Exam 2

Wednesday, October 21, 2015 7:08 PM

Accretion/Dilution Analysis

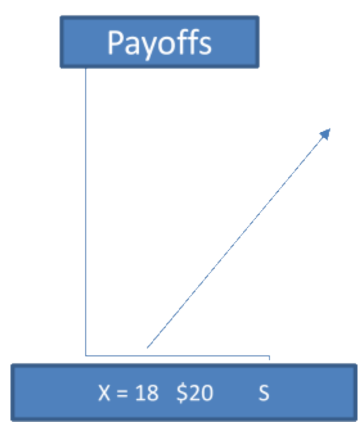
- Accretion/Dilution analysis
  - Assess the impact of an acquisition on the acquirer's EPS
    - **Accretive**: adds to earnings; combined (pro forma) EPS > acquirer's standalone EPS
    - **Dilutive**: earnings go down; combined EPS < acquirer's standalone EPS
    - **Breakeven**: combined EPS = standalone EPS
- Wall Street generally frowns on dilutive deals. Why?
  - For example, our industry trades @ PE (comps) ratio of 10x; EPS = $5 implies share price $50.
    - Dilutive EPS = 4.50 to $45
  - However, deals are often tolerable if they are expected to be accretive in year 2
- Fundamental flaw?
  - There's always a fundamental flaw when talking about an earning based measure because managers do a lot to manipulate earnings (accounting treatments, LIFO, FIFO).
  - Cash flow based is more accurate

Steps

1. Estimate a pro forma net income for the combined entities (assuming we're making the acquisition)
   a. Potential Adjustments:
      i. New acquire debt
      ii. Excess cash and liquid securities used to finance the acquisition
      iii. Synergies
      iv. Option proceeds
      v. Deal-related fees
      vi. Underwriting fees
      vii. Goodwill, incremental depreciation and amortization, asset write-ups/write-downs
2. Calculate the combined company's new share counts
   a. Depends on how we are paying for the acquisition (cash/stock?)
   b. Acquirer's share count + new shares created to finance deal
3. Divide pro forma net income by pro forma share outstanding to arrive at pro forma EPS
4. Compare pro forma EPS to acquirer's EPS without the transaction

- What factors can lead to dilution?
  - Target negative net income
  - Target P/E > Acquirer P/E
  - Transaction results in a significant amount of intangible assets to amortize
  - Increased interest expense
    - Borrow $ and increase interest expense
  - Decreased interest income
  - Low (negative synergies)

- Calculating fully diluted shares outstanding:
  - What kind of options do we grant to managers?
    - Call options
    - Option vs. Warrant
      - Firms sell warrants to raise capital for the firm; they do not sell options as a way to raise money
  - What the different between Basic Shares outstanding vs. Fully diluted shares outstanding?
    - FDSO: captures equity based securities not yet converted to shares
      - Ex:// manager of a target company w/ stock options that can't be exercised for 3 years. You agree to sell company so what happens to those options? Exercised options fast forward to today and you get to make that decision now. If Shares are in the money exercise those options and change to shares.
  - **Treasury Stock Method:**
    - In the money Options and warrants
    - Assumes that all tranches of the in-the-money options and warrants are exercised at their weighted average strike price. The resulting proceeds are used to repurchase outstanding shares at the company's current share price. Newly issued shares represent any remaining value.
  - **If converted vs. Net share settlement method**
    - In the money convertibles and equity linked securities
      - **If converted:**
        - Assumes the entire issue is exchanged for newly issued shares of stock
      - **Net share settlement**
        - Cash is used to settle up the conversion price. Value in excess of the conversion price is settled with additional, newly issued shares of stock
    - (will be obvious which of these 2 to choose)



Example:

Pre-Money Valuation			Post-Money Valuation		
	Value	Percent		Value	Percent
Entrepreneur	$1,000,000	80%	Entrepreneur	$750,000	75%
Investor	$250,000	20%	Investor	$250,000	25%
Total	$1,250,000	100%	Total	$1,000,000	100%

Ray Eckert, Wilton Re:

- What does Wilton Re do?
  - M&A specialist in North American life insurance industry
  - Stock acquisitions
    - Non-strategic subsidiary of larger organizations
    - All the assets and liabilities of the business
    - Generally in run - off
    - Executed through Stock Purchase Agreements
  - Reinsurance
    - Bulk insurance policy that assumes the risks of an insurance companies' business
    - Can assume all the risk of the business through reinsurance including operations
    - May represent a line of business or a block of policies
    - Executed through reinsurance agreements
- Types of buyers
  - Strategic
    - New business revenues
    - Distribution methods; clients
    - Product expansion
    - Intellectual property
    - Operations platform
    - Methods/processes
    - Goodwill
    - Other intangibles
  - Financial
    - No synergistic opportunities
    - New business value dependent on hurdle rate
    - Strict underwriting and financial analysis
      - Key variables
        - Financing approach / lower cost of capital
        - Cost savings
        - Tax
- M&A Process
  - Who's involved in M&A
    - CEO: Thesis proposal/governance
    - HR: value of employee benefits, hr conforming policies, staff reduction + outplacement
    - CIO: systems integrations, IT standards
    - COO: integration, go-forward processes, expense savings
    - General counsel/legal: regulatory approvals, litigation, contracting
    - CMO/Sales: revenue projections, sales plans, client management
    - CFO: ROE accretion, rating agencies, financing
  - Process
    - Planning
      - Thesis development, bankers hired, appraisal completed, confidential information, pre-marketing by bankers
    - 1st and 2nd round (auction)
      - Invitation to bid
    - Finals
    - Closing
      - Regulatory filings made
      - Shareholder approvals
    - Transition
      - New ownership, plan of operation
      - Disconnecting from seller/transition services
      - Earn outs

Dell Buyout Example

- Approved by shareholders 9/2013
- Completed 10/29/2013
- 10.88 share (27.6% premium)
- <u>Purchase</u>
  - $13.75/share + .13 special dividend = $13.88 share

Debt Structure