UNIVERSITY INVESTMENT CLUB

6.0 Merger Model Guide

Purchase Price Allocation, Synergies & Accretion/Dilution

Guide 6 of 6 | IB & PE Interview Prep Series

Compiled for internal club use. Questions are illustrative and drawn from commonly tested technical themes in IB and PE recruiting — not affiliated with, or sourced verbatim from, any bank or recruiting firm.

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Merger model questions test your understanding of how two companies' financials combine, and why a deal can be accretive or dilutive to the acquirer's earnings — a favorite interview topic in M&A-focused groups.

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1. M&A Basics

Q1.1 What's the difference between a stock deal and a cash deal for the acquirer and the target's shareholders?

In a **cash deal**, the acquirer pays with cash on hand and/or new debt; target shareholders receive cash and exit their position immediately, and the deal is typically taxable to them.

In a **stock deal**, the acquirer issues new shares to target shareholders, who become shareholders of the combined company; this can be tax-deferred for the target's shareholders and doesn't strain the acquirer's Balance Sheet, but it dilutes existing acquirer shareholders.

Q1.2 Why might a strategic acquirer be willing to pay more for a target than a financial sponsor?

Strategic acquirers can capture **synergies** — cost savings and/or revenue opportunities from combining operations — that a financial sponsor generally cannot. This lets strategics justify a higher purchase price while still creating value.

Q1.3 What's the difference between cost synergies and revenue synergies, and which are typically valued more conservatively?

Cost synergies come from eliminating duplicate functions, combining procurement, closing overlapping facilities, etc. — generally easier to estimate and execute. **Revenue synergies** come from cross-selling, expanded distribution, or combined product offerings — harder to predict and execute, so they're typically valued (and weighted) more conservatively, or excluded from the model entirely.

2. Purchase Price Allocation & Goodwill

Q2.1 What is Goodwill, and how is it created in an acquisition?

Goodwill represents the premium paid above a target's identifiable net assets — it captures things like brand value, customer relationships, and assembled workforce that don't show up as separately identifiable assets. Goodwill = Purchase Price – Fair Value of Net Identifiable Assets Acquired (post any write-ups).

Q2.2 Walk me through what happens to the combined Balance Sheet immediately after an acquisition.

- The target's Shareholders' Equity is wiped out (set to zero).
- The target's Assets and Liabilities are added to the acquirer's, often with some assets written up to fair value (e.g., PP&E, identifiable intangibles).
- Any cash used and/or new debt raised to fund the deal flows through.
- Goodwill is created as a new Asset to make both sides of the Balance Sheet balance again.

Q2.3 Why does an asset write-up create a Deferred Tax Liability?

Because the write-up is typically recognized for book purposes but not for cash tax purposes (unless it's a stock-for-stock deal treated as an asset purchase for tax). That means the company will record higher book depreciation/amortization than it can actually deduct for cash taxes, so it will owe more in cash taxes relative to book taxes in the future — the definition of a Deferred Tax Liability.

Q2.4 Under what circumstances would Goodwill later be impaired?

If the acquirer determines the acquired business is worth meaningfully less than what was originally paid for it — often after overpaying, or after the acquired unit underperforms or its outlook deteriorates. Impairment is a non-cash charge that reduces Net Income and the Goodwill balance, and it is *not* deductible for cash tax purposes when it stems from an acquisition.

3. Accretion / Dilution

Q3.1 What does it mean for a deal to be "accretive"? What's "dilutive"?

A deal is **accretive** if the combined company's pro forma EPS is *higher* than the acquirer's standalone EPS. It's **dilutive** if pro forma EPS is *lower*. Neither term is a verdict on whether the deal creates real economic value — it's purely an accounting-EPS metric.

Q3.2 What's the quick, back-of-the-envelope way to tell if an all-stock deal will be accretive or dilutive?

Compare the P/E multiple the acquirer is *paying* for the target to the acquirer's own P/E multiple. If the acquirer's P/E is **higher** than the multiple it's paying for the target (i.e., the target is "cheaper" on an earnings basis), the deal is generally accretive, all else equal — and vice versa.

Q3.3 How does a cash deal's accretion/dilution differ mechanically from a stock deal's?

In a cash deal, there's no new share issuance, so the impact on EPS comes from comparing the target's Net Income contribution against the acquirer's foregone interest income on cash used (or added interest expense if funded with new debt), net of tax. In a stock deal, there's no interest impact, but the acquirer's share count rises, diluting the denominator of EPS even before considering the target's earnings contribution.

Q3.4 Why would a company still pursue a dilutive deal?

- Strategic rationale (market share, new capabilities, defensive positioning) that outweighs near-term EPS impact.
- Expected synergies not yet reflected in current estimates, which management believes will make the deal accretive over a longer horizon (e.g., "accretive by Year 2").
- Long-term value creation that isn't fully captured by a single-year EPS metric.

Q3.5 What happens to Interest Expense and share count in the pro forma combined Income Statement?

Interest Expense increases by the cost of any new debt raised to fund the deal (net of any interest income lost from cash used). Share count increases by the number of new shares issued in a stock deal (or a mix in a cash-and-stock deal), both of which flow through to the pro forma Net Income and EPS calculation.

4. Advanced Topics

Q4.1 What's a Contingent Value Right (CVR) or earnout, and why would it be used in a deal?

An earnout ties part of the purchase price to the target hitting future performance milestones post-close. It's used to bridge a valuation gap between buyer and seller (e.g., when they disagree on the target's growth prospects), and to reduce the acquirer's upfront risk if the seller's projections don't materialize.

Q4.2 How would a Section 338(h)(10) election (in the U.S.) affect the deal's tax treatment?

It allows a stock purchase to be treated as an asset purchase for tax purposes, letting the buyer step up the tax basis of the target's assets (creating real, tax-deductible depreciation/amortization going forward) — generally beneficial to the buyer, though it may trigger a larger current tax bill for the seller, which is often negotiated into the purchase price.

Q4.3 Why might an acquirer prefer to structure a deal as an asset purchase rather than a stock purchase?

An asset purchase lets the buyer selectively acquire specific assets/liabilities (leaving unwanted liabilities behind) and typically allows a tax basis step-up, generating a real cash tax shield from higher depreciation/amortization going forward — though it can be more operationally complex and may require re-assigning contracts and licenses individually.