What to Look for in a Takeover Target

Description

Companies that are acquired or merge with larger companies are attractive prospects for investors. That's because when an acquisition is announced, the price paid for the takeover target is often at a premium, typically 20-30% of the share price at the time the deal is announced.

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Instantaneous one-day gains like that are hard to come by and very difficult to pass up.

One of the more famous acquisitions in recent memory, as far as the Canadian market is concerned, was Burger King's acquisition of Tim Hortons in 2014 to form **Restaurant Brands International Inc.** (TSX:QSR)(NYSE:QSR).

The deal created the third-largest quick-service restaurant company in North America, and Tim Hortons shareholders saw the value of their investment in the coffee and donuts chain jump 30% on the news.

One of the appealing aspects of Tim Hortons, as far as Burger King was concerned, was the company's ability to generate generous amounts of excess cash flow.

While many investors pay close attention to dividends, large businesses that are looking to acquire smaller businesses will tend to favour free cash flow metrics over the size the company's dividends.

That's because free cash flow will tell you how much the company *could* actually pay out to owners versus what the company *is* actually paying out.

The new owners, if they wanted to, could raise the company's dividend following the acquisition, could redirect that cash flow to reinvest that money in growth initiatives, or even use that cash flow to acquire additional companies.

A recent example of the dynamic between free cash flow versus dividends playing out is with **Calpine Corporation** (NYSE:CPN), which was acquired earlier this year by a private equity firm Energy Capital Partners and a consortium of investors for $5.6 billion — a nearly 50% premium to the value of the company in May, when rumours started to circulate that Calpine's business was looking to be sold.

While Calpine didn't pay a dividend, which is unusual for a utility company, it was the free cash flow that private equity investors were after, knowing they could redirect that cash flow in whatever manner their hearts desired.

Another factor to watch out for when looking for a potential takeover target is the synergistic value of the business to a strategic acquirer. A good example of this is **Maxar Technologies Ltd.** (TSX:MAXR)(NYSE:MAXR), which acquired DigitalGlobe earlier this year.

DigitalGlobe offered unique value to Maxar, as the company had an established footprint in the U.S. defence market — a market which Maxar is aggressively pursuing.

Another recent example would be the currently pending merger between **Potash Corporation of Saskatchewan Inc.** (TSX:POT)(NYSE:POT) and **Agrium Inc.** (TSX:AGU)(NYSE:AGU). If approved, it would create the world's largest crop nutrient company.

Facing lower prices for potash and nitrogen, the newly created company, to be named Nutrien, will jointly be in an improved position to take advantage of economies of scale and manage supply chain issues.

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Bottom line

Ultimately, it's the same element — free cash flow — that makes for a winning trade and which will also help you locate attractive takeover targets.

After all, companies such as Restaurant Brands, Maxar Technologies, or even private equity firms are looking to do the same thing as every other investor, which is to buy undervalued businesses.

Those hunting for takeover opportunities will be best advised to look for synergistic opportunities and businesses generating strong cash flow that would present value for a potential suitor.

Currently rumoured to be on the shopping block is **DHX MEDIA LTD CLASS B** (TSX:DHX.B)(NASDAQ:DHXM), which has struggled to meet analyst expectations recently but may offer strategic value to media companies looking to round out their children's programming offering.

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