Option to Abandon Non-Core Part of Company Acquisition

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ABSTRACT

This paper discusses the before-acquisition-analysis of potential target companies that have substantial assets, which are not the core-business of the acquiring company. The background work for this paper is done in cooperation with corporate managers from a multinational company. The perspective is an active acquirer’s focusing on non-public acquisition targets operating in the same industry with the acquirer. The problem is to screen and value potential non-public acquisition target companies including non-core business parts using only in-house resources at this point.

The paper concentrates on the trade-off between the costs and benefits of acquiring a company with substantial non-core business assets. Number of key driving factors important in the analysis are identified and discussed; some arising rules of thumb are presented.

Non-core-business assets are analyzed as an option to abandon. Different ways to abandon, including asset liquidation, MBOs, and LBOs, are included in the analysis. We apply discounted cash flow valuation, firstly, separately for the core-business and the non-core business parts, and then combine the values in a scenario framework. This is done using a spreadsheet decision support system also presented in the paper.

We further present a simple way to turn the constructed scenarios into a binomial decision tree. This is done using yearly decision nodes on scenario space and finding the lacking decision nodes between the scenarios by interpolation. The simple method is compared to the risk neutral approach to construct a lattice. The abandonment nodes are presented graphically both in a scenario space as well as in a lattice based on the presented real option model. An example case with numerical data is presented and used to illustrate the discussed issues and the model.

Keywords: Acquisitions, non-core business assets, real option, option to abandon, decision support system