamental value obtained (the premium) versus the company's market value. Valuing using indirect methods requires identifying a group of comparable companies, thus, the relative ones are also called the comparable approach.

There are two types of direct valuation models based on cash flow: those using discounted cash flow, such as free cash flow to the firm model, free cash flow to the equity model, and adjusted present value model. The second kind is based in option pricing models, denominated the real option analysis.

Direct ones based on other variables are the economic income models, usually called the economic value analysis.

Among the indirect methods, we find only one that is based on cash flow: price to cash flow ratio, using price multiples. Based on other variables while keeping price multiples we can identify: price to earning ratio, price to Ebit ratio, price to sales ratio and price to book ratio. This method of valuation is a relative one (indirect) because it relies on a financial variable rather than on cash flow.

To decide on an acquisition, it is essential to evaluate the future reward after the purchased company is successfully incorporated to the acquirer firm, through properly exploiting the synergies, such as: the same target market, same suppliers, a good blend of products offered, the same geographical coverage, similar organizational culture, and others. The first objective pursued through the acquisition is that the final profit must be higher than the sum of each parts individually, usually called "*the bounty*", which is the goodwill.

AIMS AND OBJECTIVES

This paper is focused on the strategy of mergers and acquisitions (M&A), at the stage of the target firm valuation.

Considering the previous statement, the research area is related to the performance of M&A with reference to the selection of target firm, business evaluation, and the negotiation undertaken by the acquiring firm, and how these processes can impact the outcome.

The general objective is to convince that the valuation method has a crucial influence on the M&A's success. Business evaluation process, adopted by the acquiring firms while undertaking such transactions, was not thoroughly investigated, and required detailed study. To emphasize the significance of business evaluation while carrying out M&A transactions, Chase (1997) has planned and executed mergers that increase the value of the firm and the value of the firm to society. Well-planned means proper assessment covering the choice of a target firm and an analysis about how possible benefits (tangible and intangible) can be derived.

This paper would help not just the investors and sponsors, but also the management to carry out a more trustworthy business evaluation process. It will develop a better understanding of its scope, particularly with reference to the valuation method. More importantly, this would also help to unveil the relationship and behavior between different components and related factors of business evaluation.

The first step for M&A is to assess your own situation and determine if a merger and acquisition strategy should be implemented. If a company expects hard times in the future when it comes to keeping its core competencies, market share, return or capital, or other key performance drivers, then M&A is necessary. The second step is to search for possible takeover candidates.

Target companies must fulfil a set of criteria in order to fit with the acquiring company. For example, the target's drivers of performance should complement the acquiring. Compatibility should be assessed across a range of criteria: type of business, size, capital structure, organizational culture, core competences, market channels, organizational strengths, etc.

Firms that are undervalued by financial markets can be targeted for acquisition by those who can recognize this mispricing. The acquirer can then gain the difference between the value and the purchase price as a bounty. Although it seems obvious, the real challenge is to detect an undervalued firm.

A capacity to find such companies requires access to better information than what is available to other investors in the market, or a better analytical staff and tools than those used by other investors.

No doubt most mergers start when high level managers make discreet contact with their colleagues within the candidate company, sending a tender offer.

This phase is usually followed by a feasibility stage, where the financial, commercial and logistical considerations are taken into account. Confidentiality is required and it is signed for an N.D.A. It is not uncommon for many conditions to remain open and, thus, the M&A agreement may require amendments to cover the results of future due diligence. Investment bankers now enter into the M&A process to assist with the evaluation.

The due diligence is an effort to identify issues that must be resolved for a successful merger to occur. This process must be aggressive, collecting as much information as possible on the target company, taking anywhere between 4 to 6 months.

A key part of the due diligence is the valuation of the target company. In the preliminary phases of M&A, we will calculate a total value for the post-merger company. Therefore, it is necessary to value the acquiring firm as well in order to reach the combined value. This is the

sum of the value of the acquiring company, plus the value of the target firm, plus the value of the synergies, minus the legal and other costs involved in any merger.

The next stage is to sign a commitment to the merger and to allocate funds and resources for it. Then, the pre-merger negotiation step begins. The senior managers of both organizations enter firmly into the negotiation process in order to reach an agreement on the structure and format of the resulting company.

Once the negotiation phase is completed, a formal and detailed merger contract is signed. This is the fifth and last step: the post-merger integration.

The implementation process (a stage that often represents the failure of the merge) starts immediately after the monetary transaction occurs, and it consists of actually making the merger happen.

In order to proceed according to Yin's outline of a case study research and case study method, it seems necessary to remark the objective of this research: to estimate the relevance of proper target firm valuation for any M&A success. The assumption is that the valuation variable has a crucial influence on the success of M&A. This leads to research questions regarding the role played by the business valuation process in the M&A and its future outcomes, which are the factors that influence the selection of a firm, and it is how the performance of the M&A can be better assessed by using different valuation methods.

CONCLUSIONS AND RECOMMENDATIONS

Knowledge is power, to take time might even help to reduce the final price and to obtain better conditions. Despite the previous, sometimes to move quickly is the best procedure when the preparatory work was properly done. Therefore, manager's expertise is fundamental. To walk away from a bad deal might be the best step, but a rookie never will do so. To spend time with shareholders when they sale only partially the company is crucial. The negotiation is just a mean, the future convenience is the real challenge. As shown in the case studies presented at this research, never can be assumed that everything regarding the target firm can be known before the acquisition.

The main questions are:

1-What are the factors that influence the selection of a firm?

The criteria used to select a candidate company depends on the country's characteristics: how concentrated is the firm industry in that region, the grade of informality (for instance: non-billed sales, staff hired without formal contracts), market growth trends, availability of accurate and updated data, the degree of strategic fit with the acquirer firm, the threat of a foreign investor

entry, the total amount required for the acquisition, plus any additional fixed asset investment or working capital requirement.

2- What is the role of the valuation in the M&A success?

Business evaluation is related to processes which would ensure efficient handling of the causes of M&A failures researched so far. Mergers can be successful when the price to be paid by the acquiring company to the target firm is based on a realistic amount that is in viable proportion to the tangible and intangible returns as well. Overpayment has been reported as the main reason of merger failure, while less quantifiable causes such as strategy and merger execution have been downplayed.

The previous discussion can lead to the following research questions:

a-What is the role played by the business evaluation process in the outcome of a merger or an acquisition?

Mergers can be successful when the price to be paid by the acquiring company to the target firm is based on a realistic amount that is in viable proportion to the tangible and intangible returns as well. Overpayment has been reported as the main reason of merger failure, while less quantifiable causes such as strategy and merger execution have been downplayed.

b-How M&A performance can be better assessed by using different valuation methods?

M&A performance can be better assessed by using simultaneously different valuation methods, taking the most suitable for each case.

Managers are always fighting to achieve the control of the firm (Agency Problem). In this arena, the market will punish any managerial divergence from shareholders' value maximization goal. In this case, the stock price of those companies will drop. As a consequence, those companies appear to be attractive targets for other companies.

M&A is a perfect field for the exacerbation of divergence of goals between managers and shareholders. Shareholders only have one goal: getting rich through increasing the value of their investments. Managers have a variety of goals, and maximizing company's value is just one of them. Company's size or power may be more valuable for managers than maximizing shareholders' value.

Roll (1986) proposed in the *Hubris hypothesis* that acquisitions are the result of managers' mistakes in evaluating target firms and that the synergy gain is zero. Consequently, when managers make errors of overestimating the synergies of the merger or the acquisition, the takeover may take place and as a result there might be an overpayment for the target.

This paper adds further information to the limited available knowledge of the field of M&As, since it focuses on the impact of the valuation method used on an M&A process. It is necessary to emphasize the valuation method as a crucial parameter that should be taken into consideration when any M&A process between companies is planned and performed.

Author's pretension is to help decision makers know exactly why they are buying a company and to value it properly, because this is crucial.

All the available research studies faced serious difficulties in obtaining data from managers and honest answers regarding their true motives and thoughts, which tended to overcomplicate the empirical M&A studies since researchers must rely on relatively small samples and unknown data quality.

This study can serve as introductory ground work for people who want to go deeper and expand into the research on M&A, a necessary and immediate task.

DECLARATION

This study contains no material that has been accepted for the award of any degree in any university or equivalent institution and, to the best of my knowledge and belief, the research contains no material previously written or published by any person, except where due reference is cited within the text of the work.

REFERENCES

- Angwin, D (2008), Mergers and Acquisitions, Strategic Management, Vol 12
- Arzac, E (2007), Valuation for mergers, buyouts, and restructuring, John Wiley & Sons
- Astrachan, J & Jaskiewicz, P (2008), Emotional returns and emotional costs in privately held family firms, Family Business Review, Vol 21
- Basu, D & Ghosh, S (2008), Corporate M&A in India, Global Business Review, August
- Bates, T & Lemmon, M (2006), "Shareholder wealth effects and bid negotiation in freeze-out deals", Journal of Financial Economics, Vol 81
- Bhide, A (1993), The hidden cost of market liquidity, Journal of Financial Economics, Vol 34
- Bjerke, B (2012), The Mismanagement of Mergers and Acquisitions, Linnaeus University
- Bourne, S (2000), Financial due diligence: a guide to ensuring successful acquisitions.
- Bower, J (2001), Not all M&As are alike and that matters, Harvard Business Review
- Cameron, E & Green, M (2009), Making Sense of Change Management, Kogan Page
- Cartwright, S (2012), 30 years of mergers and acquisitions, Manchester Business School, University of Manchester
- Chisnall, P (2001), Fair value accounting: an industry view, Balance Sheet, Vol 9
- Colman, H & Lunnan, R (2011), Organizational Identification and Serendipitous Value creation in Post-acquisition integration, Journal of Management
- Damodaran, A (2005), The Value of Synergy, Stern School of Business
- Epstein, M (2005), The determinants and evaluation of merger success, Business Horizons, Vol 48

- Eriksen, R & Moller, L (2008), An Empirical study of the Value creation in M&A, Aarhus School of Business
- Evans, F & Bishop, D (2005), Valuation for M&A: building value in private companies, Wiley Publishers
- Evans, M (2000), Excellence in Financial Management, Sage
- Ferris, K & Petit, B (2013), Valuation for A&M, an overview, Sage
- Fight, A (2005), Corporate valuation, Oxford: Elsevier Science & Technology
- Fight, A (2006), Mergers and acquisitions, Oxford: Elsevier Science & Technology
- Frankel, M (2005), Mergers and acquisitions basics: the key steps of acquisitions, divestitures, and investments, John Wiley and Sons
- Galpin, T & Herndon, M (2007), The complete guide to mergers and acquisitions: process tools to support M&A integration at every level, John Wiley and Sons
- Haleblian, J & Devers, C (2009), Taking stock of what we know about M&A, Journal of Management, Vol. 35
- Hayward, M (2002), When do firms learn from their acquisition experience, Strategic Management Journal, November.
- Howson, P (2006), Commercial due diligence: the key to understanding value in an acquisition, Gower Publishing Ltd.
- Jackson, S & Schuler, R (2001), HR Issues and activities in M&A, The State University of New Jersey
- King, D & Dalton, D (2004), Meta-analysis of post-acquisition performance, Strategic Management Journal, Vol 25
- Meglio, O & Risberg, A (2011), The (mis) Measurement of M&A Performance, Scandinavian Journal of Management, Vol 27
- Moeller, S & Brady, C (2005), Navigating the Mergers and Acquisitions, Frost& Sullivan
- Rankine, D & Stedman, G (2003), Due diligence: Definitive steps to successful business combinations, Pearson Education Ltd.
- Reuer, J & Shen, C (2003), Sequential divestiture through initial public offering, Journal of Economic Behavior and Organization
- Reuvid, J (2007), Mergers and acquisitions: a practical guide for private companies and their UK and overseas advisers, Kogan Page
- Robert, A (2011), Mergers & Acquisitions, Edinburgh Business School, Heriot-Watt University
- Schweiger, D & Goulet, P (2000), Integrating Mergers and Acquisitions, An International research Review, Emerald Group Publishing Ltd.
- Sudarsanam, S (2003), Creating Value from Mergers and Acquisitions, Pearson Education Ltd
- Sudarsanam, S (2010), Creating Value from Mergers and Acquisitions, Sage
- Trautwein, F (1990), Merger motives and Merger Prescriptions, Strategic Management Journal, John Wiley & Sons
- Villar, C. & Pla-Barber, (2012), Evaluating Companies for M&A, International Business and Management, Vol 30, Emerald Group
- Weston, J & Weaver, S (2007), Mergers and acquisitions, McGraw-Hill Education
- Zappa, M (2008), The Fundamentals of Strategic Logic and Integration for M&A, Swiss F. I. of Technology, Zurich