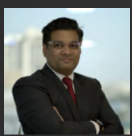
HELIOS
Financial Group

October 2023

Helios Global Publications

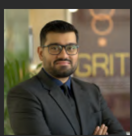
Valuation Series

The Rational Foundation of Stock Market Valuations: Debunking Myths and Embracing Economic Fundamentals



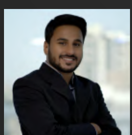
Asadullah Khan
Partner, Mergers & Acquisitions

Asad is the global co-leader of the HFG Global Publications, a global hub for world-class research, analysis, and collaboration in M&A productivity and performance.



Mansoor Najam
Senior Specialist, Knowledge Management, Product, Practice, and Knowledge (PPK).

Mansoor, specialist in knowledge management, dives into the stories of extraordinary transactions and deals in M&A productivity and performance.



Ammad Ahmed
Associate, Digital Intelligence, Creative & Design

Ammad, believes in all things digital, his passion for design led him to be associate partner Creative & Design at HFG

Global Transactions Practice Leader: Asadullah Khan
Analyst: Mansoor Najam
Art director: Ammad Ahmed
Copy editor: Ammad Ahmed
Lead Reach and Relevance partner: Rehan Farooqi

Structured Success: Deal & Transaction Series is published by the Helios Global Publications, part of Helios Financial Group. The Helios Global Publications is led by Asadullah Khan and Imranullah Khan.
Helios Financial Group
Balad Technology Towers, Suite 410
Karachi, Sindh 07482
Pakistan

Preface

In an ever-evolving global economy, navigating the complexities of the business world and deciphering the mysteries of share valuations is an art and science unto itself. As a global financial advisory firm, we recognize that understanding the complexities of this field is not merely a matter of accumulating data or crunching numbers. It is about grasping the intricate dance between market forces, investor sentiment, and the underlying economic fundamentals that shape the world of business and finance.

Our journey begins with a deep dive into the often-perplexing relationship between stock prices and economic fundamentals. We confront the age-old debate of whether the stock market is a turf ruled by emotions or a domain that follows the path of rationality. We bring you empirical evidence that illuminates the key drivers of value – growth and return on invested capital. Throughout this publication, we challenge commonly accepted beliefs that sometimes run counter to the fundamental principles of valuation.

With each page, we aim to provide you with a clear roadmap, giving you the tools you need to make well-informed decisions and to understand the underlying principles of business and share valuations.Whether you are a seasoned financial Expert, a budding entrepreneur, or an inquisitive investor, this book empowers you with insights that can shape your understanding of the financial world.

The research underlying this publication was run by the dedicated team of Helios Financial Group M&A valuations team, led by Asadullah Khan, a partner. Valuable perspectives and advice were offered by a distinguished panel of academic and industry experts. Including, various articles, publications, books and research materials.

The report also benefited enormously from the contributions of HFG's global network of industry experts. It drew on HFG's indepth analytical expertise, our work with leading preferred acquirer organizations, distinguished lawyers, esteemed tax advisors and our understanding of deals space around the world.

The authors would like to thank the external and internal advisers for their contributions. In addition, the authors would like to thank Ammad Ahmed and Waqas Ahmed for their help in art directing, producing, and disseminating this report.

TABLE OF CONTENT

INTRODUCTION

It is hard to pinpoint the exact strategies that create value in mergers & acquisitions, mainly because of the diversity and subjective classification of acquisitions. Companies often tout strategic benefits while mainly aiming to reduce costs.

Below are some broad areas or value-creation models that are beneficial for the acquirer:

1. Enhancing the target company's performance.
2. Consolidating to eliminate industry overcapacity.
3. Facilitating market access for products.
4. Efficiently acquiring skills or technologies.
5. Leveraging industry-specific scalability.
6. Supporting and nurturing early-stage successes.

An acquisition must align with one of these models to create value. Its strategic rationale should be a clear expression of one of these models. Additionally, even if an acquisition aligns with models, overpaying for it can diminish its value creation.

ENHANCE TARGET COMPANY'S OPERATIONAL PERFORMANCE

Enhancing the performance of the target company is a prevalent approach for creating value through acquisitions. This strategy entails cost reduction to boost profit margins and, in some cases, driving revenue growth.

It's worth noting that it's more feasible to enhance the performance of a company with low profit margins and a low return on invested capital (ROIC) compared to a high-margin, high-ROIC company. For instance, acquiring a company with a 6 percent operating profit margin and reducing costs by three percentage points can raise the margin to 9 percent, potentially resulting in a 50 percent increase in the company's value. In contrast, for a company with a 30 percent operating profit margin to achieve a 50 percent increase in value, costs would need to decrease by 21 percent, which could be challenging.

Revenue growth synergies, sometimes referred to as revenue-enhancing opportunities (REO), can be more challenging to achieve compared to cost reduction synergies. REO is defined as the creation or strengthening of a product or service by combining distinct attributes of merging partners, leading to immediate and/or long-term revenue expansion. Various potential sources of revenue enhancement exist, and they can vary significantly from one deal to another.

Economies of scope, closely related to economies of scale, involve a firm's ability to utilize a common set of resources to produce a broader array of products and services. These benefits are particularly relevant in industries like banking, where shared resources can enable a broader service offering. Smaller banks may lack the financial capacity to sustain specialized departments and shared resources for various products. Such considerations have played a role in explaining the consolidation in the banking sector during periods of deregulation.

Despite the numerous opportunities, achieving revenue enhancements can be challenging, often defying precise quantification in valuation models. Consequently, cost-related synergies tend to take precedence in merger planning, while potential revenue enhancements may be discussed more vaguely. The inability to quantify and plan for these enhancements is one reason some deals fail to deliver their expected benefits, stemming from a lack of precise pre-merger planning.

STREAMLINE INDUSTRY CAPACITY THROUGH CONSOLIDATION.

In mature industries, excess capacity is a prevalent challenge. It results from increased production and the entry of new competitors, leading to an oversupply of goods. However, it is often impractical for individual companies to shut down their plants.

Through acquisitions, companies can more efficiently address excess capacity by consolidating Operations and eliminating unproductive assets, both physical plants and intangible capacities, such As sales forces and research and development efforts.

It's important to note that the value created by reducing excess capacity typically favors the seller's shareholders rather than the buyer's. Additionally, the entire industry may benefit from capacity reduction without any individual competitor taking action, a phenomenon known as the free-rider problem.

ESTABLISH MARKET ENTRY FOR PRODUCTS.

Small companies with innovative products often face challenges in reaching their full market potential due to limited resources. To overcome this, larger corporations acquire these smaller firms and utilize their extensive sales forces to expedite product sales.

IBM exemplified this approach by acquiring 43 companies from 2010 to 2013, with each acquisition averaging $350 million. By leveraging IBM's global sales force, these acquisitions experienced significant revenue acceleration, sometimes exceeding 40% within the first two years.

In some cases, the acquired company can also contribute to accelerating the acquirer's revenue growth. In the Procter & Gamble acquisition of Gillette, their combined strengths in different emerging markets allowed them to introduce products more rapidly and efficiently.

EFFICIENTLY ACQUIRE SKILLS OR TECHNOLOGIES

Technology-driven companies frequently acquire firms possessing essential technologies to improve their products. This approach offers advantages such as faster technology access, avoiding patent royalties, and maintaining a competitive edge.

For instance, Apple acquired Siri in 2010 and later bought Novauris Technologies in 2014 to enhance Siri's capabilities. They also purchased Beats Electronics in the same year to swiftly offer a music-streaming service in response to evolving market trends.

In a similar vein, Cisco Systems, a network product and services company with $49 billion in revenue in 2018, executed 71 acquisitions from 1993 to 2001, each averaging around $350 million. These strategic moves enabled Cisco to expand its product offerings and revenue significantly, with nearly 40 percent of its 2001 revenues stemming from these acquisitions

HARNESS INDUSTRY-SPECIFIC SCALABILITY.

Economies of scale are frequently cited as a valuable aspect of mergers and acquisitions (M&A). However, it's crucial to exercise caution when justifying an acquisition solely based on scale-related benefits, especially in the context of significant M&A.

Large companies often operate at scale, and combining them may not necessarily result in lower unit costs. For instance, major package-delivery companies with large and efficient airline fleets may not achieve substantial savings by merging their flight operations.

Economies of scale become more relevant when a larger company acquires a smaller one or when the unit of incremental capacity is substantial. This is evident in industries like auto manufacturing, where sharing platforms across brands can lead to cost savings.

Moreover, economies of scale can be realized in purchasing functions, but these benefits come with nuances. Health insurance companies can negotiate better rates with hospitals after merging, particularly in markets where both companies were already present. However, these savings are limited to the specific regions where both insurers operate since most hospitals are local, and insurers compete only within the same local market.

It's important to note that while economies of scale can be a significant driver of acquisition value, acquisitions are rarely justified by generic scale-related savings, such as back-office cost reductions. To warrant an acquisition, economies of scale should be unique and substantial.

IDENTIFY AND NURTURE EARLY SUCCESSES IN BUSINESS DEVELOPMENT.

The strategy of selecting early winners and aiding in their development involves making acquisitions in nascent product areas or industries before they gain broader recognition. This approach is particularly evident in sectors like medical devices, where established companies purchase innovative startups, assist in refining their technology, and accelerate product launches. It's important to note that the payoff from this strategy can take several years.

However, this strategy carries a level of risk, as illustrated by the cannabis industry in the United States, where some major consumer-goods companies have invested in anticipation of significant growth despite legal uncertainties. The outcomes of such investments may not be clear for some time.

To effectively implement this strategy, managers must adopt a disciplined approach on three fronts: willingness to make early investments, a readiness to make multiple bets with an awareness that some may not succeed, and the possession of the requisite skills and patience to nurture the acquired businesses.

CONCLUSION

Separating the Signal from the Noise: While the number of stock splits has decreased in the past decade, some U.S. listed companies still employ stock splits to adjust their share prices to an "optimal trading range." However, it's important to note that stock splits do not inherently create value because they don't change the overall value available to shareholders.

Empowering the global transactions **community** with essential **data** and **insights.**

RELATED PAGES

Valuation Series
The Rational Foundation of Stock Market Valuations

Read now

Valuation Series
The Rational Foundation of Stock Market Valuations

Read now

Valuation Series
The Rational Foundation of Stock Market Valuations

Read now

HELIOS
Financial Group

Learn More

For more information, please contact:

Asadullah Khan
M&A | Transactions,
Helios Financial Group
+92 312 240 3989
ak@heliosfinancialgroup.com

Imranullah Khan
Financial Services | Transactions,
Helios Financial Group
+44 20 7951 0278
Imranullah.khan@heliosfinancialgroup.

Farooq Akhtar
Transactions| Transformations,
Helios Financial Group
+1 312 879 3680
farooq.akhtar@heliosfinancialgroup.com

Special thanks to Nick Greos, Linda Zhang, and the editorial team for their valuable contributions to this point of view.

Endnotes

1. Ellen Eichhorn and Stephen Smith, "2019 CIO Agenda: Consumer Goods in a Climate of Change," Gartner, June 22, 2018.
2. Based on Deloitte's own consultative experience of working with clients on product life cycle management assessments and implementations.

HELIOS
Financial Group

Advisory | Strategy & Transactions | Tax | Consulting

About Helios Financial Group

Helios Financial Group stands as a pinnacle of excellence in financial advisory, tax, strategy, transaction, and consulting services on a global scale. Our steadfast commitment to delivering unparalleled insights and top-tier services fosters trust and confidence within the international capital markets and economies. Through our relentless dedication, we nurture exceptional leaders who collaborate to fulfill our commitments to all stakeholders. This vital undertaking positions us as catalysts in constructing an improved working world, benefiting our people, clients, and communities alike.

For more information about our organization.

please visit heliosfinancialgroup.com.