Deal Synergies & Accretion/Dilution

Fall 2023

AGENDA

- What are synergies?
- How do we calculate and value synergies?
- What is accretion / dilution?
- Why is it important to conduct a merger analysis?
- Is it a good representation of value creation?

SYNERGIES OVERVIEW

- **Synergies** – additional value created through the combination of two or more entities
  - Ex. Parent ($100 EV) + Target ($50 EV) = MergeCo ($160 EV)
- Three types of synergies:

1. Revenue – cross-selling, upselling, new customers
   - Generally more difficult to attain/justify
2. Cost – labor/management cuts, volume discounts, other cuts
   - Generally easier to attain/justify
3. Financial – tax rates, working capital, debt capacity
   - More intricate; in-depth financial analysis needed

Calculating Synergies

- To determine the potential synergies of a deal, look at synergy expectations in similar transactions
  - Synergies as a % of total purchase price (EV)
  - Synergies as a % of target's revenue
- Depending on the type of cost savings, synergies can be either one-time or recurrent
  - Sale of warehouse (one-time) vs. labor force cuts (recurrent)
- "Run-rate" refers to the continuation of an assumption for the purposes of projecting financial statements
  - You may sometimes see this term in press releases
    - Ex. "Annual run-rate cost synergies of $50 million"

VALUING SYNERGIES

- The value of synergies can be assessed by comparing the EV of the pro forma company with the combined EVs of the two standalone companies
  - Synergy value = MergeCo EV – ParentCo EV – TargetCo EV
  - Requires valuation of the combined entity (DCF with synergies)
- Alternative method is to value the synergies separately by discounting the effects to FCF at the cost of equity
  - Less formal, but can act as a check on DCF with synergies
  - Synergies can be ambiguous, deserve a higher discount rate

What is the value of synergies in the example on slide 3?

Three Sources of Financing in M&A

- Cash, Debt, and Equity are used by companies to pay for acquisitions, capital expenditures, and other ventures
- In an acquisition you have to choose the blend of cash, debt, and equity that you will use to pay for it
- When you pay for an acquisition with cash, you may need to raise debt to pay for the acquisition in cash
  - When you buy a house you don't use your whole checking account balance to pay for it, you take out a mortgage
- When you pay for an acquisition with equity, you could dilute your current shareholders
  - You need to calculate the pro forma earnings per share to see if earnings per share is going up or down as a result of the acquisition

How can you pay for an acquisition?

How to decide Mix

- One way to decide how much debt / equity / cash to use is to pick a target leverage ratio
- First, calculate the EV of the target firm then calculate the Proforma EBITDA – Look at comparable firms and find an appropriate leverage ratio (gross debt / EBITDA)
- Take the appropriate leverage ratio (for example 5.0x) and multiply it by the proforma EBITDA to get the total amount of gross debt that the proforma company can handle
- Then take EV = (Max Gross Debt – (acquirer debt + target debt) + Equity Plug + Cash from b/s
  - Solve for the equity plug

ACCRETION/DILUTION

- An accretion/dilution analysis measures the impact of a transaction on the earnings of the acquirer
- **“Pro forma”** – value after the effects of a transaction, such as an M&A deal
  - Ex. Pro forma earnings are earnings if the acquisition were to take place
- EPS Accretion (dilution) $= \frac{\textbf{Pro forma EPS}}{\textbf{Acquirer EPS}} - 1$
  - If positive, then accretive; if negative, then dilutive

CALCULATING PRO FORMA EPS

- Pro forma EPS $= \dfrac{\text{Pro forma earnings}}{\text{Pro forma shares outstanding}}$
- Pro forma earnings = acquirer earnings + target earnings + synergies – forgone interest on cash – incremental interest expense on debt – other effects
  - Other effects include write-ups to PP&E, M&A fees
  - Everything should be after-tax
- Pro forma shares outstanding = acquirer shares outstanding + new shares issued in transaction
  - Only changes if stock is issued in the deal

Importance of Acc/Dil

- EPS accretion is often a measure that investors look at to determine, at a glance, if a deal is reasonable or not
- Usually only quoted one or two years into the future
  - Projected earnings after the first few years tend to be less reliable
- EPS is not a measure of value, it is just a measure of earnings
  - If you are pitching for two companies to merge, there have to be several business reasons for the merger; it cannot just be based on EPS accretion/dilution

FCF PER SHARE ACCRETION

- Alternative forms of accretion are used for companies without meaningful EPS metrics
- Using the levered (interest) free cash flow per share we can measure the impact of the merger
- $\text{Pro forma FCF Per Share} = \dfrac{\text{Pro forma LFCF}}{\text{Pro forma shares outstanding}}$
- PF LFCF = Combined Net Income + Combined D&A – Combined ΔNWC – Combined Capex – Mandatory Debt Payments
- $\text{FCF Accretion (dilution)} = \dfrac{\text{Pro forma FCF}}{\text{Acquirer FCF}} - 1$

ENBRIDGE EXAMPLE

- Enbridge share price: $44.21
- Spectra shareholders get 0.984 Enbridge shares for each Spectra share they own
- Enbridge issued 694mm shares to buy Spectra

Deal of the Week: Enbridge to Buy Spectra for $28B

Announcement Date	• September 6, 2016	
Acquirer	• Enbridge Inc. (NYSE: ENB)	
Acquirer Description	• Energy transportation and distribution company in the US and Canada • Incorporated in 1949 and headquartered in Calgary, Canada	
Acquirer Financial Statistics	• Mkt Cap: $40.2 billion • EV: $70.4 billion • LTM Revenue: $26.3 billion	• LTM EBITDA: $4.6 billion • LTM EV / Revenue: 2.7x • LTM EV / EBITDA: 15.4x
Target Company	• Spectra Energy Corp (NASDAQ: SE)	
Target Description	• Owns and operates a portfolio of natural gas-related energy assets in North America • Founded in 2006 and headquartered in Houston, Texas	
Target Financial Statistics	• Mkt Cap: $28.8 billion • EV: $39.5 billion • LTM Revenue: $5.0 billion	• LTM EBITDA: $2.5 billion • LTM EV / Revenue: 8.0x • LTM EV / EBITDA: 16.0x
Acquirer Advisors	• Credit Suisse and RBC Capital Markets	
Target Advisors	• BMO Capital Markets and Citigroup	
Price / Consideration	• $28 billion	• Stock

What is the value that Spectra shareholders get for each of their shares?

Enbridge Example

- See how the purchase price affects the pro forma earnings per share for the company
  - Purchase price increases, Enbridge has to issue more shares, but earnings stays the same, which means earnings per share decreases

Enbridge merger analysis accretive (mm)		
Enbridge net income before merger	$	1,154.0
Enbridge shares before merger		858.0
Enbridge earnings per share	$	1.34
Spectra Energy purchase price	$	43.50
Enbridge share price		44.21
Exchange ratio		0.984
Spectra energy shares outstanding		705.3
Enbridge shares issued		694.0
Pro forma Enbridge shares		1,552.0
Enbridge net income	$	1,154.0
Spectra net income		900.0
Post tax synergies		50.0
Pro forma net income		2,104.00
Pro forma shares outstanding		1,552.0
Pro forma earnings per share	$	1.36
Enbridge original earnings per share	$	1.34
Pro forma earnings per share		1.36
Accretion/dilution		**0.8%**

Enbridge merger analysis dilutive (mm)		
Enbridge net income before merger	$	1,154.0
Enbridge shares before merger		858.0
Enbridge earnings per share	$	1.34
Spectra Energy purchase price	$	48.00
Enbridge share price		44.21
Exchange ratio		1.086
Spectra energy shares outstanding		705.3
Enbridge shares issued		765.8
Pro forma Enbridge shares		1,623.8
Enbridge net income	$	1,154.0
Spectra net income		900.0
Post tax synergies		50.0
Pro forma net income		2,104.00
Pro forma shares outstanding		1,623.8
Pro forma earnings per share	$	1.30
Enbridge original earnings per share	$	1.34
Pro forma earnings per share		1.30
Accretion/dilution		**-3.7%**

Enbridge merger analysis breakeven (mm)		
Enbridge net income before merger	$	1,154.0
Enbridge shares before merger		858.0
Enbridge earnings per share	$	1.34
Spectra Energy purchase price	$	44.28
Enbridge share price		44.21
Exchange ratio		1.002
Spectra energy shares outstanding		705.3
Enbridge shares issued		706.4
Pro forma Enbridge shares		1,564.4
Enbridge net income	$	1,154.0
Spectra net income		900.0
Post tax synergies		50.0
Pro forma net income		2,104.00
Pro forma shares outstanding		1,564.4
Pro forma earnings per share	$	1.34
Enbridge original earnings per share	$	1.34
Pro forma earnings per share		1.34
Accretion/dilution		**0.0%**

How does purchase price affect pro forma EPS in this example?

QUESTIONS?

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