The Impact of Consolidation Economies on Business Value

by BRIAN H. BURKE, ASA

I have had several assignments recently in which the economies expected from the consolidation of the seller with its buyer had a significant potential impact on the seller's business value. A typical such case involves a relatively small target (the firm being appraised) that could be merged physically with a buyer who is a larger, neighboring competitor. The general issues and the underlying economic arguments are not new, but their importance seems to be growing. This is, no doubt, caused by the increasing pace of business consolidations resulting from economic conditions generally and in certain industries in particular. Our firm has a specialty in insurance agencies, an industry segment in which many local and regional firms are experiencing pressures to consolidate; and there are many other industries feeling the same pressures, such as distributors, job-shop manufacturers, professional practices, and retailers of all kinds.

For purposes of this article, I have organized the discussion of the subject into three categories – pragmatics, economics, and implications for the appraisal.

Pragmatics

When two similar businesses consolidate in an acquisition or merger, the economies are easy to imagine. There may be some revenue synergy, but the benefits usually are on the expense side of the income statement in the form of the elimination of some of the target's expense items (personnel, occupancy, supplies, and the like). That such savings are real is seldom disputed. Arguments arise over two important points: whether the economies are temporary or permanent, which will be dealt with below under "Economics"; and whether the existence of such economies means that the buyer somehow owes them to the seller.

In an arm's-length transaction that involves competition, the forces of the marketplace will usually answer the question of whether the seller benefits from the expected expense savings. Presumably, what brokers would term a "strategic buyer" will readily utilize the expected economies to improve its offer. Even if such a buyer pays "too much," the consolidating economies frequently allow the deal to be financed out of cash flow.

However, in the case of internal buyers (frequently termed a "business-continuity" deal or a "perpetuation" deal) in which the younger generation, sometimes family members, is acquiring the interest of the senior owners in a structured deal, this issue needs to be resolved more on the basis of philosophical argument than marketplace economics, and the apppraiser is often in the middle of it. Advocates for the buyer's position in such deals take the position that the potential consolidation-related economies are academic, since the business is being acquired on a stand-alone basis. To base the purchase price on cash flow that won't be realized would be unfair and imprudent. Advocates for the sellers, on the other hand, argue that selling to the younger generation (which often involves favorable seller financing) and not taking the business to the market is a concession for which the sellers should be compensated. It is easy to understand both sides of the argument and to imagine how, without effective mediation, this often leads to hard feelings and failed deals. As a practical matter, the argument often gets resolved with a mid-point price that is justified by favorable financing terms, such as long-scheduled notes, balloon notes, low down payments, and various arrangements that make the deal tax efficient.

Economics

The longer I am in business, the more I find practical application of nearly forgotten principles taught in undergraduate economics. The economic principle in this issue is the proposition that in the long run all costs are variable; or said another way, the phenomenon of marginal costs being lower than average cost is real but temporary. Applied to an acquisition and consolidation of an independent insurance agency, for example, this means that while it may be true that the accounts being acquired can be serviced at lower personnel expense and without the need for additional office space or equipment in the buyer's location, the acquisition only brings nearer the time when the acquiring agency will have to add staff or expand plant and equipment. Thus, the critical point: *The consolidating economies are almost always real but they are seldom if ever permanent.* The acquisition itself does not create fundamental productivity improvements out of thin air.

Implications for the Appraisal

If the business being appraised is of a size and in an industry in which acquisitions are frequently made by other firms in some sort of business combination, then the appraiser needs to address the impact that consolidation economies may have on value. If the appraisal is in connection with an actual transaction or an adversarial legal situation, the matter is often unavoidable. The advocates for either side will probably raise the issue before the appraiser even gets started. But the issue is real, whether the circumstances surrounding the appraisal force it or not.

For the appraiser, I see two potential pitfalls. The first is one of ethical practice. An appraisal that focuses on only one scenario runs the risk of breaching the code against advocacy or at least giving the appearance of doing so. Proper practice should involve either an appraisal on both scenarios (consolidation and no consolidation) or a clearly stated position that the specific circumstances of the appraisal warrant only one approach.

The second pitfall is superficiality. One might avoid the possibility of consolidation economies altogether because they appear too vague or cumbersome to handle analytically. But an equally likely problem is recognizing the economies and assuming, or at least implying, that they are permanent. For example, in appraising an independent insurance agency on a stand-alone basis, one might arrive at a pro-forma earnings rate of 25% of revenue and then capitalize that at, say, 20%, which would lead to an income-based value of 1.25 times revenue. If that same agency was appraised on the basis of its being consolidated into a larger agency in the same community that had excess capacity, the incremental profit rate to the buyer might be as high as 60%. Superficial practice might then yield a value of 3.0 times revenues (5 x 60%). If one considers that to be an unreasonable value, then what is the proper way to fix it? One way might be to adjust the capitalization rate, on the argument that consolidations often cause greater risk of lost revenue when, say, the acquired agency's location is changed. While that is conceptually possible, I don't know of a way to make such an adjustment in the capitalization rate and defend it on grounds other than pure guesswork.

A practical alternative that I have used is to recognize that the higher profit rate resulting from the consolidation is incremental and unless accompanied by fundamental structural improvements in productivity will not lead to longer-term operating ratios that are better than the buyer's normal experience. Accordingly, I have from time to time appraised an agency on the basis of normal operating and profit ratios and then added incremental income over a two-to-five-year period, diminishing each year in magnitude and discounted to the present value. Also, if the facts dictate, then one might apply a higher discount rate to these incremental

and temporary profits than is applied to the normal earnings of the buying firm. A simplified example is below.

Incremental Revenue (revenue from the acquired firm)	$300,000
Normal Expenses for This Mix of Business	225,000
Normalized Pre-Tax Earnings	75,000
Divided by Capitalization Rate	20%
Preliminary Income-Based Value	$375,000
Additional Consolidation-Based Profits	
Year 1 $ 75,000	
Year 2 50,000	
Year 3 25,000	
Total $150,000	
Present Value Using a 25% Discount Rate	105,000
Income-Based Value (before balance sheet considerations)	$480,000

Brian H. Burke, ASA, is President of B.H. Burke & Co., Inc., and New England Business Apppraisers, Inc. of Cromwell, Connecticut. He earned his Masters degree in economics from the University of Connecticut. He is past contributor to BVR, and past president of ASA's Connecticut Chapter.