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Being marvellous

Tony Grundy uses the example of entertainment company Marvel to illustrate the relationship between strategy and finance during mergers and acquisitions

Marvel, the entertainment company famed for its comics and films, is a brilliant MBA case study for illustrating the interplay between strategy and finance in an M&A context. Marvel's films are based on comic characters that were popular half a century ago. Technology has given them another surge of karmic-like popularity.

In 2009, Disney bought Marvel for US$4bn, at a 29% premium to its existing share price of US$38 (see Marvel's results over a five-year period below). This gives MBA students two dilemmas. One is that its sales growth (one of the seven value drivers of a company's share price) is highly volatile, so not only is it hard to assume a positive figure in the future, but there are also big questions over the stability of its cash stream. This is obviously vulnerable to pulling off 'blockbusters' in the box office, and that is in turn dependent on fads. The second dilemma is that operating profit margin is volatile too – because Marvel has high fixed costs and volatile revenue due to lumpy blockbusters.

In understanding the company's valuation, MBA students are inclined to simply take an average over the five years and hope for the best. This is a start, but this situation is screaming for a set of assumptions that are based more on strategy and the future environment. Some get that; others don't.

Alternative models

It's crucial to get one's head around the valuation problem, particularly as, at the time, Disney didn't want to be seen to overpay – something that was suggested and affected the share price. So one starts by looking at what combinations of sales growth rate and operating profit margin are consistent with the current share price. One rather crude model is that, if operating profit margin were 50%, based on more recent results, then zero sustainable growth rate would give you the current share price.

The next step would be to see what sustainable growth rate and operating profit margin would give Disney its break-even share price of US$50 per share. This is achievable if financially modelled using Disney's cost of capital, tax rate and extra investment costs under some reasonably stretching strategic assumptions. At first pass this suggests Disney paid a stiff price. To actually add economic value to its shareholders and get at least as big a share of the 'value cake', Disney needs to take the Marvel brand and really motor with it.

To achieve this, it is no good just to throw in ballpark assumptions (as many MBA students do) that economies of scale will improve operating profit margin by 2% without calculating in real money as to what that actually means and how it can be achieved. Financial models that work just through flexing percentages can be quite delusional. Another example is where you have a sustainable growth rate of, say, 8% over 10 years: that compounded is an increase in sales of 115%, which would make Marvel a £1.45bn business. What does that mean in terms of overall market share and overall relative market share?

Disney effect

One useful exercise is to see what new strategies a Marvel board can come up with on its own. Could these produce a valuation that would persuade its shareholders to tell Disney to go away or to squeeze more out of Disney? What does Disney actually bring to the party? Distribution, creativity, cost synergies? These things are often unclear.

Unfortunately, many MBA students are at the age when they don't watch Marvel films, so their sense of the underlying psychology of demand (a clue to fathoming sustainable growth rate) is weak. Over the last five years, I have seen many films with my stepchildren and listened to their appetite for these films. It seems that after *Iron Man 6*, you have probably had enough, so there are some potential market and product-lifecyle constraints on the horizon.

But over progressive cycles of doing the simulation, more

Marvel results in US$m

	2008	2007	2006	2005	2004
Sales	676.2	485.8	351.8	390.5	513.5
Operating profit margin	346.5	271.8	110.8	169.0	207.3
Operating profit margin	51%	55%	31%	43%	43%

and more ideas have emerged for exploiting the Marvel brand and its lesser-known characters that can be 'pick and mixed'. Not only are there TV media opportunities, but also other brand extensions such as theme parks and adult computer games.

So in latterday runs of the model, we have been getting reasonably plausible sets of strategic assumptions consistent with share prices of US$80-plus. This would certainly suggest that on the basis of strategic vision and new strategic development, Marvel was undervalued and – although not a cheap buy at US$50 per share – still an attractive one. Marvel, however, could and should have put up a more spirited defence.

When I teach this case, I drum it into the students that they have to do a number of things to make their projections and valuations robust:

* Think about the drivers and constraints to market growth, and have some idea, percentage-wise, what that is likely to be.
* Think about the impact of competing films and also of substitutes over time.
* Think about ways of extending the business model.
* Translate any percentage changes in variables into real strategies and test their plausibility.
* Ensure that if you are making improvements that will necessitate revenue costs, that this is modelled in some way through the operating profit margin; or where capital or other investment is needed, ensure this is included.
* Make sure the terminal value (the value at the end of the planning period, valued as a perpetuity) is entirely credible.

The array of potential valuations of Marvel is huge. Its value is highly dependent on the external environment and on future strategy; simply extrapolating from the past using sustainable growth rates and operating profit margins (as many MBA students choose to do) is simply dipping your toe in the water.

Many new strategies are derived from working out new ways to exploit the distinctive strategic assets of the business – and, in this case particularly, the brand and the heritage of its characters and the innovative brilliance of its film designers and technicians. One thing that Disney certainly needed to get right was to avoid alienating them. This would almost certainly have caused value destruction.

So ask yourself the following questions:

* What's the value of your business on the basis of present strategies?
* Does that give you a value gap between this and what you really want?
* What strategies can be used to fill that value gap?
* How robust are these given your true capabilities, potential imitation and the resources you have? ■

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