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Valuing Synergies in M&A

When a business owner considers growing through acquisitions, he should take the same approach as an individual investor would. "Think like an investor" should be his mantra.

By the same token, a buyer should only consider purchasing a target if an overall benefit will accrue to the buyer's shareholders that they wouldn't be able to generate on their own. These benefits are also known as synergies.

The concept can be summed up as follows: The whole is greater than the sum of its parts: 1+1 = 3.

If an acquisition is only additive (i.e. 1+1 = 2), no value is created for the shareholders as they could buy shares of the target on their own and be no better or worse off.

So what types of synergies should a buyer search for when considering an acquisition? Some of the most common include:

1. **Revenue Enhancement.** The combined entity can generate more revenue as a result of cross-selling and/or re-branding of each other's products.

2. **Cost Reduction.** This can occur in a number of ways including: (a) eliminating duplicate costs (rent, headcount etc.); (b) economies of scale (better pricing due to increased purchase volumes); (c) transfer of technology or know-how from the target to the buyer.

3. **Redundant Assets.** The sale of duplicate assets not required by the buyer can generate significant returns and will offset the purchase price of the target.

4. **Tax Reduction.** This can usually be done in one of two ways:

    a. **Through Increased Tax Depreciation.** The purchase price is allocated to the fixed assets of the target and results in an increase in the asset values for tax depreciation purposes. The buyer can use this to take additional tax depreciation and therefore reduce future income taxes; and

    b. **Through Utilization of the Target's Operating Tax Loss Carryforwards.** This occurs in cases where the target has tax losses it was not able to use prior to the acquisition. It also assumes the target is in a same or similar business as the buyer. Otherwise, the buyer may not be able to utilize the losses to reduce future taxable income.

5. **Financing.** This synergy is generated if the combined entity can access debt financing that it would not be able to obtain if the acquisition did not occur. Future tax savings on this debt would accrue through additional interest deductibility.

6. **Options.** Through an acquisition, a buyer may now have access to options that it wouldn't have on its own such as the option to exploit R&D of the target that the target was unable to exploit due to lack of resources. Or the option to enter or exit a business sooner rather than later.

It is extremely important to calculate the true value of synergies accruing to the buyer rather than estimating them on the back of an envelope. Financial modelling and generating "what if" iterations under worst case, most likely and best case scenarios will assist the buyer in establishing a range of values from which a purchase price can be negotiated. A buyer should attempt to acquire a target at a price close to the target's standalone or intrinsic value. A savvy seller will realize that synergies will accrue to the buyer and will want the buyer to pay as much as possible for this synergistic value.

Finally, each synergy has a different probability of occurring and should be valued according to the likelihood of it being realized or not. For example, the sale of redundant assets is a synergy that would be given a much higher probability of occurring than a year over year increase in sales due to cross-selling or rebranding of the target and buyer's products.

Aries Advisory Group can assist you with your acquisition strategy. We can perform valuations of target companies on a standalone basis and with synergies included. We can then assist you with negotiating the best purchase prices for your acquisitions. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.