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Acquirer TSR Hinges on Economic Results

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Why do shareholders respond favorably to some acquisitions while others struggle to ever materialize in enhanced returns? We took a fresh look at whether acquisitions create value for shareholders and despite the prevalence of "announcement" event studies which suggest otherwise, we find that acquisitions typically do create value for the buyer's shareholders. What's more, we found the pattern of internal economic performance after the transaction to be critical in determining if and when the company's share price outpaces the general market over time. These findings are particularly interesting in that they provide executives with clear evidence on how to make an acquisition strategy work in their organization.

> ***On average, companies that grew their RCE faster (or declined less) in the first full year after an acquisition are recognized for it by investors and create more value in terms of share price performance.***

Our capital market research covered the the decade of the 2000's and focused on companies that devoted a significant amount of cash to acquisitions. A company was deemed "acquisitive" when total cash acquisitions in a given year exceeded 20% of the buyer's market capitalization at the outset of their fiscal year. We focused on companies that completed significant acquisitions relative to the buyer's size so we can be confident that a substantial portion of the performance changes were driven by the acquisitions.

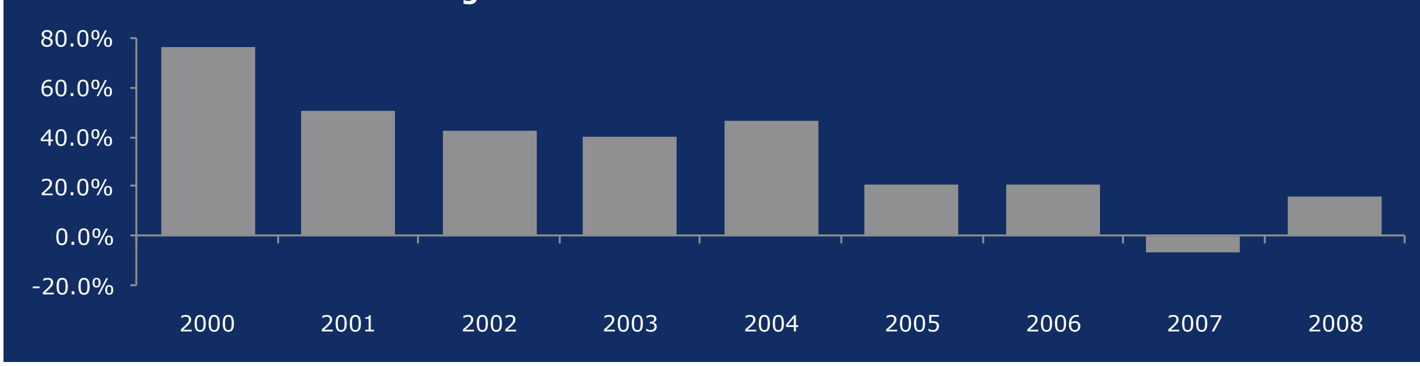
We examined whether the acquisitions had a positive impact on externally measured Total Shareholder Return (TSR) and internally measured economic performance, as indicated by Residual Cash Earnings (RCE)[1], our measure of cash flow in excess of covering the required return on capital.

Our findings are based on a comparison of TSR and RCE from the last full financial year before the acquisitions to the first full year afterward. By looking at TSR and RCE over this period, we avoid the noise associated with the event and focus on the medium-term value implications for extracting value from acquisitions.

Acquisitions Create Value

Consistent with our firm's previous research[2], we found clear evidence that companies that devote more cash to acquisitions out-perform the overall

Figure 1: Median 2-Year Relative TSR



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stock market. As shown in Figure 1, over the 2-year period before and after the deal, our acquisitive companies outperformed the general market in every period except for acquisitions that occurred in 2007, the year the stock market peaked.

During the early 2000's, when the stock market was struggling back from the bursting of the internet bubble, acquisitive companies created tremendous value with the median TSR of the acquisitive group outperforming the S&P by 40% or more. Since the middle of the decade, the results have been more subdued, but still positive.

This positive market reaction for acquiring firms can be explained by either: a) good companies and management teams tend to do the most acquisitions; and/or b) these companies are particularly good at identifying, executing and integrating acquisitions. Based on our experience working with acquisitive companies we believe it is a combination of these factors.

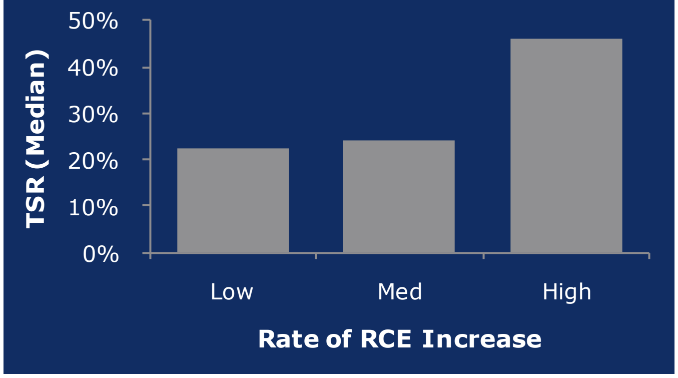
Grow RCE More to Drive Better TSR

As expected, the economic performance of the acquisitive companies had a significant impact on the timing and level of TSR achieved. We evaluated the change in the buyers' RCE from the year before the company made their large acquisitions and compared this with the RCE the first full year after the acquisition. We included goodwill and other intangibles in RCE to fully account for the cost of the acquisition.

By focusing on the change in RCE from the year before the acquisitive year to the year afterward, we measure the degree to which improvements in after tax cash flow more than cover the required return on the incremental capital. We separated companies into three groups based on the rate of growth in RCE over this two year period.

As shown in Figure 2, on average, companies that grew their RCE faster (or declined less) in the first full year after an acquisition are recognized for it by investors and create more value in terms of share price performance.

Figure 2: TSR vs RCE Increase



Companies in the lowest group had a median change in RCE of -8.3% and those in the middle group generated a median 28.2% increase in RCE. Both groups delivered TSRs that while positive and in excess of the market, significantly lagged that of the top RCE improvement group. The top group, as one would expect, not only benefitted from the growth offered by the acquisitions, but by improving RCE by a median of 96%. It is frankly astounding that a third of these companies generated enough cash flow in the first full year after the acquisition to more than cover a capital charge on the full increase in assets and a nearly doubling of RCE. Investors clearly value this level of performance as these companies delivered TSR that was 23% higher than the median of the two lower performing groups.

Many executives are quite rightly concerned not just with the average level of success but also with the probability of success. In our study, approximately 80% of companies were able to increase RCE after the acquisition. Within this group, approximately 73% outperformed the market over a two year period. For the remaining 20% of the companies that had lower RCE in the year after the acquisition, TSR outperforms the market 65% of the time. Combining these groups we find that about 70% of acquisitive companies outperformed the market with companies that grow RCE nearly three times as likely to see a positive market reaction over time compared with a negative reaction. As indicated above, the odds of success are far more favorable than most executives expect.

Strategic Implications

For executives, these findings offer persuasive vali-

In October of 2005, GameStop merged its operations with Electronic Boutique. At the time of the announced deal, GameStop's enterprise value was approximately $1.6 billion. With an acquisition value of $1.4 billion, Electronic Boutique represented a sizeable bet by GameStop. In 2004 (the last fiscal year before the deal), GameStop generated RCE of $95 million. One year after the completion of the deal (2006), the combined company generated $342 million in RCE (including a capital charge on the intangibles and goodwill acquired in the transaction) – nearly 4x the level of economic profit of GameStop just two years before. Perhaps not surprisingly, GameStop's share price outperformed the S&P 500 during this two year period by 160%.

dation of the concrete performance requirements for increasing the probability of value creation from an acquisitive growth strategy.

First, compelling evidence demonstrates that acquisitions can and do typically create value for shareholders, despite the prevailing wisdom of the "experts". This observation is critical to truly embed in the evaluation of strategic options and decision making by executives. Too often acquisitions are pitted against a share repurchase program to assess value accretion and the typical myopic and one-time nature of a share repurchase program often limits, rather than creates value for shareholders. Our research on this topic has demonstrated over and over again that companies that reinvest more, including acquisitions, outperform companies that simply distribute capital via share repurchase programs. The market values and rewards growth and the option value it creates for the long-term attractiveness of the business.

Second, to create substantial value, acquisitions need to have a positive impact on the company's economic earning power, and the more significant the impact the better. Our analysis, both in this acquisition study and in broader market analyses, shows that investors respond to cash flow improvements in excess of earning a required return on new investments. This is what RCE measures. When making an acquisition, there is often an interruption to the company's RCE trend as the new business is acquired at market value including a premium for future cash flow growth, and this initially weighs on the company's economic earnings. The best acquirers are able to quickly recover from this temporary dip in RCE and deliver revenue and margin improvements so the acquisition delivers superior performance to their base business before the acquisition.

So how can executives achieve this increase in RCE? These four areas should be the primary focus to help the business manage an acquisition growth strategy and integrate the acquired companies:

1. **Continued execution and positive momentum in the base business.** Regardless of what new initiatives are being pursued, it is imperative that the base business continues to improve performance and drive value. If management takes its eyes off the core source of value for shareholders, there is risk that the value potential of the new investment could be more than offset by declining performance in the base business. Not only will this negatively impact TSR, but the credibility of management will be impaired as the market becomes skeptical the company is able to execute a growth strategy without sacrificing the core business.

2. **Seek out high RCE opportunities but recognize you will have to pay for them up front.** By continuously seeking out businesses and industries that are able to generate RCE at or above the existing business, management has an opportunity to continually position the company into the most attractive segments of the market and build momentum for higher returns. However, these acquisitions often carry higher multiples due to their attractive markets so diligence must be maintained in the valuation process to avoid over-paying for the company.

3. **While finding high RCE opportunities are critical, it is equally important how the post-acquisition integration is executed.** Many companies use hurdles like 'We seek opportuni-

ties where ROIC exceeds WACC by year 3 or 4'. Why so long? Should investors wait 4 years for value to be extracted from the acquisition? When evaluating the best acquirers, they don't wait 4 years to realize value but begin extracting value on day one. As our research shows, shareholders respond to positive RCE momentum and so the quicker the company can recover its RCE to surpass pre-deal levels and begin to grow, the faster the share price will recover following the closing.

4. **While cost synergies are important, don't forget the growth.** Eliminating duplicative costs is a key driver behind many acquisitions – it provides the quick wins on earnings and provides cash necessary to reduce the debt load of the business after the acquisition. However, our research shows that ultimately, the company must be able to reinvest and grow the business to truly drive superior Total Shareholder Returns. In fact, some of the best acquisition targets are those that can accelerate the total company's growth after the acquisition, possibly through increased exposure to growing emerging markets or access to more differentiated and desired products and services.

Keeping these key strategic factors in mind and delivering true improvements in economic performance can greatly increase the likelihood of successfully implementing a growth strategy for a business…and for its shareholders.

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Notes:

1 See www.fortuna-advisors.com for more on Residual Cash Earnings (RCE) and other aspects of Fortuna-lytics. We adjusted our standard RCE methodology to include goodwill & intangibles to account for the full cost of acquisition.

2 Who Says M&A Doesn't Create Value?' demonstrated that companies which allocate more cash to acquisitions can create greater value for shareholders than more conservative growth strategies. 'Want to be a Great Acquirer, Do more Deals' provided a case study of two companies' acquisition strategies which resulted in superior value for shareholders. See http://www.fortuna-advisors.com/buona-fortuna.html.