THE WATERMARK WIRE

WHY DO ACQUIRERS OVERPAY FOR TARGETS?

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As discussed in previous issues of the *Wire*, the challenge that acquirers have in being successful in mergers and acquisitions (M&A) is significant. There are many contributing factors, but according to a survey conducted by Watermark Advisors, the three most common reasons for this are: (1) cultural issues leading to the loss of key people from the target, (2) integration issues, and (3) overpaying for the target. Having covered the first two earlier, in this month's *Wire*, we take a closer look at why overpaying for the target occurs time and time again.

There is no way to exhaust the reasons for target overpayment in one issue of a newsletter. Here, we spotlight three persistent oversights resulting in overpayment. First, buyers fail to accomplish the all-important goal of paying less than intrinsic value. Second, and one of the reasons intrinsic value is so hard to arrive at, buyers fail in their efforts to follow valuation best practices. Third, buyers underestimate the risks in executing the target's business model. Let us consider each of these issues.

The Difficulty of Estimating a Company's Intrinsic Value

The goal for a buyer in M&A is to acquire a company that helps it accomplish its vision in a way that maximizes return on investment (ROI) for shareholders. Maximizing ROI for shareholders is rooted in paying less for the target than its intrinsic value.

The challenge is that intrinsic, or true, value of a target company is unobservable. Said another way, the valuation exercise will never result in the practitioner arriving at the actual value because virtually every variable one uses in valuation is measured with error, due to flawed methods to describe the past, or because of uncertainty about the future.

The best one can do is to observe value from several angles or methods and reach conclusions on where the overlap of those methods occurs with the most defendable assumptions. This requires being schooled in valuation best practices and understanding how to apply those best practices to each company that is being valued.

Valuation Is Tricky

There are so many decisions that go into a well-developed valuation, and each one needs to be defendable. From selecting which valuation methods to triangulate, to identifying the best comparable M&A deals to use, to selecting the best assumptions for the Capital Asset Pricing Model (CAPM) method in determining cost of equity, to selecting the right assumptions for Terminal Value, the decisions seem endless. At the end of the day though, the buyer must transact the deal at a value that is less than the intrinsic value.

The intrinsic value should result from a calculation of the value of the target company under the ownership of the buyer, with the new ownership's influence, including synergies. When buyers pay more than estimated intrinsic value, they are likely to lose the ROI battle.

Overpaying is easy to do when one is buying in a hot market or when the seller is going through a process where multiple buyers are involved. Once buyers invest more and more resources into an acquisition, they can be guilty of softening from disciplined thinking that tells them to walk away when the price tag gets too rich.

In fact, statistics prove that as a deal drags out over time, the buyer is often the one that gives in to assumptive thinking, loosens its bottom line offer, and compromises to a purchase price that originally it had never intended to pay. The allure of ownership crosses a line of reason very subtly. This is where the buyer becomes overly convinced that the deal must close or else it and its leadership will be viewed through a lens of failure.

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Valuation Best Practices Are Often Not Followed

Some buyers simply do not follow best practices of valuation. This happens with infrequent acquirers. They do not triangulate between several methods of valuation, but just use a transaction method. Within a transaction method, they reach a valuation multiple off a deal with which they are familiar, rather than from multiple deals. They do not consider applying discounts for liquidity, for customer concentration.

In the discounted cash flow method, they do not adequately evaluate the building blocks of Weighted Average Cost of Capital, nor do they consider a discount for lack of marketability. Revenue assumptions are not grounded, but based on a simple growth rate. The list goes on and on, and it becomes easy to see how acquirers can fall short in thoroughly utilizing best practices when valuing the target companies they want to acquire.

Underestimating Execution Risk

Besides the difficulty of determining a target's intrinsic value, and, relatedly, the lack of using the best and right approaches in valuation, buyers often overpay for the target because they overestimate the growth rate of the target under their ownership, and/or the value of the synergies between the two firms.

Estimating future performance for any business is an art. Buyers know this. However, buyers often underestimate the cost of integration, as well as accurately valuing the magnitude of a synergy, and the difficulty in actually capturing the synergy.

Many integrations, as we know it, fail to a small or large degree. When that happens, the projected performance captured in the projections is off and value is lost.

How To Mitigate Risk of Overpayment

How do buyers mitigate the risk of overpaying? First, they should have an internal or external "go to" resource that has proven skills in corporate valuation. It is a complicated and sophisticated process, and to treat it otherwise is short-selling oneself. Second, the target should be valued as a stand-alone company, but then also under the new ownership.

Identify and evaluate each synergy. Be realistic and actually place a value on each synergy like you value a company. Before beginning negotiations with the target, establish an opening bid and final offer. Base your conclusions on valuation range off not just the valuation, but ROI expectations that you need to hit in order for the investment to be worth it in the long run. The ROI should be significantly greater than your cost of capital.

If not, the investment might fulfill a vehicle to help you achieve your corporate vision, but it might miss the mark as a vehicle to create shareholder value. A good acquisition needs to accomplish both.