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The Case for Pricey Acquisitions

by Justin Pettit

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High-multiple acquisition targets can be the best bargains.

by Justin Pettit

It's no secret that acquisitions often provoke skepticism on Wall Street — especially with respect to the acquiring company. While the target company is popping open the bubbly, the executives doing the buying often face shareholder questions and endure at least a temporary decline in their company's share price.

The initial skepticism is understandable. Forty-four percent of deals do indeed destroy value, according to a study by UBS Investment Bank. But that leaves 56 percent that create value. What's interesting, and instructive, then, is to determine the characteristics of deals that work. That analysis yields an unexpected answer: The priciest acquisitions usually serve buyers better.

UBS looked at 1,500 acquisitions that took place between 1992 and mid-2004, all with public companies as the acquirers and with targets that had at least $100 million of revenue. (UBS did not indicate specifically which acquisitions it examined.) It found that acquirers whose stock prices rose in the post-M&A year had bought companies with 50 percent higher price-to-book multiples, on average, than those targeted by acquirers whose stock prices fell.

To some extent, we should intuitively grasp the promise of higher-value acquisition targets. In our own investing we are typically drawn to markets in which fast growth and rising profits translate into a high cost of entry. But when it comes to corporate acquisitions, many companies are frightened by what they must pay for a promising business. Attuned more to the risk than to the reward, acquiring companies sometimes play it too safe. The result is a focus on businesses that can provide immediate earnings accretion — lower-growth businesses, turnaround prospects, and targets that overlap in so many ways with the acquirer that cost-cutting is fast and straightforward.

Acquirers that avoid high-multiple targets are opting for an M&A strategy that is easy to defend but that is likely to result in some significant missed opportunities. If we assume that stock market prices generally reflect value over time, then expensive companies are expensive because they have great futures. They are more profitable, faster-growing, and operate in attractive industries. They often have stronger positions within their industries.

By contrast, targets with lower multiples that are more likely to be immediately accretive to earnings often have dimmer economic prospects. The only way to find excitement in these acquisitions is through operational efficiencies and cost reduction. This is why mergers and acquisitions are so often associated with massive layoffs and plant closures.

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This is not to deny the role of factors other than growth and profit potential in making an acquisition successful. In the year after an acquisition is completed, the key challenge is post-merger integration. There are a few factors that make integration simpler. One is a close strategic fit; companies in the same industry have a much easier time melding their operations. Another factor is the size of the company being acquired. It's simpler to incorporate the operations and systems of a small company than of a large one. And acquisitions of private companies also tend to work better. Private-company owners are often highly motivated sellers with less bargaining power, making it unlikely that the acquirer will overpay.

Financial structure also affects Wall Street's reaction to an acquisition a year after it has happened. For instance, the UBS study showed that cash acquisitions usually have better results than acquisitions made with stock, partly because of the discipline imposed by taking on debt and partly because the use of stock as an acquisition currency sends a negative signal to the market. Executives eager to use stock in an M&A are signaling that they believe their shares are fully valued. In addition, using stock leads to a "double dip" for the target company, because the seller receives both a premium in the purchase price of the transaction and a piece of the gains from the prospective synergies that justified the premium paid.

To be sure, high-multiple acquisitions run bigger risks in the short run and often encounter skepticism in the form of investor churn and temporary stock-price weakness. There is an understandable wait-and-see attitude while Wall Street determines whether the high price meant that too much was paid for an unattractive target or that a fair price was paid for a desirable one.

A higher-multiple target may also involve a foray into a less stable sector, such as telecommunications or energy; in other words, higher risk commensurate with potentially higher return. Today's shareholder base may not like the shift in direction. But for every shareholder who wants out, there are bound to be many more who will consider investing. Preoccupation with the existing shareholder base ignores the reality that today's markets provide an unconstrained source of efficient capital.

Yes, high multiples raise the stakes. But if companies have been diligent about choosing the appropriate acquisition, a target's seemingly high multiple shouldn't be a deterrent. On the contrary, it may point to the rare situation in which one plus one can be made to equal three. +

Resources

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