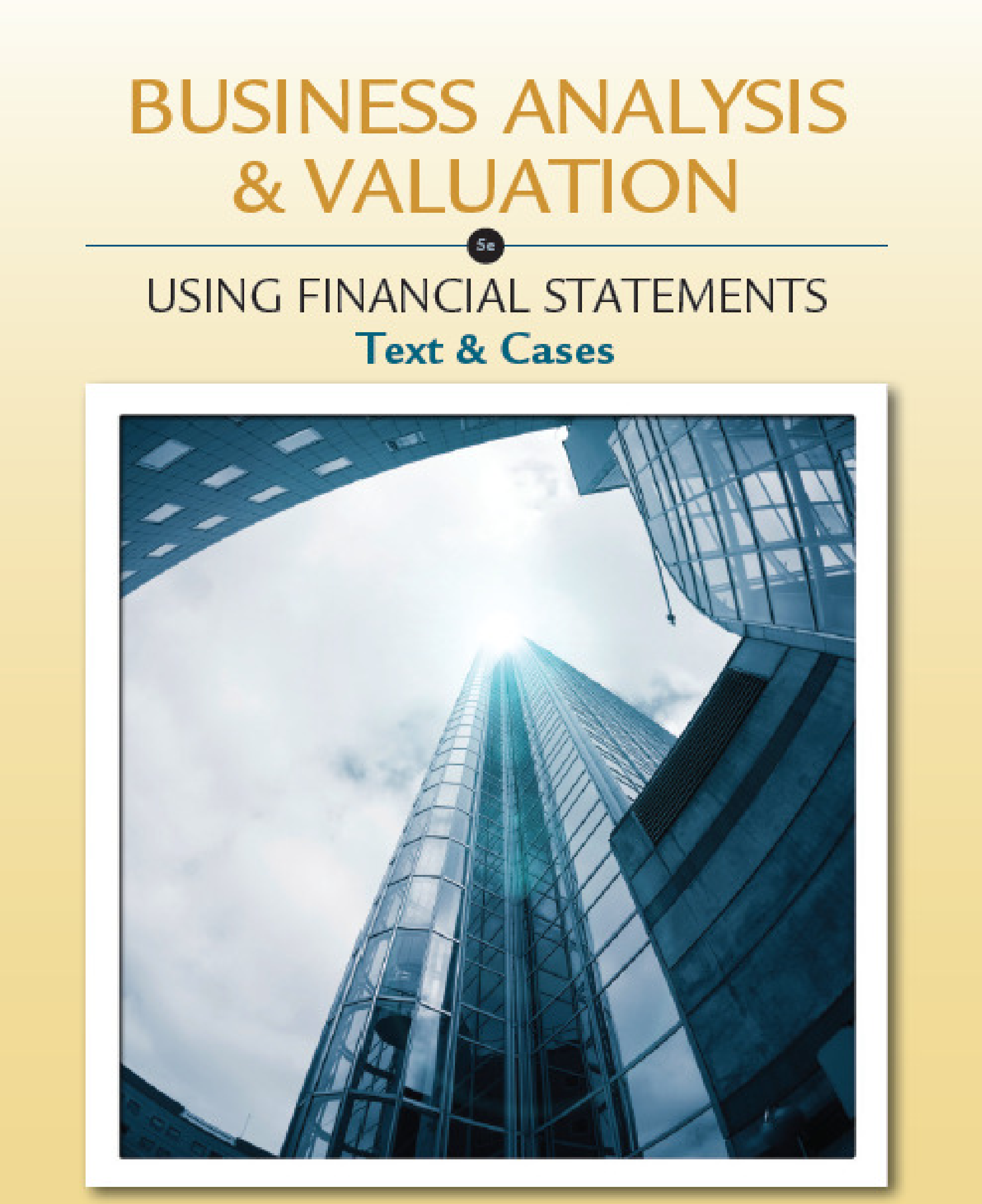


Chapter 11: Mergers and Acquisitions

Key Concepts in Chapter 11

- Mergers are performed for a variety of reasons, most of them involve an attempt to improve a firm's competitive advantage in the market.

- This chapter focuses on the use of financial statement analysis to evaluate whether a merger creates value for the acquiring firm's shareholders

Motivations for Merger or Acquisition

There are a number of reasons why a firm may choose to merge with or acquire another one, including:

– Economies of scale

– Improving target management

– Combining complimentary resources

– Capturing tax benefits

Motivations for Merger or Acquisition, Continued

- Providing low-cost financing to target
- Creating value through restructuring and breakups
- Penetrating new markets
- Increasing product-market rents
- Diversification

Motivation for the Pfizer's acquisition of Wyeth

This merger serves as a great real-life example to examine some of the issues related to M&A.

Motivation for the merger:

- Efficiency gains
- Complimentary strengths and assets
- Risk management related to new exploration projects

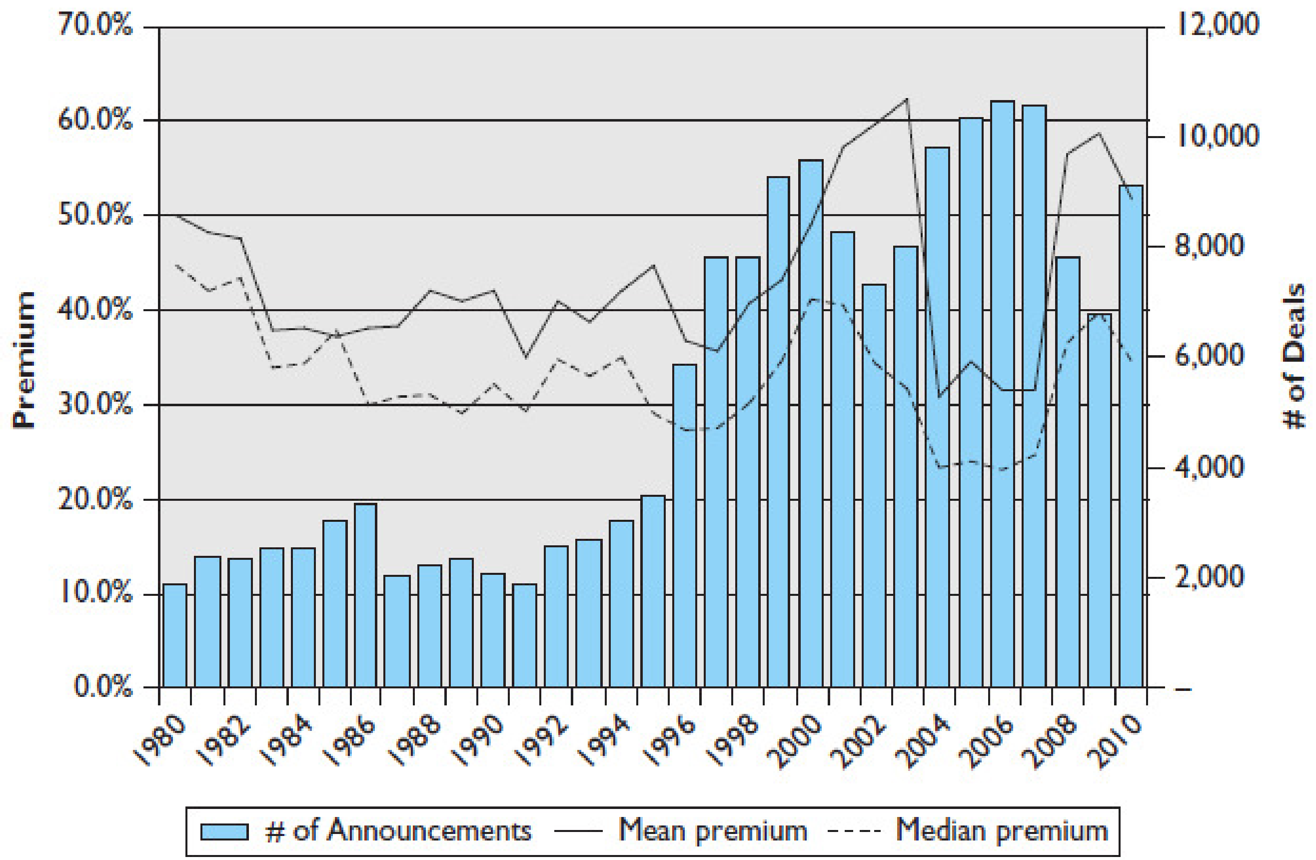
Acquisition Pricing

It is crucial for the analyst to determine the appropriate price to pay for the target firm. Following are the methods used:

- Analyzing premium offered to target shareholders
  - One popular way is through comparisons of similar transactions, though this may be difficult.
    - Comparable transactions are difficult to define
    - Degrees of investor anticipation of the event may drive the premium

Historical M&A Premiums

FIGURE 11-1 Merger Activity and Premium Paid: 1981–2010



Source: Mergerstat Review 2011 (FactSet Mergerstat, LLC).

Acquisition Pricing, Continued

- Analyzing value of the target to the acquirer, a second and more reliable method.
- Earnings multiples:
  - Forecasting earnings
    - Compare with and without merging companies
  - Determining the price-earnings multiple
    - Both pre- and post-merger forward PE multiples are possibilities
  - Limitations of price-earnings valuation
    - PE models focus on immediate increases in earnings or earnings growth, but do not easily incorporate all benefits

Acquisition Pricing, Continued

- Discounted abnormal earnings or cash flows
  - Forecasting abnormal earnings/free cash flows
    - Assume the target is standalone, as a starting point
    - Improvements in earnings/free cash flows can then be incorporated
  - Compute the discount rate
    - Use post-acquisition cost of equity instead of WACC
  - Sensitivity analysis
    - Questions may include
      - What if the acquisition takes longer than anticipated?
      - What if competitors respond with their own M&A?

Pfizer’s Pricing of Wyeth

- Pfizer’s bid price represented a 29% premium to target shareholders.
- Traditional multiples-based valuation supported the bid price.
- Market reactions to the deal were negative, both at the announcement and subsequent.

Acquisition Financing and Form of Payment

The form of payment is an important financing decision.

- Capital structure effects
  - If debt financing is used, analysis should be conducted to see if the increase in financial leverage is excessive.
- Information problems
  - Asymmetric information levels between management and shareholders may cause investors to misinterpret the form of financing.
- Control and the form of payment
  - Using stock to finance M&A dilutes the ownership and control of the acquiring firm.

Acquisition Form of Payment

- Effect of form of payment on target stockholders
  - Tax effects
    - Cash received by target shareholders triggers capital gain (loss) recognition, while receiving shares of the acquiring firm defers recognition of gain (loss).
  - Transaction costs
    - Incurred when target stockholders sell stock received under consideration for their shares in the target
    - If the bidder offers cash, target stockholders won't face these costs.
    - Not significant for investors planning to hold acquirer's stock following the acquisition.

Pfizer’s Financing of Wyeth

- Pfizer offered Wyeth shareholders $33 cash and 0.985 shares for each share of Wyeth.
- After the merger, Pfizer’s shareholders owned approximately 84% of the combined company, and Wyeth’s owned approximately 16%.
- Pfizer increased its financial leverage by using cash to finance the acquisition.

Acquisition Outcome

Another consideration should be whether the transaction will be completed.

- Other potential acquirers
  - Others may offer a higher bid
- Target management entrenchment
  - Target management may fear losing their jobs
- Antitrust and securities issues
- Outcome of Pfizer's offer for Wyeth
  - The merger was bilaterally desirable, and took place without much difficulty.

Concluding Comments

- There are many motivations for firms to merge with or acquire others.
- It is important to assess whether a merger or acquisition creates value for the acquiring firms' shareholders.
- Valuation tools learned in prior chapters may be employed in determining a reasonable price for a target firm.