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# Acquiring minds: Consolidation stars make it look easy

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"While it seems like an incredibly small window to judge multi-billion-dollar acquisitions, it turns out if it's a star at the beginning, it tends to be more a star in long run," said Alexander Dyck, a University of Toronto professor in corporate finance and mergers and acquisitions.

The average company faces long odds in pulling off a major acquisition.

To a chief executive, there's no quicker or easier way to build value than to buy it. Yet investors tend to regard the acquisition as a corporate get-rich-quick scheme — heavy on promises, little chance of success.

Which makes the reception to a number of recent blockbuster deals all the more remarkable.

Among the most active Canadian practitioners of the corporate takeover, Alimentation Couche-Tard Inc., SXC Health Solutions Corp. and Valeant Pharmaceuticals International Inc. have all seen recent plans to acquire major competitors meet with resounding market endorsement.

## 'If it's a star at the beginning, it tends to be more a star in the long run'

Those early verdicts of success are very much the exception when examining market history. The simple reason: acquiring companies usually pay too much, a conclusion shown repeatedly by exhaustive studies.

"This is a robust result, found over many years across multiple countries that acquirers tend to overpay," said Alexander Dyck, a University of Toronto professor in corporate finance and mergers and acquisitions.

Investors clearly understand this tendency. Almost two-thirds of corporate acquisition announcements prompt a loss of equity value, according to a 2009 McKinsey & Co. report.

Beating those odds requires meeting some simple conditions, against which Couche-Tard, SXC and Valeant measure very well.

The appeal of the strategic acquisition is justified by research showing the average deal results in about a 4% increase in the combined equity value of the two companies, Mr. Dyck said.

"The question is, who's capturing that value? The targets always capture some of the value otherwise they wouldn't sell themselves," he explained.

Every good M&A deal involves accretive potential as well as costs of integration. A proper division of the net gains between the target and the acquirer is necessary to earn the blessing of the market.

Easier said than done.

"A lot of acquisitions go sour because they don't pay attention to integrating cultures," said Lorraine Rieger McGregor, an M&A specialist and chief executive of Spirit West Management Ltd. in Vancouver. "It's great to buy these companies, but they lose a lot of value when they're not integrated well."

Combining all of the systems required for running a corporation is a monumental and unpredictable task with costs that are difficult to reliably forecast.

Acquisitive companies systematically underestimate those costs while overestimating the gains of integration, Mr. Dyck said. The potential value of a deal is accordingly inflated, resulting in overpayment and the subsequent destruction of shareholder value.

The McKinsey study, which examined acquisitions by U.S. publicly traded companies between 1997 and 2008, showed an average loss in market value of the acquiring company of between 2% and 4% within three days of the deal's announcement.

"While it seems like an incredibly small window to judge multi-billion-dollar acquisitions, it turns out if it's a star at the beginning, it tends to be more a star in long run," Mr. Dyck said. "If it's a dog coming out, it tends to be more of a dog down the road."

The further out the examination of stock behaviour, the more difficult it becomes to distinguish the effect of an acquisition from broader market events.

Despite periods of mass misjudgment, such as during the tech boom, the immediate market reaction tends to be predictive of a deal's ultimate success. The correlation stands when comparing early stock movement to eventual accounting returns, Mr. Dyck said.

The validity of stock market reaction bodes well for some recent acquisitions.

Couche-Tard, the Quebec-based corner store chain, last month struck its largest deal to date, acquiring Norwegian gas-station operator Statoil Fuel and Retail ASA (SFR) for US$2.8-billion. Within the three-day window, Couche-Tard's shares rose by 15% on the Toronto Stock Exchange.

Also last month, Valeant, Canada's largest drugmaker, announced a deal to acquire Mexican pharmaceutical company Atlantis Pharma. The value of the deal was too small to register in a big way on the stock market, but Valeant's aggressive acquisition strategy has won the approval of analysts and investors.

The company made 13 takeover bids last year, the largest of which was a US$5.7-billion attempt to acquire U.S. drugmaker Cephalon Inc. While that deal fizzled, Valeant's stock rose by almost 20% on the TSX within three days of announcement.

Capping off a month of big M&A headlines in April, pharmacy benefits manager SXC unveiled a US$4.3-billion acquisition of Catalyst Health Solutions, which almost doubles the company's market value.

While it's a stretch to call SXC a Canadian company, having moved its headquarters to Chicago in 2006, the company was conceived in Canada, is still incorporated here and is still listed on TSX, on which its shares rose by more than 20% immediately after announcing the deal.

According to Brad Cherniak, a partner at Sapient Capital Partners, all three companies passed a series of tests markets implicitly conduct to evaluate potential takeovers.

**- Is the deal expected by investors?**

“The market hates surprises,” Mr. Cherniak said. “If a deal is announced they want it consistent with the growth story of the company and what it has said to shareholders and the press.”

**- Is the deal affordable?**

The acquiring company must have the cash and/or borrowing capacity to comfortably finance the deal. “There’s a balance between doing too big of a deal and borrowing too much, and doing too small of a deal and not moving the needle,” Mr. Cherniak said. “You’ve got to get that just right.”

**- Is the management team credible and respected?**

An acquisition is more likely to succeed if the acquiring company’s management has the faith of the market to execute deals accretive to earnings, rather than trying to make up for past management missteps.

**- Is the price right?**

“If you hit all four of those, you’ve got a pretty good shot of having a very positive reaction despite the buyer’s premium and all the theory about how acquisitions aren’t good,” Mr. Cherniak said.

Valeant, for example, has made M&A central to their growth strategy, making their expansion into Europe anticipated and blessed by investors. The current management team has built a track record for squeezing value out of affordable acquisitions. And the company is not too leveraged to strain its finances with its deals.

“There you have the formula for a very positive market response,” Mr. Cherniak said.

Couche-Tard also meets all conditions, although investors are largely taking management at their word that the deal will be “immediately and significantly accretive to earnings.” Management credibility affords some latitude.

When SXC announced it was acquiring Catalyst, investors, who had already anticipated the deal, immediately saw the potential value.

By acquiring a company that uses the software SXC designed, many of the typical costs of integration should be avoided.

Many costs duplicated by both companies can also be cut quite easily, Mr. Dyck said. “The can eliminate a lot of back office operations immediately. This is a perfect economies-of-scale story.”

And because this particular corporate marriage was practically preordained in an industry racing to consolidate, SXC avoided a competitive bidding situation and thus didn't overpay, Mr. Dyck said.

Yet meeting the necessary conditions for market approval is not sufficient to ensure success, which can be spoiled by bad luck or bad timing.

"The reaction can be swamped by market developments," Mr. Cherniak said. "There's no guarantee."