



Alternative framework to quantifying transaction value



How do CFOs know that they are making the right financial decision when acquiring another company? When the strategy aligns, the culture is a fit, and both sides are excited, does the price matter?

Transactions are often used as a vehicle to strategically advance the strength and position of businesses. While doing so, CFOs must make decisions on mergers and acquisitions (M&A) while also managing the financial health of their company, the capital of their investors, and, potentially, risking their own careers. Therefore, it is critical that the analysis to approve or reject an acquisition is sound and leads to making an informed decision.

Let's look at history to understand how acquisitions have performed in the recent past. From 2011 through 2020, over 3,000 U.S. public companies disclosed that they underwent a material acquisition. Of those companies, approximately 30 percent¹ also disclosed a goodwill impairment over the same period. Goodwill impairment occurs when the fair value of a previously acquired entity decreases beneath its book value, where the book value can be considered an approximation for the value at the time it was acquired. As such, a goodwill impairment is an indicator of an M&A transaction that has not provided the expected returns. The prevalence of impairments from 2011 through 2020 is one indicator that many acquisitions do not go to plan.

Over the past 10 years, approximately 30 percent of transactions have not met financial expectations

How do most companies evaluate transactions?

When it comes to the approval process to determine whether to move forward with a transaction, each company will be different. Further, the strategic need to make an acquisition varies by the specific

situation of each company. Yet, while the needs are different, we find that most companies consider the same metrics.

- Common metrics to evaluate deals:**
- Net present value (NPV)
 - Internal rate of return (IRR)
 - Return on invested capital (ROIC)
 - Payback period
 - Implied multiples

Definitions

NPV	Discounted cash flow analysis to calculate the current value utilizing an expected future return on estimated future cash flows
IRR	The calculated return on an investment based on its future cash flows
ROIC	The annual return on an investment
Payback period	The number of years required to earn enough cash to offset your investment
Implied multiples	Value of an investment divided by a revenue or profit metric

¹ Source: CapitalIQ

With regard to the valuation metrics, the most common in our experience is the NPV. The benefit of the NPV is that the output provides a direct answer for what should be paid. However, is it reliable? It depends. When peeling back the value, it should be noted that the value is calculated as a combination of the cash flow over the first few years (typically, three to five years) in addition to the terminal value, which is the value into perpetuity. Most of the value tends to be derived from the terminal value, which means that the majority of the value is far into the future. Value creation 5, 10, 15 or more years into the future is often not the strategic objective of M&A.

Next most prevalent is the IRR. With the IRR, the investment value and cash flows are known (or estimated), and the expected return is calculated. The return is then compared to the weighted average cost of capital (WACC), and if higher, it is generally considered to be a good investment. While the IRR is easy to understand, it also has the same limitations as NPV in that if the returns are heavily weighted to the long-term forecast, the IRR will not provide much insight.

Two metrics that try to address the need to assess near-term cash flows differently than NPV and IRR are ROIC and payback period. ROIC calculates the annual return of an individual year over the invested capital. However, it doesn't indicate what is creating the incremental value (synergies, etc.) and the risk associated with it.

The payback period is often used in the investment community, for instance, private equity. As such, it is a valuable tool to estimate if returns are being made in the short term. However, it does not consider the risk associated with achieving those returns.

Lastly, implied multiples are often calculated as the NPV divided by a historical or projected profit measure. The result can be compared to public company data, and if the implied multiple is within the range of the comparable companies, it may signify that the value is within the range that the general market would expect. However, understanding implied multiples relies on the availability of comparable public companies, which can be a limitation for most companies and industries.

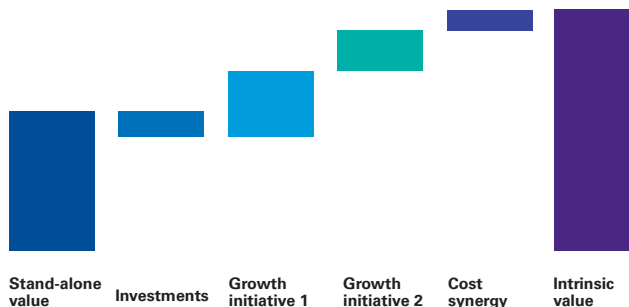
How can value be assessed differently?

No matter the investment, the key is to differentiate the current value of the target company versus the value that you can add by acquiring the company, or its intrinsic value. The incremental value may come from new markets, new distribution methods, innovation, or efficiencies. However, it is critical to identify these value drivers, forecast them separately, and incentivize the synergistic behaviors. In short, the challenges that most companies encounter when

evaluating their transactions are assessing the sources of value creation, timing, and their ability to influence behavior. As such, we would suggest adjusting the framework by which investments are evaluated to be focused on value creation, instead of the metrics discussed previously.

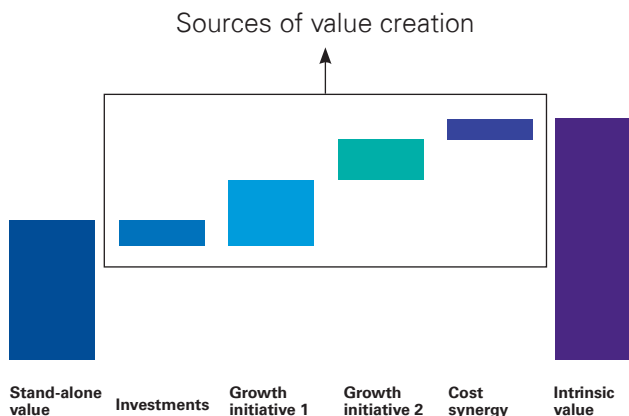
Step 1: Identify the sources of value creation

Separate the value of the current business as a steady-state company to set the baseline. Next, add the incremental value of each initiative to pressure test the current value as compared to the intrinsic value. This concept can be shown graphically as follows:

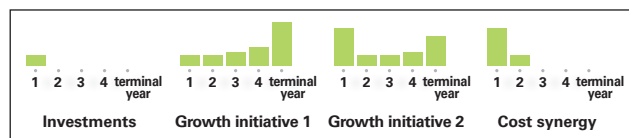


Step 2: Understand the timing of the incremental value-creation initiatives

Each investment, initiative, and/or synergy can be further bifurcated to reflect the timing of the value creation as shown below. By also showing the timing of the cash flows, you can better assess the impact and timing of each strategic initiative.



Timing of incremental value

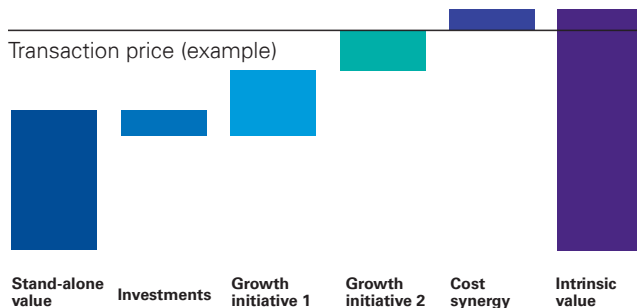


Timing of incremental value created in years 1 to 5 and in the terminal year

Step 3: Layer in the transaction price compared to stand-alone value and intrinsic value

Commonly, companies understand that they will likely pay a premium above stand-alone value to acquire a target. In public company transactions, frequently observed premiums above quoted stock prices are approximately 20 percent to 30 percent. Yet they vary widely. Conceptually, the closer that the hypothetical transaction price gets to the intrinsic value, the more important it will be for management to have confidence in the ability to achieve the value creation initiatives.

For instance, in our example, the transaction price is above the values associated with the stand-alone company plus the incremental impact of the investments and growth initiatives. As such, in order to support the transaction price, management would need to be confident in the source, timing, and risk of those initiatives. By understanding how value will be created through a transaction and how it corresponds to the transaction price, management can prioritize their initiatives and focus on those that are most critical to their financial and strategic objectives.



Timing of incremental value



Step 4: Consider other potential outcomes via scenario analysis

Scenario analysis is a powerful tool to be able to stress test the value. By building the components of value from the stand-alone value to the intrinsic value, each component can be assessed independently providing further insights. By looking at multiple scenarios, management can understand the variability associated with each value creation initiative and their interplay with the transaction price, leading to better decisions.

KPMG can work with you to understand your transaction values

Companies need to change their framework used to assess deal value. To gain a better understanding of what makes a deal financially successful, companies should shift away from traditional metrics, such as NPV and IRR, and focus on the sources of value creation. To do this effectively, it requires a different skill set and new tools.

Our Valuation & Business Modeling Services practice helps clients develop new deal models and evolve their M&A process. Our methodology emphasizes enhancing value creation opportunities while balancing timing and risk. We work with our clients to understand their strategic objectives and develop new tools that more effectively align strategy to value and drive better outcomes.

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