

## Mergers and Acquisitions: Today's Catalyst Is Working Capital

by James S. Sagner

### Executive Summary

- In developed economies M&As are now used to acquire balance sheet assets, particularly cash hoards and other working capital; previously, M&A was oriented to strategic diversification or integration.
- Although the volume of deals is down due to global economic conditions, the premiums paid for companies remain robust.
- Acquirers appear to understand the risk inherent in these transactions, including the threat of investigation by US, EU, and Japanese regulators.
- Until the recent problems with lines of credit provided by banks, many companies held excessive amounts of liquidity, making them vulnerable to unfriendly takeovers.
- Various consulting companies have international practices in working capital management, including advising on mergers and assisting management to achieve efficiencies after the deal is completed.
- Global M&A looks for the following characteristics: a high current assets-to-revenue relationship; a holding of cash that is not likely to be applied to business operations; and a proven income stream that should provide adequate cash flow to pay down borrowings used to provide financing for an acquisition.

### Introduction

Merger and acquisition (M&A) activities in developed countries once focused on strategic transactions for diversification or for vertical or horizontal integration. While that continues to be the situation in the developing economies, the M&A game in the United States, Western Europe, and Japan is often either to gain balance sheet assets, particularly hoards of underperforming cash, or to improve the acquired company's working capital management. It's a complete revolution in the way companies and investment bankers look at candidates for M&A. What's going on?

### Changes in the M&A Landscape

M&A transactions for all of 2012 declined about 10% from 2011 to US\$2.2 trillion, the same level as 2010. CFOs have been holding more than US\$3.5 trillion in cash while delaying deals for most of 2012, as EU countries slid into recession and developing economies such as China and India experienced lower growth.<sup>1</sup> However, improving economic prospects and the need to manage costs and reduce competition led to several recently announced deals, including the merger of AMR (parent of American Airlines) and US Airways, and the acquisition of HJ Heinz by Berkshire Hathaway and the Brazilian firm 3G Capital Management (for US\$28 billion).

Prior to the recession that began in 2008, the global annual appetite for M&A was nearly US\$4 trillion. The premiums being paid for companies continues to remain strong, with the Heinz deal at 19% above the publicly traded stock price as compared to pre-recession deals averaging about 25% above the share price.<sup>2</sup> The weak US dollar has brought several foreign buyers to the United States in the search for access to attractive markets and technologies.

Some of the past M&A hype has been tempered by a better understanding of the risk of these transactions, as documented<sup>3</sup> by such publications as *BusinessWeek*<sup>3</sup> and as experienced in the loss of value to investors.<sup>4</sup> The lure of expanding markets, product lines, technologies, and customer bases drove much of M&A through the last three decades of the 20th century. Many of these hopes turned out to be illusory as mergers underperformed or failed due to incompatibilities between the marketing, production, engineering, financial, and systems functions of the participants.

Some mergers came under investigation by one or more US regulatory agencies, and were delayed, rejected, or abandoned. For example, the Federal Trade Commission has acted against “threats” of raised concentration in markets for frozen pizza, carburetor kits, urological catheters, and casket parts. The Justice Department hit mergers threatening to raise concentration in markets for frozen dessert pies, artificial Christmas trees, vandal-resistant plumbing fixtures used in prisons, local towel rental services, drapery hardware, and commercial trash hauling in Dallas.<sup>5</sup> The European Commission has been even more rigorous in its merger reviews than the two US agencies.

Research by Towers Perrin and the Cass Business School finds that the most recent era of M&A deals has created value, rather than led to its destruction as in earlier periods.<sup>6</sup> The emphasis has switched to the execution of the deal and a focus on improved financial performance.

Although strategic expansion will continue to be of interest despite the threat of antitrust review, future M&A practice will likely focus on two completely different attractions that avoid the regulators’ microscope:

- underused liquidity on balance sheets, offering opportunities for the acquirer to redeploy cash in productive activities;
- inefficient working capital management, leading to opportunities to improve the utilization of current assets and liabilities.

## Underused Liquidity

Recent studies illustrate the predicament that many businesses currently face: too much money on balance sheets and too few attractive capital investments. This situation has been developing for at least a half dozen years; for example, the Association for Financial Professionals (AFP) conducted a study reported in 2007 that 36% of respondents held larger amounts of short-term investments than six months earlier.<sup>7</sup>

As of early 2013, the typical public company had a weighted average cost of capital of just over 10%; see Table 1 for the calculation. A company with cash or near-cash investments can only earn about 1% pre-tax on these assets at the current rates available,<sup>8</sup> or about ¾% (75 basis points) after tax, assuming some holdings of medium-term investments. Thus, companies holding cash incur a direct loss of more than 9% on that asset without receiving any possible strategic gain. Acquirers of these cash hoards can use these funds to pay down debt, acquire stock in the open market, increase dividends, or expand business operations. In fact M&A deals are often financed by loans made against the assets and cash flow of the acquired company. For example, the 2006 deal involving the hospital company HCA, Inc. involved only US\$5.5 billion in cash, with the balance of the US\$33 billion price financed by the cash and future income of HCA.

Table 1. Illustration of cost-of-capital calculation

	Balance sheet portion	After-tax costs	Weighted component costs
Debt	40%	0.056*	0.022
Equity	60%	0.140†	0.084
	100%		0.106

\* Pre-tax 8% less corporate tax rate.

† 12% growth + 2% dividend.

## Inefficient Working Capital Management

Working capital (WC) is defined as current assets less current liabilities; in this section we will focus on current assets other than cash. In the last four decades of the previous century, the percentage of WC as a percentage of sales declined by three-fourths.<sup>9</sup> Although this represents a significant improvement in the

management of these balance sheet accounts, estimates are that the total of excess WC may still exceed US\$900 billion, up one-third since 2005.<sup>10</sup>

There are merger opportunities in acquiring companies with excess WC and managing these accounts so that it approaches as close to zero as possible. The concept of WC as a hindrance to financial performance is a complete change in attitude from the conventional wisdom before the turn of the 21st century. However, WC has never contributed to a company's profits; instead, it just sits on the balance sheet awaiting disposition. The Checklist below gives some ideas for working capital management.

Various consulting companies have developed international practices in working capital management, including advising on mergers and assisting management to achieve efficiencies once the deal has been completed. For example, REI is a US-based advisory services organization that has developed a global brand in WC services. REI has enabled clients in more than 60 countries to free up tens of billions of US dollars through optimization of working capital in the last 10 years alone. FTI Consulting offers an array of services designed to help companies address critical issues and improve performance prior to engaging advisory services for acquisitions, divestitures, and recapitalizations. There are several other firms that support M&A analyses while assisting the new management to squeeze efficiencies out of the current asset and/or current liability portions of the balance sheet.

## Checklist of Working Capital Ideas

### Accounts Receivable

The credit and collection process, no matter how aggressive, inevitably results in some uncollectable amounts. When faced with the cost of the credit review process, bad debt expenses, and the cost of credit and collections, some businesses outsource their collection activities to a factor. Factors purchase or lend money on accounts receivable based on an evaluation of the creditworthiness of prospective customers of the business calculated as a discount from the sale amount, usually about 3–4%. That is, the factor will receive the entire sales amount, the selling company having received 96–97% at the time that the buyer was accepted by the factor.

### Receivables Collateralization

In collateralization, a receivables package is offered as a security to investors. The critical element is a periodic, predictable flow of cash in payment of debts, such as credit cards, automobile loans, equipment leases, healthcare receivables, health club fees, and airline ticket receivables.

The market for public collateralizations is in the hundreds of billions of dollars, which has driven the required interest return to investors to become competitive with bank lending arrangements. Initial costs are higher than bank loans because the services of several professionals are required: attorneys; commercial and/or investment bankers; accountants; rating agencies (when ratings are required); and income servicers. However, the advantage of receivables collateralization is substantial—the transformation of receivables into cash.

### Inventory

Just-in-time (JIT) requires that required materials be in the place of manufacture or assembly at the appropriate time to minimize excess inventory and to reduce wastage and expense. JIT succeeds when there are: a limited number of transactions; few “disturbances” due to unscheduled downtime, depending instead on periodic maintenance; the grouping of production processes to reduce the movement of work-in-process; and a significant focus on quality control (QC). QC minimizes downtime and the holding of buffer or safety stock to replace defective materials.

In traditional JIT, the company owns the inventory of components and parts, assuring access as the next production operation begins. JIT as currently practiced places the materials at the manufacturing or assembly site, but title remains with the vendor until production begins. This relationship requires suppliers to optimize the stock of inventory, holding only those items that have been specified or are known to be required based on a statistical analysis of purchasing history. Both the provider and the user of materials are

forced to develop a strong partnering attitude and minimize the adversarial stance often observed between purchasing counterparties.

## Accounts Payable

Inefficient payables pervade US business. Invoices presented for payment should be matched against purchase orders and receiving reports to determine that the vendor has met the terms and conditions of the order, and that materials were received in good condition and in the correct amount. In practice, invoices are often paid without ascertaining that all requirements have been met. In about one-third of all payables situations, no purchase order was ever issued, nor was there a contract or other written agreement as to price or specifications.

A substantial number of companies have inadequate policies regarding appropriate purchasing and accounts payables practices. For example:

- Should the payment be released on the due date or some specified number of days after the due date?
- Are all cash discounts to be taken, or only those that provide a stipulated discount?
- Can the requesting business unit choose the supplier, or does purchasing have the authority to select vendors so as to maximize volume pricing?
- Has purchasing determined that approved vendors are legitimate businesses, with a suitable record of providing goods and services to the business community?

## Let's Look at a Deal

The US\$90 billion hostile takeover by Pfizer of Warner-Lambert (Warner), completed in 2000, was hyped as a traditional horizontal integration of two powerful pharmaceutical companies. Clearly, Pfizer was acquiring a significant asset in Lipitor, Warner's cholesterol-lowering drug, and established cost savings through headcount reductions. Stock analysts even made statements to the effect that the deal was strictly "...for strategic reasons—for Lipitor, for the therapeutic enhancements Warner-Lambert brings, and for the sheer marketing clout..."<sup>11</sup>

However, the merger was motivated in large part by financial considerations. In 1999 Warner reported cash and short-term investments of US\$1.943 billion, equivalent to 17.0% of total assets of US\$11.442 billion, versus 13.8% for the industry. Pfizer was buying the cash hoard, which was US\$360 million more than the rest of the industry required for the assets carried. Pfizer was also buying an excellent balance sheet, including a current ratio of 1.5 times and current assets as a percentage of sales of 44.0%. And Warner earned US\$2.441 billion before taxes in 1999, a very healthy 18.9% of sales versus 9.6% for the industry.

## Tips for CFOs on Future M&A Deals

The flood of US dollars in foreign ownership continues to grow due to the persistent balance of payments deficits in the United States. Global investors looking for properties will be looking at public companies with the following characteristics:

- a high current assets-to-revenue relationship, particularly where the current ratio exceeds the average for the industry;
- a cash (and near-cash) hoard that is not likely to be applied to business operations and is unlikely to be used for dividends or stock repurchases;
- a proven income stream that should provide adequate cash flow to pay down borrowings used to provide partial financing for an acquisition.

Furthermore, there is a trend toward M&A that is not strategic within an industry, meaning that a hostile or friendly approach can come from anywhere at any time.

Too many companies hoard cash while waiting for capital projects with superior returns. In fact, those opportunities may never appear. Financial analysts are beginning to recognize that worthwhile capital investments are unusual and are likely to be short-lived. In other words, the reality of international

competition shortens any competitive advantage a company may gain, unless protected by patents or other exclusive arrangements. To quote a leading finance text:

“It is a basic principle of economics that positive NPV [net present value] investments will be rare in a highly competitive environment. Therefore, proposals that appear to show significant value in the face of stiff competition are particularly troublesome, and the likely reaction of the competition to any innovations must be closely examined.”<sup>12</sup>

Savvy outsiders can analyze the financial statements of targeted companies and, with the help of their investment bankers, take friendly or hostile action to seize a financially inefficient business.

## See Also

### Best Practice

- [How to Set the Hurdle Rate for Capital Investments](#)

### Checklists

- [Achieving Success in International Acquisitions](#)
- [Acquiring a Company](#)
- [Acquisition Accounting](#)
- [Planning the Acquisition Process](#)
- [Structuring M&A Deals and Tax Planning](#)
- [Using IRR for M&A Financing](#)
- [Using the Market-Value Method for Acquisitions](#)

## Notes

An earlier version of this article appeared as “Why working capital drives M&A today.” *Journal of Corporate Accounting & Finance* 18:2 (2007): 41–45. Used by permission of John Wiley & Sons, Inc.

1. Kirchfeld, Aaron, and Serena Saitto. “Fourth-quarter M&A surge spurs optimism after 2012 deals decline.” *Bloomberg.com* (December 27, 2012). Online at: [tinyurl.com/ahbsn4m](http://tinyurl.com/ahbsn4m)

2. Data from June 2008; see “M&A premiums up despite slowdown” at [www.businessweek.com/investing/insights/blog/archives/2008/06/despite\\_the\\_ma.html](http://www.businessweek.com/investing/insights/blog/archives/2008/06/despite_the_ma.html)

3. Henry, David. “Mergers: Why most big deals don’t pay off.” *BusinessWeek* (October 14, 2002). Online at: [www.businessweek.com/magazine/content/02\\_41/b3803001.htm](http://www.businessweek.com/magazine/content/02_41/b3803001.htm)

4. According to *BusinessWeek*, 61% of acquirers in a merger destroyed their stockholders’ wealth (*ibid.*).

5. These situations were noted by Frederick M. Rowe on pp. 1512–13 of “The decline of antitrust and the delusions of models: The Faustian pact of law and economics.” *Georgetown Law Journal* 72:5 (1984): 1511–1570. For a review of American antitrust policy, see James S. Sagner. “Antitrust as frontier justice: Is it time to retire the sheriff?” *Business and Society Review* 111 (March 2006): 37–54.

6. At [www.innovations-report.com/html/reports/economy\\_finances/report-112476.html](http://www.innovations-report.com/html/reports/economy_finances/report-112476.html) (June 17, 2008). Towers Perrin is a global consulting firm that specializes in human capital strategy, program design and management, and risk and capital management.

7. AFP in conjunction with Citigroup. *2007 AFP liquidity survey: Report of survey results*. Online at: [www.afponline.org/pub/pdf/Liquidity\\_2007.pdf](http://www.afponline.org/pub/pdf/Liquidity_2007.pdf)

8. Commercial paper rates for up to 120 days were 2.50% in mid-June 2008 according to the *Wall Street Journal* (rates are from June 10, 2008, as quoted on page C10). Early 2013 rates are about one-tenth of that paid in 2008 (about 25 basis points).

9. Standard and Poor’s *Financial Analyst’s Handbook*, 2002.

10. Banham, Russ. “Too much of a good thing.” *CFO Europe* (July/August 2012). Online at: [tinyurl.com/cg9gpdm](http://tinyurl.com/cg9gpdm)

11. Comment by Martyn Postle, Cambridge Pharma Consultancy (UK), reported in David Shook. "Pfizer-Warner: One drug merger that might just deliver." *BusinessWeek* (May 17, 2000). Online at: [www.businessweek.com/investor/content/eemi/emi0517a.html](http://www.businessweek.com/investor/content/eemi/emi0517a.html)

12. Ross, Stephen A., Randolph W. Westerfield, and Bradford D. Jordan. *Essentials of Corporate Finance*. 5th ed. Boston, MA: McGraw-Hill/Irwin, 2007; p. 275.

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