



How Mergers and Acquisitions Create Value

Recent merger and acquisition activity, especially in the core middle market manufacturing base, appears to be driven by the realization that well-managed business combinations can create value. "Synergy" refers to the phenomenon that occurs when the value of the combined enterprise exceeds the value of the companies taken separately. Synergies have a real impact on many transactions. The question for buyers and sellers is: "How much value will be created by the proposed transaction, and how do I ensure that I am appropriately compensated for such value?"

Common synergies include:

- Elimination of duplicate staffing, particularly in administration, accounting, and human resources.
- Sale of excess plants, property, and equipment by combining manufacturing facilities. This may also lead to additional reductions in labor and overhead.
- Reduced risk management, benefit, and compensation costs.
- Economies of scale and expanded opportunities in purchasing, marketing, distribution, and research and development.
- Greater access to capital, at a lower cost.
- Increased market power.

The remainder of this article discusses how potential synergies should be addressed by buyers and sellers.

Buyers

Although a buyer should have ample opportunity to quantify potential synergistic benefits during due diligence, in most cases the purchase price is agreed to in advance. The buyer should make high-level assumptions regarding available synergies and request supporting data from the seller. In addition, the letter of intent should provide the buyer with an exit strategy should due diligence indicate that the projected cash flow is materially less than originally anticipated.

In general, when synergies are expected to create significant value, the buyer should:

- Assemble its internal and external due diligence teams well in advance.
- Identify additional experts required for specific due diligence areas, such as environmental, pensions and benefits, and risk insurance.
- Outline reporting formats, assign responsibilities, and set deadlines.
- Prepare detailed projections of synergistic benefits for each operational and administrative area.
- Consolidate operating projections and develop cash flow forecasts to determine the appropriate value and capital structure.

- Receive "buy-in" from those charged with implementation. This is essential in order to maximize the likelihood of capturing all available synergies.

Sellers

The seller should design its marketing strategy to create a competitive atmosphere among potential buyers. In addition to presenting the company's key attributes in the customary selling memorandum, the seller should highlight the synergies available to key classes of strategic buyers. Among other things, the seller should:

- Adjust operating income and cash flow for any unusual or nonrecurring items such as excess owners' compensation or one-time capital expenditures.
- Prepare pro forma projections that consider the benefits available to strategic buyers.
- Develop a list of prospective actions that can result in additional cash flow.

The seller should be actively involved in managing the due diligence process and should request regular meetings with the buyer's due diligence team to ensure that information is being interpreted correctly and potential synergies are recognized. In addition, key managers should be given proper incentives to represent the company in the most favorable manner possible.

How Much Will a Buyer Pay?

Sellers can enhance their chances of receiving maximum credit for potential synergies by creating a competitive atmosphere during the selling process. Here are a few tips:

- Approach financial as well as strategic buyers. Even if financial buyers cannot compete because of the synergies available to strategic buyers, they can help set a floor for the valuation and create a competitive atmosphere.
- Make sure all interested parties have all relevant information and are interpreting it correctly.
- Research individual potential buyers. Try to quantify the benefits they could derive from the proposed transaction.
- Manage the process by keeping all potential buyers on the same schedule and controlling access to key information and employees.
- When soliciting bids, request a discussion of the buyers' valuation methods.
- Be creative when negotiating payment for the value created by the synergies.

Most important, be prepared to help potential buyers analyze the benefits of the transaction. Too often, sellers leave money on the table by failing to communicate to buyers the value of available synergies.

Conclusion

Transactions being contemplated primarily for potential synergies present challenges to both buyers and sellers. The buyer's challenge is to identify and quantify all benefits of the business combination so it can accurately project cash flows and value the business. The seller's challenge is to create a competitive atmosphere and effectively negotiate for the synergistic value.

Discounted Cash Flow Model (000's)

I. Target Value Without Synergy	2001	2002	2003	2004	Residual
Cash Flow (projected)	1,000	\$1,500	\$2,000	2,500	\$20,825
Present Value Factor	0.8929	0.7972	0.7118	.6355	0.6355
Present Value	893	\$1,196	\$1,424	1,589	\$13,235
Total Present Value					18,337
Less: Existing Debt					6,000
Equity Value					12,337

II. Target Value With Synergy	2001	2002	2003	2004	Residual
Cash Flow (projected)	1,250	\$2,000	\$2,500	3,000	\$24,990
Present Value Factor	0.8929	0.7972	0.7118	0.6355	0.6355
Present Value	\$1,116	\$1,594	\$1,779	1,907	\$15,882
Total Present Value					22,278
Less: Existing Debt					6,000
Equity Value					16,278

III. Value of Synergy	
Value with Synergy	16,278
Value without Synergy	12,337
Value of Synergy	3,941

The value of synergies is estimated to be \$3,941,000. This assumes the synergistic benefits are as achievable as any other part of the cash flow (i.e., the risk of achieving the synergies is equal to the overall business risk).