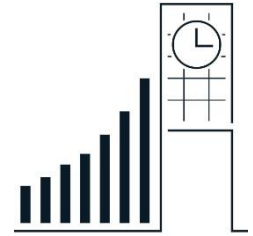


# DEAL SYNERGIES & ACCRETION/DILUTION

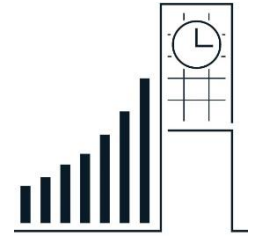
FALL 2023

# AGENDA



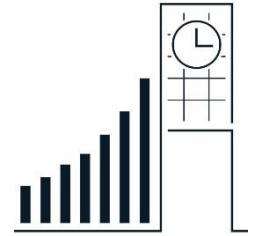
- ▶ What are synergies?
- ▶ How do we calculate and value synergies?
- ▶ What is accretion / dilution?
- ▶ Why is it important to conduct a merger analysis?
- ▶ Is it a good representation of value creation?

# SYNERGIES OVERVIEW



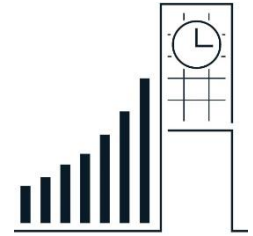
- ▶ **Synergies** – additional value created through the combination of two or more entities
  - Ex. Parent (\$100 EV) + Target (\$50 EV) = MergeCo (\$160 EV)
- ▶ Three types of synergies:
  1. Revenue – cross-selling, upselling, new customers
    - Generally more difficult to attain/justify
  2. Cost – 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”

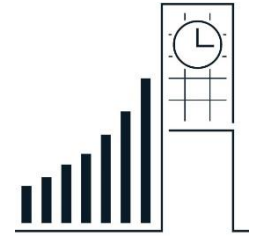
# VALUING SYNERGIES



- ▶ 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

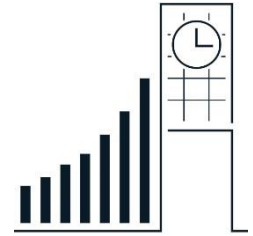
*What is the value of synergies in the example on slide 3?*

# 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

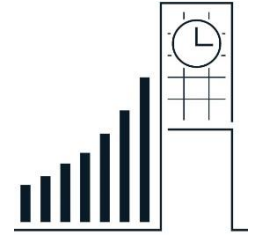
*How can you pay for an acquisition?*



# 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  $EV = (\text{Max Gross Debt} - (\text{acquirer debt} + \text{target debt}) + \text{Equity Plug} + \text{Cash from b/s})$ 
  - Solve for the equity plug

# ACCRETION/DILUTION



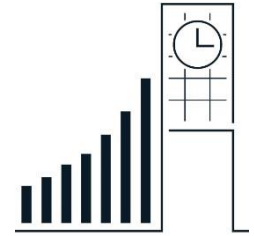
- ▶ An accretion/dilution analysis measures the impact of a transaction on the earnings of the acquirer
- ▶ **“Pro forma”** – value after the effects of a transaction, such as an M&A deal
  - Ex. Pro forma earnings are earnings if the acquisition were to take place
- ▶  $\text{EPS Accretion (dilution)}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



# CALCULATING PRO FORMA EPS



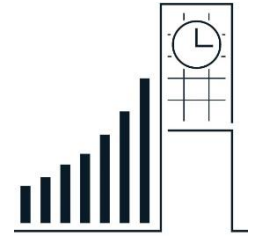
- ▶ Pro forma EPS =  $\frac{\text{Pro forma earnings}}{\text{Pro forma shares outstanding}}$
- ▶ Pro forma earnings = acquirer earnings + target earnings + synergies – forgone interest on cash – incremental interest expense on debt – other effects
  - Other effects include write-ups to PP&E, M&A fees
  - 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



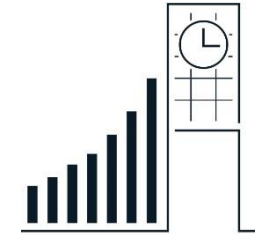
# IMPORTANCE OF ACC/DIL

- ▶ 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
- ▶ Pro forma FCF Per Share = 
$$\frac{\text{Pro forma LFCF}}{\text{Pro forma shares outstanding}}$$
- ▶ PF LFCF = Combined Net Income + Combined D&A – Combined  $\Delta$ NWC – Combined Capex – Mandatory Debt Payments
- ▶ FCF Accretion (dilution) = 
$$\frac{\text{Pro forma FCF}}{\text{Acquirer FCF}} - 1$$



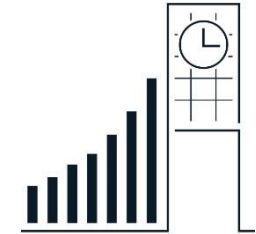
# ENBRIDGE EXAMPLE

- ▶ 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	<ul style="list-style-type: none"> <li>• September 6, 2016</li> </ul>	
Acquirer	<ul style="list-style-type: none"> <li>• Enbridge Inc. (NYSE: ENB)</li> </ul>	
Acquirer Description	<ul style="list-style-type: none"> <li>• Energy transportation and distribution company in the US and Canada</li> <li>• Incorporated in 1949 and headquartered in Calgary, Canada</li> </ul>	
Acquirer Financial Statistics	<ul style="list-style-type: none"> <li>• Mkt Cap: \$40.2 billion</li> <li>• EV: \$70.4 billion</li> <li>• LTM Revenue: \$26.3 billion</li> </ul>	<ul style="list-style-type: none"> <li>• LTM EBITDA: \$4.6 billion</li> <li>• LTM EV / Revenue: 2.7x</li> <li>• LTM EV / EBITDA: 15.4x</li> </ul>
Target Company	<ul style="list-style-type: none"> <li>• Spectra Energy Corp (NASDAQ: SE)</li> </ul>	
Target Description	<ul style="list-style-type: none"> <li>• Owns and operates a portfolio of natural gas-related energy assets in North America</li> <li>• Founded in 2006 and headquartered in Houston, Texas</li> </ul>	
Target Financial Statistics	<ul style="list-style-type: none"> <li>• Mkt Cap: \$28.8 billion</li> <li>• EV: \$39.5 billion</li> <li>• LTM Revenue: \$5.0 billion</li> </ul>	<ul style="list-style-type: none"> <li>• LTM EBITDA: \$2.5 billion</li> <li>• LTM EV / Revenue: 8.0x</li> <li>• LTM EV / EBITDA: 16.0x</li> </ul>
Acquirer Advisors	<ul style="list-style-type: none"> <li>• Credit Suisse and RBC Capital Markets</li> </ul>	
Target Advisors	<ul style="list-style-type: none"> <li>• BMO Capital Markets and Citigroup</li> </ul>	
Price / Consideration	<ul style="list-style-type: none"> <li>• \$28 billion</li> </ul>	<ul style="list-style-type: none"> <li>• Stock</li> </ul>

*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

M&A SYNERGIES & ACCRETION/DILUTION

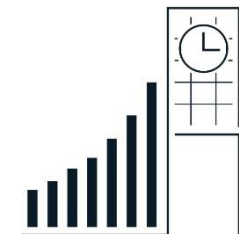
Enbridge merger analysis accretive (mm)	
Enbridge net income before merger	\$ 1,154.0
Enbridge shares before merger	858.0
Enbridge earnings per share	\$ 1.34
Spectra Energy purchase price	\$ 43.50
Enbridge share price	44.21
Exchange ratio	0.984
Spectra energy shares outstanding	705.3
Enbridge shares 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
<b>Accretion/dilution</b>	<b>0.8%</b>

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
<b>Accretion/dilution</b>	<b>-3.7%</b>

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
<b>Accretion/dilution</b>	<b>0.0%</b>

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

# QUESTIONS?



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