

The hurdle rate implied in this EPS accretion test is 3.6%. If PAT exceeds the after tax financing costs of \$3.6m, the deal will be accretive to (i.e. add to) earnings. Since the purchase price of the acquisition is \$100m, the hurdle rate is 3.6%, as follows:

$$\frac{\text{After tax financing expense}}{\text{Purchase price}} = \frac{\$3.6\text{m}}{\$100\text{m}} = 3.6\%$$

Is 3.6% an appropriate return for shareholders? Hardly! Investors could typically earn a higher rate by investing in essentially risk free treasury notes. In all investment decisions, the hurdle rate should be based on the specific risk associated with the investment. In acquisitions, the hurdle rate should be based on the target's risk profile adjusted for any perceived addition/reduction in risk due to the acquisition.

In spite of the reduced usefulness of the accretive-dilutive metric, bankers, managers and analysts continue to use it as a primary measure of the financial performance of an acquisition. If you listen to any conference call announcing an acquisition, EPS accretion dilution will likely be prominently featured. It is certainly important to understand and communicate the EPS effect of a deal. However, it is **not** a comprehensive economic test.

Comparable or relative pricing Methods: Multiples of revenues, earnings and cash flow

Nearly all acquisition decisions will include an analysis of the pricing of similar companies in recent acquisitions. It is an important tool to determine whether pricing of a proposed transaction is in the pack of other recent deals. Nearly all transactions will be reviewed in the context of what other parties have paid for similar businesses. This process is no different than evaluating the pricing of residential real estate. Prior to negotiating on the purchase price of a home, real estate brokers typically provide a "Comp Listing", which summarizes transaction prices on recent home sales in the area. In a similar way, investment bankers and Corporate development managers will identify recent transactions in the industry and compute key valuation metrics such as Enterprise Value/EBITDA, EV/Revenue, etc. These valuation metrics are then used to set or evaluate the pricing of the deal under review. Generally, companies must pay a "full" or "strong" value in order to convince the target's management and board that they should sell. Sometimes acquirers offer preemptive bids to prevent the target from considering other potential parties. Further, many companies are sold through "auctions", where they are essentially marketed to a large number of potential buyers. The winners of this process are typically the highest bidder. All of these factors put upward pressure on the transaction prices. Therefore, managers who wish to build economic value through an acquisition program must recognize that the comparable transaction valuation methodology has a strong upward bias on transaction pricing.

Additional Methods Should be utilized

Despite their shortcomings, both the accretive-dilutive test and Comparable methods are useful tools in the decision process. The danger in placing too much reliance on these methods results from two factors. First, neither method reflects the full economics of the deal, since they do not utilize an appropriate measure of return on the capital invested. Secondly, the measures do not require explicit assumptions about the total performance of the combined businesses. It is difficult to understand the performance expectations that are built into a comparables pricing analysis. How can operating managers understand what performance they are signing up for?

The use of EPS Accretive Dilutive test and multiples pricing methods should be complemented by a comprehensive Discounted Cash Flow analysis. The analysis should include a "base case" valuation and sensitivity analysis to understand the impact of critical assumptions on valuation. Similarly, acquirers should estimate the expected economic return using Return on Invested Capital ("ROIC"). In the example in figure 1:

$$\text{ROIC} = \frac{\text{Operating profit after tax(target + synergies)}}{\text{Acquisition price}} = \frac{\$4.2\text{m} + \$3.6\text{m}}{\$100\text{m}} = 7.8\%$$

A return of 7.8% is unlikely to exceed a realistic estimate of the cost of capital for this investment. If the Acquirer proceeds with this acquisition, it will be accretive to earnings but will not earn an acceptable return for the shareholders of the acquiring Company.

Summary

Determining an appropriate transaction price for an acquisition target is a critical element of a successful acquisition. Acquirers must set prices that enable them to earn an economic return on the investment. Care must be exercised in the use of common methods, which should be complemented by DCF and other economic based methods.

References: Performance Dashboards and Analysis for Value Creation, Alexander, Wiley 2006

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