BAIN & COMPANY

Getting the price right

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The power of strategic intent in dealmaking

When AOL and Time Warner announced plans to merge in January 2000, the deal was worth $166 billion on paper to Time Warner. By December of the same year, a dip in AOL stock had reduced the Internet giant's offer by about a third. The fact that the deal closed, despite this price cut, stands as a tribute to the way Steve Case and Gerald Levine communicated their strategy for the combined company. When no precedent exists to guide analysts in assessing the value of an alliance, the task of justifying a price to shareholders falls to those who lead the deal.

Increasingly, companies see mergers and acquisitions as a strategic tool and expect to benefit from synergies—improvements in competitiveness, customer value or product innovation—that can be achieved by integrating two entities. This added complexity means executives have a more difficult task trying to identify, value, and negotiate closure on attractive deals. Also, as investment banks pitch deals more aggressively, executives fear being trumped by competitors and thus feel more pressured to act. Successful buyers are those who approach deals proactively and are driven by strategic intent. Successful buyers court targets early to develop an understanding of what value the acquisition will add and how it will do so—and they are able to explain this to investors. Successful buyers also understand the perspectives of competing bidders and the negotiating stance of all players involved.

With time short, and management egos and adviser fees at stake, one can easily overestimate the benefits of a merger and underestimate the costs of integrating the acquisition.

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Why do so many executives find themselves unprepared for merger and acquisition opportunities, thus missing deals or executing them poorly? Why do half to three-quarters of mergers and acquisitions fail to create shareholder value? The answer lies in a failure to align the process of generating and executing transactions with strategic goals, and adapt valuation methods accordingly.

For some, particularly leveraged-buyout firms, the strategic goal is to "squeeze the lemon" through active investing: to manage the acquired business more effectively and help the business achieve its full profit potential. For others, the acquired company may help to build scale or provide a stepping-stone into businesses or customer segments related to the buyer's core activities.

In other cases, the acquisition may broaden the scope of the acquirer's business by adding new capabilities. Or the deal might result in a fundamental change in the business of the combined company, or its sector. Whatever the rationale, buyers need to keep focused as they move through the deal, from screening to negotiating a close. This will help them zero in on the few companies critical to their rationale, accurately value them, and negotiate a successful transaction.

Screening strategically

Corporate acquirers should take a page from financial buyers and investment bankers and screen acquisition candidates based on strategic goals. This will establish a focused search that not only identifies the right targets, but also gives buyers a head start on the due-diligence process. ***(See Sidebar: "Grocery shopping: Screening food retailers")***

Further, it pays to consider several options simultaneously and to court likely prospects months or even years ahead of a sale. With this approach, a buyer has a head start on other bidders regarding due diligence, as well as an inside link that can help build enthusiasm for the deal within the target company. One branded consumer-products company maintains files on all potential players in its business. These files contain details of companies' performance histories, likely strategies, and even employee morale. The database helps the consumer-products company assess the fit of potential acquisitions and prepares the chief executive for frequent meetings that form part of the ongoing courtship.

Grocery shopping: Screening food retailers

A major regional grocery chain was compelled to quickly build national scale to fend off new mega-competitors such as Wal-Mart. This dictated that the grocery chain expand into new territories via acquisition. The retailer adopted a three-tier screen to target an acquisition. First, the company sifted territories according to demographics and the level of competitiveness in the sector. Second, it checked individual companies for key indicators of profit potential—the most important being local market share—and for a match with the acquirer's merchandising strategy. Third, teams visited the top candidates' stores, interviewing customers, employees and suppliers. The buyer compiled a database of each company's performance and management practices to help assess the full profit potential and determine the additional benefits of a merger. Having narrowed down the field systematically, the grocery chain went on to purchase two of its top-priority candidates.

Setting a price

Once a buyer has zeroed in on acquisitions in line with its strategic goals, the buyer needs to assess price tags. Every corporate buyer knows the formula for valuing business is: stand-alone value, plus the value of synergies, less the cost of closing the deal and integrating the acquisition. The challenge lies in putting numbers into this equation.

With time short, and management egos and adviser fees at stake, one can easily overestimate the benefits of a merger and underestimate the costs of integrating the acquisition.[1] The more complex the strategic rationale—and the vision for the combined company—the more work required to determine the right price, and the more leverage one has to transform the rules of the valuation. ***(See Figure 1: Strategic rationales and the elements of valuation)***

A. Check the cash flow

Valuations for all acquisitions start by predicting the full potential of the business on a stand-alone basis and projecting the cash flows the new business will generate. To ascertain a company's soundness requires rigorous analysis of competitive environment and strategic positioning, market trends, cost structures, employee issues, capital requirements and many other factors. The degree of risk that each factor presents needs to be reflected by adjusting cash-flow forecasts.

More often than not, the management of the selling company provides rosy forecasts inconsistent with historical performance. Such forecasts ignore threats like competitor rivalry, new entrants, or new technology that could render products obsolete. Worse, these forecasts rarely offer sound rationale for performance improvement, nor do they budget the cost required for implementing changes.

The lesson for buyers? Build your own projections. Standard market multiples do not reflect an individual company's position, and a low price does not necessarily indicate a bargain.

***Figure 1*: Strategic rationales and the elements of valuation**

	Play by the rules					**Transform the rules**
	Buyouts/ Private Equity	**Corporations**				
Value Considerations	Active Investing	Scale	Adjacency Expansion	Scope	Redefining Business Models	Redefining Industries
Stand-alone cash flow	●	●	●	●	●	●
Cost of integration		●	●	●	●	●
Scale economies		●	●	●	●	●
Revenue and customer synergies			●	●	●	●
Value of options					●	●

[1] The strategic rationale, by clarifying the desired end point for the acquisition, helps buyers identify appropriate top-down checks on growth, margin and cash-flow projections. Examples include normative performance bands, industry scale curves and margin benchmarks.

In the mid-90s, value-added computer resellers, such as Vanstar or Entex, looked cheap—market valuations had declined 50%. But they weren't a bargain: the economic rules of reselling were being rewritten, and valuations tumbled a further 50%.

B. Predict the benefits of scale

Once the buyer determines the future cash flow of a stand-alone business, he or she needs to value the benefits of combining the target's operations with its own. Deals founded on increasing scale often fail to create value because the acquirer has misguided expectations of the economies in store. To achieve success in a scale-driven acquisition, determine which aspects of scale really count—i.e., what allows the company to take advantage of joint revenues and costs. Different businesses achieve the benefits of scale differently. Some, such as automotive, derive the highest profitability from global scale. Others, such as supermarkets, gain the most profitability from regional or local scale. And some, such as medical products, find profitability from scale within a distribution channel. Further, in some sectors, such as cosmetic products, branding has a stronger impact on margins.

When consumer-products maker Philip Morris acquired a series of food-service distributors in the 80s, the company intended to build national scale. Philip Morris did achieve the No. 2 position nationally, but it overlooked a key factor of success: In the food-service sector, profitability chiefly depends on the efficient use of local distribution centers and routes, which in turn depend on local market share, not national scale. Philip Morris's shopping spree bought a leading position in only one city, while most of the acquisitions were trailers in third, fourth or fifth place. The results were miniscule margins and disappointing performance, which led Philip Morris to sell off its food-service business.

Once the acquirer understands how and where to capitalize on scale, he needs to predict the financial impact of combining two companies: How much scale buys how much cost reduction? Industry experience curves help here, because they chart how average production costs fall as volume accumulates. And benchmarks allow comparison with competitor cost structures.

Ideally, these analyses should be combined with detailed information on the target's cost structure —and detail is key. For each function the buyer must ask: Where can I save on head count; how many employees should be offered severance or redeployed? Which plants, distribution centers or stores can be closed, and which activities can be moved to more efficient locations? Which contracts can be renegotiated at advantageous rates? What savings will these changes yield after deducting lost sales, closure and severance costs?

Then, there are further questions related to the balance sheet: What capital equipment or property can be sold as consolidation progresses? What cash can be freed up through inventory reduction? What benefits that can boost revenue, such as a broadened product mix or more effective advertising budget, may also derive from scale? The answers to these questions create inputs for a more reliable cash-flow model for valuing the target company, far superior to models that use industry acquisition multiples or comparisons with top-performing companies.

Finally, check your assumptions—especially the ones that drive the most benefit. Furniture manufacturer Mity-Lite[2] recently bought CenterCore, planning

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[2] Now Mity Enterprises

to save costs by folding the target's New Jersey operations into one of its plants in Arkansas that was operating below capacity. The value of the deal was destroyed when none of CenterCore's employees agreed to move south. Mity-Lite would have avoided this error if it had tested employees' willingness to relocate ahead of time.

C. Test-related business opportunities

All valuations need to undertake the painstaking, detailed work of predicting cost savings. But companies moving into highly related, or "adjacent," businesses need to add to the equation a calculation of potential revenue synergies.[3] Incremental revenue is more elusive than people think—particularly those responsible for sales and marketing. To grow sales from existing customer and product assets, a company usually needs to change its customers' behaviors; not a simple task. For example, additional revenue may depend on cross-selling new products or persuading consumers to buy bundles of goods or higher-priced brands and services. These objectives are tough to achieve when sales forces, brands and pricing also may be changing. To value incremental revenue correctly companies need to rigorously test whether the new entity's combined offerings would hold more appeal for customers than stand-alone offerings.

Just ask brewer Anheuser-Busch. When the company first moved into snacks, the synergies were clear: The firm bought a nut company to provide snacks as a service to beer-establishment customers. Snacks, an easy drop-off alongside the beer, made sense as a niche related to the core business. Busch steadily grew its peanut distribution on the back of its beverage distribution.

But problems arose in 1992, when the company decided to move from peanuts to a full snack business. Busch strayed far outside its core, acquiring several food and snack companies to extend its product line. Succeeding as a major player in snacks demanded a presence in grocery stores, where Busch had weak distribution. Busch mistakenly assumed economies of distribution scale in the retail channel between beverages and newly acquired food products. In fact, supermarkets order these goods on different schedules, and the products have different delivery needs. Busch's expected synergies never materialized. The beverage company suffered from price retaliation by the snacks market leader, Frito-Lay, leading the brewer eventually to withdraw from the market and refocus on beer.

By contrast, Getty Images, the leading marketer of reproduction rights to still photographic images, identified an opportunity to leverage its customer base, content and sales capabilities through early entry into an emerging channel—the Internet. With online delivery of photographs set to grow, and barriers to entry high compared to traditional channels, the company saw the benefits of moving quickly. Getty determined its customers would value the opportunity to source photographs online. So, the company forecast growth in this digital channel at the expense of the traditional analog one. Getty acquired the leading online player, converted its content to digital format, and invested heavily to offer unrivaled services to its online customers. An early lead positioned the company to grow rapidly, surpassing and then acquiring Image Bank, a subsidiary of Kodak and the historic leader in stock photography.

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[3] Chris Zook with James Allen, Profit From the Core: Growth Strategy in an Era of Turbulence. Boston: Harvard Business School Press, 2001.

D. Check the fit of acquisitions that increase scope

Some companies, most notably fast-growing technology outfits such as Cisco, Microsoft and Intel, have used acquisitions as a principal source of growth. They target companies with capabilities that would be either too expensive or too slow to develop internally, or that would dilute management's focus on their existing businesses. For these acquirers, potential for cost savings or revenue growth are important factors in the valuation, but the make-or-break issue is whether the new outfit has high-quality employees who can be integrated into the acquiring company.

The cost of retaining such employees—in terms of compensation raises, stock options and other incentive schemes—remains an important factor in arriving at a deal price.

The head of Cisco's acquisition team, Mike Volpi, searches for start-ups to fill gaps in Cisco's portfolio of technical expertise. He says, "We look at a company's vision; its short-term success with customers; its long-term strategy; the chemistry of the people with ours; and its geographic proximity." His goal is to hide the seams between the acquired company and Cisco within a hundred days. Cisco's continued success at picking businesses that meld with the parent has earned Volpi *Fortune* magazine's crown of "Silicon Valley's shrewdest shopper."

E. Assess the potential value of transactions that transform the business

Some companies use mergers and acquisitions fundamentally in their business or even in their sector. These deals are often based on a vision that's difficult to prove or express in numbers. As a result, they're risky and hard to justify to the markets. ***(See Sidebar: "Calling investors: How Vodafone won market approval on hard-to-value acquisitions")***

When Ted Turner incurred almost crippling debt buying the world's largest cache of vintage cartoons and classic movies, commentators dubbed him a loony tune.[4] In fact, the gamble paid off: As the cable-TV market took hold, the value of vintage content jumped. The asset positioned Turner to compete profitably with Disney and Nickelodeon in cartoon cable and opened up new revenue streams in videos and classic-movie remakes. Although Turner did not disclose the library's purchase valuation, competitive collections have gained as much as 100 times their value over the years with the advent of VCRs and cable. Turner's video distribution rights, originally purchased from MGM's library for $125 million, were sold for a whopping $225 million in 1999.

Some mergers aim to remake a company in the image of another. When Nortel bought Bay Networks and a host of other optical-network companies, Nortel clearly intended to transform itself into an Internet infrastructure company to match Cisco. Nortel's concrete vision not only helped convince the market of the wisdom of the plan, but also gave the company, and external analysts, at least one benchmark for judging the value of the deals.

In other cases, companies set out to create something entirely new, which makes realistic projections difficult. Acquirers can do the basic work of anticipating scale and revenue synergies, but valuing these deals remains hard, the margin for error huge, and success elusive. In sectors such as media and telecommunications, where outcomes are difficult to predict, a scenario-based approach can help manage the complexity. For example, acquirers can use Monte Carlo analysis or other econometric modeling tools to calculate a reasonable value.

[4] As part of Turner's acquisition of MGM-UA Entertainment Co. for $1.5 billion in 1986

Calling investors: How Vodafone won market approval on hard-to-value acquisitions

Industries in a state of flux—such as media, telecommunications and technology—have the added challenge of finding meaningful benchmarks by which to judge the value of major mergers and acquisitions. Consider Vodafone, the British mobile-telephony company that grew in 10 years from a small subsidiary of Racal Electronics to Europe's most valuable company.

Vodafone saw significant potential for cost sharing across a global wireless provider and the potential to deliver customer benefits through a Pan-European wireless network. The company's resulting strategy—to develop a leading position in every major market—was no simple scale play. Even in the late 90s, mobile telephony was still a developing sector, and customer behavior was hard to predict. What's more, the rise of the Internet as an alternative communication channel promised unforeseen threats and opportunities. In this environment, the market's acceptance of the wisdom of acquisitions depended on communication of the underlying vision by Vodafone's chief executive, Chris Gent.

When Vodafone made a $62 billion paper bid for US-based AirTouch, Vodafone wasn't sure that the markets would reward such a big gamble. But investors received the move well, rewarding Gent with a share-price hike of almost 15%. Vodafone subsequently acquired 45% of US player Verizon and succeeded in a hostile takeover of Mannesmann, Germany's top wireless provider.

The Mannesmann takeover was a bold move, the first-ever hostile takeover of a German public company. The takeover was fraught with complexities that made observers doubt Vodafone would succeed in its bid. But Vodafone had carefully evaluated risks and opportunities and, most importantly, had a clear vision for the combined business. As a result, the bid succeeded, changing the face of competition in the European mobile market. A good part of Gent's success stems from both a deep understanding of the investor community and from effectively communicating to the market the company's strategy and goals.

At the time of this writing, Gent is investing significant capital in high-bandwidth networks and an Internet portal joint venture with an eye on the mobile Internet market. Clearly, the possibility of restructuring the Internet value chain motivates Gent: "The interesting question is," he says, "will we find the AOLs and Yahoos finding life tougher as time goes on? Will we disintermediate the disintermediators?" Gent's track record suggests current moves may pay off. Once again, his vision is at least as important as the cash-flow models.

In other industries, biotechnology for example, where acquirers such as Merck bet on the successful application of a new technology, others tools are useful. Binomial pricing and the Black-Scholes option valuation method can help account for the diverse possibilities of success and failure. Whatever the methods used, one of the most critical elements in these difficult-to-predict transactions is clearly and confidently communicating to the market the strategic rationale and approach used to pick a price. Indeed, the very process of determining which scenarios might exist and which outcomes might prevail—including competitive responses—will make for better decision-making and valuation.

Negotiate Preemptively

An acquirer who courts potential targets well ahead of a deal, forming relationships with management and understanding the culture of the organization, has a good chance of preempting an auction. By the time an acquirer approaches a target, it should have a clear idea of the acquisition's worth, to itself and to others. Knowing what value competing bidders will place on the acquisition is essential in determining whether there is a price that will trump others without overpaying for synergies.

Consider how each player's competitive position would be altered by each possible outcome and how that would affect their bid price. At this stage, the strategic rationale should be clear to all concerned and a valuation team poised to collect the internal data needed to complete due diligence.

In deals where integrating and retaining talent is vital, make friends with the target's key executives and signal their roles. Retaining stars not only improves the odds of a smooth transition, but also garners further insights into the workings of the company.

Even among strategically driven mergers there will be some spectacular failures. Journalists will look back in five years and shake their heads at the misguided alliances that shareholders optimistically approved. Nevertheless, some of the next decade's greatest success stories should spring from hard-to-value strategic alliances that effectively change the rules of valuation. A clear, strategic vision, well-articulated and linked to rigorous valuation and informed negotiation, will be a strong predictor of success.

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