RISK-RETURN ANALYSIS OF M&A INVESTMENTS. A THEORETICAL EQUITY COST FRAMEWORK FOR THE VALUATION PROCESS OF PRIVATE COMPANIES' ACQUISITIONS

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Abstract

M&A deals often have private companies as the target. One of the main concerns of this investment type is how to evaluate the target when the target is a private firm. In fact, traditional Capital Budgeting metrics are at least even inconsistent when it comes to define the target value of a private company because such measures are mostly made for public companies. As the negative outcome of this practice, the quality of the evaluation might be poor because of the imprecise discount factor used for the overtime estimate of the target's free cash flows. Building on such cues, the paper proposes a theoretical framework aimed to reinterpret the risk-return analysis of equity by re-calibrating the evaluation process on the firm's fundamental. We argue the equity cost of the private firm can be measured as the combination of the following three factors: i) intrinsic business risk tied to competitive environment volatility; ii) structural characteristics of the firm; iii) capital market dynamics. Adopting a bottom up logic, the exposition to the capital market's

volatility of a private firm depends both on the combination between its structural characteristics and on the systematic risk averagely absorbed by the industry in which the company operates. Our conceptual contribution accomplishes two major goals. First, it links the equity cost of the private firm to contingency. Second its application, highlighting linkages between structural variables of the target company and its risk-return dynamics, may improve M&A decisions in terms of a better trade-off between strategic growth and risk mitigation.

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