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Do Acquisition Premiums Matter?

A herd-like mentality leads many companies to acquire more at the top of the stock market cycle than they do at the bottom.

Gregory V. Milano, CFO.com | US

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During the second quarter of 2011, the S&P 500 crossed the psychologically significant milestone of having doubled since the low level reached in March 2009. This strong recovery in the financial markets has provided senior corporate executives with confidence that investors are putting the financial crisis behind them.

Despite continuing doom and gloom in the financial press, executives across Corporate America seem also to be looking positively toward the future. The evidence? A dramatic increase in acquisition announcements.

With just over half the year completed, the 2011 total transaction value of announced U.S. acquisitions of at least $100 million is already approaching the full year value for 2010. Average transaction size is up 39% and average total deal value per month is up 56%. Although this acquisition spree is exciting, corporate executives and their boards must make sure that their corporate development strategy creates value for shareholders.

When everyone is doing deals, there is a tendency to want to join in for fear of being left behind. This herd-like mentality leads many companies to acquire more at the top of the stock market cycle than they do at the bottom. That increases the price paid, which, in turn, drains value-creation potential from the deal. Indeed, over the last ten years, total U.S. acquisition volume was nearly 70% higher in the five years when the S&P 500 was above average than in the years when it was below average.

Just as overeagerness can derail an acquisition strategy, so can an overly conservative attitude destroy value. Our findings across many industries have consistently demonstrated that a well-executed acquisition strategy can be a great source of value creation. In nearly all our research, companies that devote more capital to acquisitions tend to outperform their peers.

For example, my colleagues Steve Treadwell and Frank Hopson analyzed companies that made acquisitions of at least 20% of the acquirer's market capitalization each year during the decade of the 2000s. They found that for such acquisitive companies, Total Shareholder Return (TSR), outperformed the S&P 500 index by 40% over the period. (TSR is the annualized growth in value stemming from share price appreciation and dividends.)

To be sure, it's understandable that many executives focus on the immediate share price reaction. But that attitude may not be appropriate for a long-term investment like an acquisition. Shouldn't a company be willing to endure a relatively short-term share price decline on the announcement of the deal in exchange for beating the market by 40% over the coming years?

Our acquisition study shows that the success of acquisitions varies considerably according to the point in the economic cycle when they're made. Acquirers between 2001 and 2004 delivered over 30% higher relative TSR over the two years after their deal announcement than those that acquired between 2005 and 2008. The question for executives is, why?

As we will see, the earlier acquirers delivered stronger results because they tended to make acquisitions at lower absolute prices. In addition, the economy grew well after the acquisitions. Acquisition volume is typically lower at the start of an upward turn of the cycle because executives often worry too much about paying a high premium relative to the target's stand-alone value.

When the stock market is down, boards of selling companies often demand a higher premium to cede control of their company. But purchase-price premium is not the best indicator of value. The median transaction premium in 2009 was 34%, which seems expensive when compared with the 21% premium in 2006. However, if we examine the acquisition prices in relation to book value, we get a better sense of the absolute value paid at each point in the cycle. It turns out that despite the higher premium, the absolute price paid in 2006 was a 25% higher multiple of book value -3.0-as compared to 2.4 in 2009. When the stock market is low it can be worthwhile to pay a higher premium if needed.

One reason executives may miss that important point is that they tend to focus on earnings-based multiples, such as price to earnings, multiples of Earnings Before Interest Tax Depreciation and Amortization (EBITDA), or cash flow. While such multiples are more prevalent, they do not provide as clear a signal of absolute pricing as price to book value does. Earnings-based multiples mislead many companies into believing they are paying a "fair" price for their acquisitions at the peak of the stock market cycle. (I use the term "fair," because banks provide a "fairness opinion" on acquisitions. The practice is typically based on the same problematic company multiples of earnings and cash flow I refer to here.)

In their valuation analyses, executives and their advisors often use the Forward EBITDA Multiple, which compares enterprise value (market capitalization of equity plus net debt) to the EBITDA expected over the next twelve months based on analyst projections. From 2002 to 2006, the median implied Forward EBITDA Multiple for announced acquisitions was within a very tight range of 10.9 to 11.6 despite a 63% increase in the EBITDA of the overall market. Acquirers kept paying essentially the same multiple of EBITDA, acting as if improvements in returns and cash flow were perfectly sustainable.

A better strategy would be to pay a lower EBITDA multiple at the top of the stock market cycle and a higher multiple at the bottom. Heeding this approach would lead more companies to make acquisitions when they are less expensive on an absolute basis. This is difficult, however, since companies and their advisors tend to look at the valuation of comparable transactions. Since the market-peak comparables are expensive, they provide a poor guide to value fairness. Relative valuation at a point in time masks the impact of the huge swings in market valuation that occur.

Acquisition premiums don't matter - what matters is the absolute price paid. To ensure that their corporate development strategy creates value throughout the business cycle, executives and boards need to pay more attention to absolute valuation rather than being wowed by comparable-company analyses. And now may be a good time to consider this approach, since acquisitions thus far in 2011 are being executed at below-average market-to-book ratios.

Gregory V. Milano, the co-founder and Chief Executive Officer of Fortuna Advisors LLC, a value-based strategic advisory firm. His column appears monthly on CFO.com.