CHAPTER 1

Introduction to Negotiating Mergers and Acquisitions

Pfizer, the pharmaceutical industry behemoth, was growing increasingly uneasy in early 2008. It had few blockbuster drugs in the pipeline, and several of its major revenue-generating drugs were about to lose patent protection. Pfizer had made several major acquisitions earlier in the decade and now looked to acquire another drug company to offset potential revenue losses. CEO Jeffrey Kindler placed a call to Wyeth Pharmaceutical's chief executive that spring.

Talks heated up in the summer months but appeared to collapse when the global banking system went into a meltdown that September. Each in a series of what appeared to be restarts over the next several months faltered on Wyeth's concerns that Pfizer could not finance the deal. Only in late January 2009, when a consortium of banks signed a loan commitment, was an agreement reached.

Pfizer, like many firms that have engaged in mergers and acquisitions (M&As) over the years, followed a pattern: management determined that an acquisition was the best way to implement the firm's business strategy; a target was selected that fit with the strategy; and a preliminary financial analysis yielded satisfactory results. It was then time to approach the target and initiate negotiations, a process that generally begins with the buyer establishing what it believes to be a reasonable initial offer price range based on preliminary information. Although a potential buyer may wish to avoid being too specific at first contact, it may be unavoidable. The seller may demand some indication of price before proceeding to release any additional information to the buyer. A wise buyer intent upon proceeding will provide a tentative purchase price or indication of value for the target firm subject to performing adequate due diligence.

Here, negotiation is considered a process that begins when the prospective buyer makes its initial contact with the potential target firm, and the target expresses interest in exploring the possibility of being acquired. You will learn about common negotiating strategies and the complexities of deal structuring. Also here, negotiation in the M&A context is viewed

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from a comprehensive, or macro, perspective, not the narrow viewpoint of negotiation often held by one or another of the key participants whose close collaboration is required for success, whether they are lawyers, accountants, investment bankers, or business managers.

Words in ***bold italics*** are the ones most important for you to understand fully; they are all included in a glossary at the end of the book.

Throughout this book, a firm that attempts to acquire or merge with another company is called an ***acquiring company***, ***acquirer***, or ***bidder***. The ***target company*** or ***target*** is the firm being solicited by the acquiring company. ***Takeovers*** or ***buyouts*** are generic terms for a change in the controlling ownership interest of a corporation.[1]

KEY PARTICIPANTS IN NEGOTIATING MERGERS AND ACQUISITIONS

Many individuals contribute to a successfully completed negotiation. Four groups play pivotal roles: senior or operating management, investment bankers, lawyers, and accountants.

Senior/Operating Management

Ultimately, senior management is responsible for the business strategy adopted by the firm and the firm's decision to use an acquisition to implement this strategy in order to achieve the firm's vision and objectives rather than "going it alone" or partnering with another firm. When the decision to acquire is made, senior management must assemble a team to find suitable target firms, approach the targets, and negotiate and complete an acquisition.

Senior management is responsible for communicating its preferences about how the acquisition process should be managed, a timetable for completing the acquisition, and who will be the "deal owner"—the individual responsible for making it all happen. Management preferences provide guidance by stipulating selection criteria for potential acquisition targets, and may include the industry or market segment to be targeted; the approximate size of the firm or maximum purchase price; financial characteristics of a desirable target including profitability and growth rate; and nonfinancial attributes such as intellectual property, manufacturing, or distribution capabilities. Management may also express a willingness to engage in a hostile takeover. Preferences could also indicate management's choice of the form

[1] For a more detailed discussion of this material, see DePamphilis (2009).

of payment (stock, cash, or debt), willingness to accept temporary earnings per share dilution, preference for a stock or asset purchase, desire for partial or full ownership, and limitations on contacting competitors.

The "deal owner"—frequently a high-performing manager—leads the acquisition effort and the negotiation, and should be appointed by senior management very early in the process. It could be a full- or part-time position for someone in the firm's business development unit or an individual expected to manage the operation once acquired. Some deal owners are members of the firm's business development team with substantial deal-making experience. Depending on circumstances, it may make sense to appoint two deal owners: the individual who will be responsible for eventual operation and integration of the target and an experienced deal-maker in a supporting role.

It is the deal owner's responsibility to oversee the negotiation process and ensure that the final agreement of purchase and sale satisfies the acquiring firm's key objectives. In an asset purchase, the contract should entitle the acquirer to rights to specific products; patents; copyrights or brand names; and all needed proprietary technologies, processes, and skills. The deal owner (in consultation with senior management) will have to choose which liabilities to assume. With a purchase of target stock all known and unknown assets and liabilities transfer to the buyer, and the deal owner ultimately is responsible for ensuring that a thorough due diligence has taken place so that the extent of the risk assumed by the buyer is well understood.

Investment Bankers

Amid the turmoil of the 2008 credit crisis, the traditional model of the mega-independent *investment bank* as a highly leveraged, largely unregulated, innovative securities underwriter and M&A advisor floundered. Lehman Brothers was liquidated, and Bear Stearns and Merrill Lynch were acquired by commercial banks JPMorgan Chase and Bank of America, respectively. In an effort to attract retail deposits and to borrow from the U.S. Federal Reserve System (the "Fed"), Goldman Sachs and Morgan Stanley converted to commercial bank holding companies subject to Fed regulation.

Although the era of the thriving independent investment banking behemoth may be over, the financial markets will continue to require investment banking services. Traditional investment banking activities will continue to be in demand. They include providing strategic and tactical advice and acquisition opportunities; screening potential buyers and sellers; making initial contact with a seller or buyer; and providing negotiation support, valuation, and deal-structuring guidance. Along with these

traditional investment banking functions, the large "universal banks" (e.g., Bank of America/Merrill Lynch) will maintain substantial broker-dealer operations, serving wholesale and retail clients in brokerage and advisory capacities to assist with the complexity and often huge financing requirements of the mega-transactions. Investment banks also often provide large databases of recent transactions, which are critical in valuing potential target companies.

Lawyers

Lawyers play a pervasive role in most M&A transactions. They are intimately involved in structuring the deal, evaluating risk, negotiating many of the tax and financial terms and conditions (based on input received from accountants; see following section), arranging financing, and coordinating the timing and sequence of events to complete the transaction. Specific tasks include drafting and reviewing the agreement of purchase and sale and other transaction-related documentation, providing opinion of counsel letters to the lender, and defining due diligence activities.

The legal framework surrounding a typical large transaction has become so complex that no one individual can have sufficient expertise to address all the issues. For these complicated transactions, legal teams can consist of more than a dozen attorneys, each bringing specialized expertise in a given aspect of the law such as M&As, corporate, tax, employee benefits, real estate, antitrust, securities, environmental, and intellectual property. In a hostile transaction, the team may grow to include litigation experts. In relatively small private transactions, lawyers play an active role in preacquisition planning, including estate planning for individuals or family-owned firms, tax planning, and working with management and other company advisors to help better position a client for a sale.

Accountants

Accountants advise on the most appropriate tax and financial structures and on performing financial due diligence. The accountant's input will affect not only how the transaction is structured, but ultimately the after-tax amount each party will pay or receive in the deal.

A transaction can be structured in many ways, each structure having different tax implications for the parties involved. Because there is often a conflict in the tax advantages associated with the sales agreement from the buyer's and seller's perspective, the accountant must understand both points of view and find a mechanism whereby both parties benefit. Income tax,

capital gains, sales tax, and sometimes gift and estate taxes are all at play in negotiating a merger or acquisition.

Accountants also prepare financial statements and perform audits. Many agreements require that the books and records of the acquired entity be prepared in accordance with Generally Accepted Accounting Principles (GAAP), so the accountant must be intimately familiar with those principles to assure that they have been applied appropriately. The accountant must recognize where GAAP has not been followed. In performing due diligence, accountants also perform the role of auditors by reviewing the target's financial statements and operations through a series of onsite visits and interviews with senior and middle-level managers.

The roles of the lawyer and accountant may blur depending on the size and complexity of the transaction. Sophisticated law firms with experience in mergers and acquisitions usually have the capacity to assist with the tax analysis. Furthermore, lawyers are often required to review financial statements for compliance with prevailing securities laws. It is helpful, especially when there can be an overlap of responsibilities, to define clearly which professional will be responsible for which tasks.

PRENEGOTIATION: PROFILING THE TARGET MARKET AND FIRM

Profiling requires collecting information on the target market and firm, which is then used to develop an initial valuation of the firm as well as a baseline notion of the initial terms and conditions (e.g., an all-cash or all-stock offer) that might make an acquisition proposal attractive to a target firm.

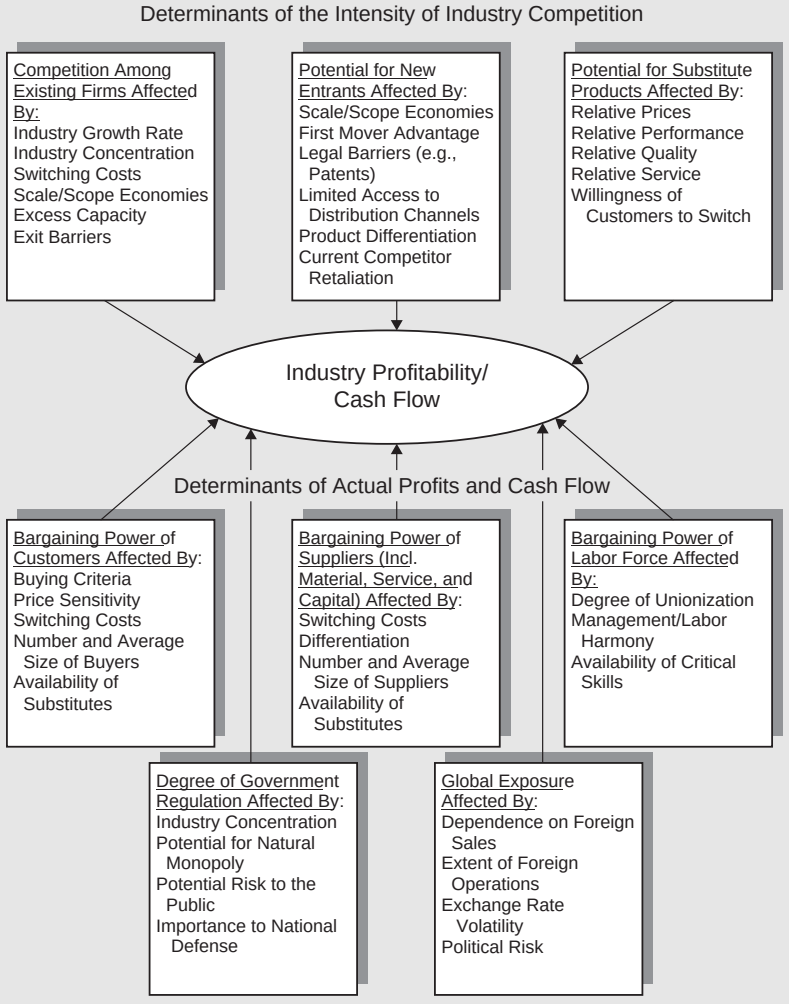
Profiling the Market/Industry

Selecting a target firm begins with identifying a target market or industry (i.e., a collection of markets) in terms of those factors that determine how firms compete and make money. Michael Porter's "Five Forces" framework—which characterizes a firm's market or industry environment in terms of such competitive dynamics as the firm's customers, suppliers, current competitors, potential competitors, and product or service substitutes—is a convenient way to group the information required to evaluate a firm's attractiveness.[2] Exhibit 1-1 illustrates a modified Porter framework.[3]

[2] Porter (1985).

[3] For a more detailed discussion of market and firm profiling, see DePamphilis (2009), 5th edition, Chapter 4.

EXHIBIT 1-1 Defining Market/Industry Competitive Dynamics [See Chapter 4 in DePamphilis (2009)]



The three potential determinants of the intensity of competition in an industry include competition among existing firms, the threat of entry of new firms, and the threat of substitute products or services. Although the degree of competition determines whether there is potential to earn abnormal profits (i.e., those in excess of what would be expected for the

degree of assumed risk), the actual profits or cash flow are influenced by the relative bargaining power of the industry's customers and suppliers.[4] A wide variety of data is required to analyze industry competitive dynamics: types of products and services; market share in terms of dollars and units; pricing; selling and distribution channels and associated costs; type, location, and age of production facilities; product quality; customer service; compensation by major labor category; research and development (R&D) expenditures; supplier performance metrics; and financial performance in terms of growth and profitability. These data must be collected on all significant competitors in the firm's chosen markets.

This framework may be modified to include other factors that determine actual industry profitability and cash flow, such as the severity of government regulation or the impact of global influences such as fluctuating exchange rates. Labor costs may also be included. Although they represent a relatively small percentage of total expenses in many areas of manufacturing, they frequently constitute the largest expense in the nonmanufacturing sector. With the manufacturing sector in most industrialized nations continuing its long-term decline as a percentage of the total economy, the analysis should also include factors affecting the bargaining power of labor.

Profiling the Firm

Within the targeted market, a potential target firm should be identified based on selection criteria such as size, market share, reputation, growth, and so on. The potential buyer should then attempt to profile that firm. For publicly traded firms, obtaining the necessary information is relatively easy. Publicly traded firms must submit audited financial statements to the Securities and Exchange Commission (SEC), often are monitored by securities analysts, may be topics of discussion in the popular press, and have executives who talk publicly about the firm. Obtaining information on privately owned firms is much more challenging, requiring excellent detective work. Where possible, it may involve talking to the firm's customers, suppliers, and current or former employees and reviewing trade press articles and speeches by the firm's management.

Often, potential acquirers pay business brokers or investment bankers to value private firms based on what was paid in recent transactions

[4] Walmart provides an extreme example of relative bargaining power. Given the ubiquity of the chain's stores, most suppliers of retail products would like to have their products displayed on Walmart's store shelves nationwide. The ability of Walmart to attract millions of customers each week gives the firm a huge advantage in negotiating the prices it pays its suppliers.

involving similar businesses. Although such estimates are useful, the information for many businesses simply is not available. Consequently, the potential buyer must piece together available data to reconstruct the firm's financial statements to the degree possible. The financial statements of similar publicly traded firms may be a useful starting point; while these "proxy" public firms are often much larger than the target private firm, the relationships among various financial variables may be similar. For example, the analyst can compute the ratio to sales of cost of sales; sales, general, and administrative expenses; assets; capital spending; accounts receivable; inventory; and so on. Such ratios may be applied to estimates of revenue for the target firm to approximate its financial statements. However, the analyst should adjust for possible differences in operating efficiency, recognizing that the larger proxy firm may be more efficient than the smaller firm.[5] Revenue or some measure of size such as unit sales of the target firm often can be obtained from newspaper accounts, speeches, or interviews. The target's estimated revenue can be multiplied by the financial ratios for the proxy firm.[6]

There are many possible sources of information. They include computerized databases and directory services such as Standard & Poor's *Corporate Register,* the *Thomas Register*, and Dun & Bradstreet's *Million Dollar Directory*, which can be used to identify qualified candidates. Potential acquirers may also query their law, banking, and accounting firms to identify candidates. Investment banks, brokers, and private equity firms can be fertile sources of candidates, although they are likely to require an advisory or finder's fee. The Internet makes research much easier than in the past, putting considerable information at the analyst's fingertips. Services such as Google Finance, Yahoo! Finance, Hoover's, or EDGAR Online enable researchers to gather data quickly about competitors and customers, and provide easy access to a variety of public documents filed with the SEC. Exhibit 1-2 provides a listing of commonly used sources of information that can be highly useful in conducting a search for prospective acquisition candidates as well as for performing due diligence.

[5] Consequently, the proxy firm's cost of sales as a percent of sales ratio should be increased before it is multiplied by the smaller target firm's revenue to reflect its potentially lower operating efficiency.

[6] Therefore, if the proxy firm's cost of sales and assets as a percent of sales are 60 percent and 40 percent, respectively, multiplying these ratios by the target's estimated annual sales of $40 million results in estimates of the target firm's cost of sales and assets of $24 million and $16 million, respectively.

EXHIBIT 1-2 Information Sources on Individual Companies

SEC Filings (Public Companies Only)

10-K: Provides detailed information on a company's annual operations, business conditions, competitors, market conditions, legal proceedings, risk factors in holding the stock, and other related information.

10-Q: Updates investors about the company's operations each quarter.

S-1: Filed when a company wants to register new stock. Can contain information about the company's operating history and business risks.

S-2: Filed when a company is completing a material transaction such as a merger or acquisition. Provides substantial detail underlying the terms and conditions of the transaction, the events surrounding the transaction, and justification for the merger or acquisition.

8-K: Filed when a company faces a "material event" such as a merger.

Schedule 14A: A proxy statement. Gives details about the annual meeting and biographies of company officials and directors including stock ownership and pay.

Websites

www.capitaliq.com
www.factset.com
www.sec.gov
www.edgar-online.com
www.freeedgar.com
www.quicken.com
www.hooversonline.com
www.aol.com
finance.yahoo.com
www.bizbuysell.com
www.dialog.com
www.lexisnexis.com
www.mergernetwork.com
www.mergers.net
www.washingtonresearchers.com
www.twst.com
www.worldm-anetwork.com
www.onesource.com
google.com/finance

Organizations

Value Line Investment Survey: Information on public companies
Directory of Corporate Affiliations: Corporate affiliations

(*Continued*)

EXHIBIT 1-2 (Continued)

Lexis/Nexis: Database of general business and legal information
Thomas Register: Organizes firms by products and services
Frost & Sullivan: Industry research
Findex.com: Financial information
Competitive Intelligence Professionals: Information about industries
Dialog Corporation: Industry databases
Ward's Business Directory of U.S. Private and Public Companies
Predicasts: Provides databases through libraries
Business Periodicals Index: Business and technical article index
Dun & Bradstreet Directories: Information about private and public companies
Dun & Bradstreet *Million Dollar Directory*: Specific data on large U.S. corporations
Experian: Information about private and public companies
Nelson's Directory of Investment Research: Wall Street research reports
Standard & Poor's Publications: Industry surveys and corporate records
Harris Infosource: Information about manufacturing companies
Hoover's *Handbook of Private Companies*: Information on large private firms
Washington Researchers: Information on public and private firms, markets, and industries
The *Wall Street Journal* Transcripts: Wall Street research reports
Directory of Corporate Affiliations (Published by Lexis-Nexis Group)

Estimating the Price Range of an Initial Offer

Prior to making contact with the target firm, you should have an idea of what that the firm may be worth. Again, the seller may refuse to provide the necessary proprietary information without some indication of value from the buyer. How can a range of values be determined?

Transactions in Which Synergy Is Believed to Exist

For transactions in which there is potential synergy between the acquirer and target firms, the initial offer price for the target firm lies between the minimum and maximum offer prices. In a purchase of stock transaction, the minimum offer price may be defined as the target's standalone or present value (PV_T) or its current market value (MV_T) (i.e., the target's current stock price times its shares outstanding). Present value is the current value of a firm based on its expected future cash flows, the risk associated with those cash flows, and financial rates of return on alternative investments exhibiting similar risk. The standalone value is the price a business would command if

EXHIBIT 1-3 Determining the Initial Offer Price (PV_{IOP})—Purchase of Stock

a. $PV_{MIN} = PV_T$ or MV_T, whichever is greater. MV_T is the target firm's current share price times the number of shares outstanding.
b. $PV_{MAX} = PV_{MIN} + PV_{NS}$, where PV_{NS} = PV (sources of value) – PV (destroyers of value).
c. $PV_{IOP} = PV_{MIN} + \alpha PV_{NS}$, where $0 \leq \alpha \leq 1$.
d. Offer price range for the target firm = (PV_T or MV_T) < PV_{IOP} < (PV_T or MV_T) + PV_{NS}.

its projected cash flows reflected fully all revenues and costs at market values. The maximum price is the sum of the minimum price plus the present value of net synergy (PV_{NS}). PV_{NS} is the difference between the present value of those factors adding to cash flow (e.g., cost savings) less those factors reducing cash flows (e.g., the assumption of certain target liabilities) as a result of combining the acquirer and target firms. The initial offer price (PV_{IOP}) is the sum of both the minimum purchase price and some percentage between 0 and 1 of the PV of net synergy (see Exhibit 1-3).

The standalone value is applicable for privately held firms. In a market in which both the buyer and seller have access to the same information, the standalone value would be the price the rational seller expects to receive. In practice, markets for small, privately owned businesses are often inefficient; that is, either the buyer or seller does not have access to all relevant information about the economic value of the target firm, perhaps due to the absence of recent comparable transactions. If the seller is uninformed, you, as the buyer, may be able to purchase the target firm at a discount from what you believe to be the actual economic or fair market value.

In an asset purchase, the target's equity would have to be adjusted to reflect the fair market value of the target assets and liabilities that are to be excluded from the transaction. The minimum price would be the liquidation value of the target firm's assets less the book value of the liabilities assumed by the buyer. The maximum price would be the minimum price plus the present value of net synergy. The initial offer price would lie somewhere between the minimum and maximum prices.

Determining Distribution of Synergy between Acquirer and Target

In determining the initial offer price, the acquiring company must decide how much of the anticipated synergy it is willing to share with the target firm's

shareholders. This is often determined by the portion of anticipated synergy contributed by the target firm. For example, if the results of due diligence suggest that the target would contribute 30 percent of the synergy resulting from combining the acquirer and target firms, the acquirer may choose to share up to 30 percent of the estimated net synergy with the target firm's shareholders.

There are at least three reasons behind the logic that the offer price should fall between the minimum and maximum prices. One, it is unlikely that the target company can be purchased at the minimum price because the acquiring company typically must pay a premium to the current market value to induce target shareholders to transfer control to another firm. In an asset purchase, the rational seller would not sell at a price below the liquidation value of the net assets being acquired. Two, at the maximum end of the range, the acquiring company would be ceding to the target company's shareholders all of the net synergy value created by the combination of the two companies. Three, it is prudent to pay significantly less than the maximum price because the amount of synergy actually realized often tends to be less than the anticipated amount.

Transactions Involving a Control Premium

For many transactions, the purchase price premium—the amount a buyer pays the seller in excess of the seller's current share price—includes both a premium for anticipated synergy and a premium for control. The value of control is distinctly different from the value of synergy. The value of synergy represents revenue increases and cost savings that result from combining two firms, usually in the same line of business. In contrast, the value of control provides the right to direct the activities of the target firm on an ongoing basis.

Control can include the ability to select management, determine compensation, set policy and change the course of the business, acquire and liquidate assets, award contracts, make acquisitions, sell or recapitalize the company, and register the company's stock for a public offering. Control also involves the ability to declare and pay dividends, change the articles of incorporation or bylaws, or block any of the aforementioned actions. Owners of controlling blocks of voting stock may use this influence to extract special privileges or benefits not available to other shareholders, such as directing the firm to sell to companies owned by the controlling shareholder at a discount to the market price and to buy from suppliers owned by the controlling shareholder at premium prices. Furthermore, controlling shareholders may agree to pay unusually high salaries to selected senior managers who

may be family members. For these reasons, the more control a block investor has, the less influence a minority investor will have and the less valuable its stock will be. Therefore, a ***control premium*** is the amount an investor is willing to pay to direct the activities of the firm.

Purchase price premiums may reflect only control premiums when a buyer acquires a target firm and manages it as a largely independent operating subsidiary. The ***pure control premium*** is the value the acquirer believes can be created by replacing incompetent management, changing the strategic direction of the firm, gaining a foothold in a market not currently served, or achieving unrelated diversification.[7] Other examples of pure control premiums include premiums paid for firms going private through a leveraged buyout (LBO) in which the target firm generally is merged into a shell corporation without any synergy being created and managed for cash after having been recapitalized—that is, after a change in the composition of the target's pre-LBO capital (i.e., equity and debt) structure to one comprising substantially more debt. Although the firm's management team may remain intact, the board of directors consists usually of representatives of the financial sponsor (i.e., equity or block investor) and selected LBO managers.[8]

PRENEGOTIATION: FIRST CONTACT

Assuming the target firm is willing to consider the buyer's preliminary proposal for acquisition, the two parties usually proceed to negotiate certain preliminary legal documents. They include a confidentiality agreement

[7] As a practical matter, business appraisers hired by buyers and sellers to estimate the values of businesses frequently rely on the *Control Premium Study*, published annually by Mergerstat. Another source is Duff & Phelps. Mergerstat estimates median control premiums and control premiums by industry by comparing the per share total consideration paid to the target to the "unaffected" price. The "unaffected" price is determined by examining the target price and volume statistics for the year preceding the takeover announcement. The use of these data is problematic because the control premium estimates provided by Mergerstat include the estimated value of synergy as well as the amount being paid to replace current management or change the firm's strategy.

[8] Although empirical studies generally confirm the existence of a pure control premium, there is considerable disagreement over its size. Country comparison studies indicate a huge variation in median control premiums from as little as 2 to 5 percent in countries such as the United States and the United Kingdom, where corporate ownership often is widely dispersed and investor protections are relatively effective, to as much as 60 to 65 percent in countries where ownership tends to be concentrated and governance practices are relatively poor, such as Brazil and the Czech Republic. Median estimates across countries are 10 to 12 percent. (See Barclary and Holderman, 1989; Dyck and Zingales, 2004; Massari, Monge, and Zanetti, 2006; Nenova, 2003.)

and either a term sheet or letter of intent. Sometimes, the buyer and seller will agree to bypass the letter of intent and proceed directly to negotiating an agreement of purchase and sale.

Confidentiality Agreement

All parties to the deal are likely to want a ***confidentiality agreement*** (also called a nondisclosure agreement), which is generally mutually binding; that is, it covers all parties to the transaction. In negotiating the confidentiality agreement, the buyer requests as much audited historical data and supplemental information as the seller is willing to provide. The prudent seller requests similar information about the buyer to assess the buyer's financial credibility. It is important for the seller to determine the buyer's credibility early in the process so as not to waste time with a potential buyer incapable of raising the financing to complete the transaction. The agreement should cover only information that is not publicly available and should have a reasonable expiration date.

Note that the confidentiality agreement can be negotiated independently or as part of the term sheet or letter of intent.

Term Sheet

A ***term sheet*** outlines the primary terms with the seller and is often used as the basis for a more detailed letter of intent. Involving lawyers and accountants at this stage may not be necessary. It is the last point before the parties to the potential transaction start incurring significant legal, accounting, and consulting expenses.

A standard term sheet is typically two- to four-pages long and stipulates the total consideration or purchase price (often as a range), what is being acquired (i.e., assets or stock), limitations on the use of proprietary data, a ***no-shop agreement*** preventing the seller from sharing the terms of the buyer's proposal with other potential buyers with the hope of instigating an auction environment, and a termination date. Many transactions skip the term sheet and go directly to negotiating a letter of intent.

Letter of Intent

A ***letter of intent*** (LOI) can be useful in identifying, early in the process, areas of agreement and disagreement. However, because it takes time to negotiate, an LOI may delay the signing of a definitive agreement of purchase and sale. For public companies, compliance with securities laws may necessitate a public announcement if the agreement is likely to have a "material" impact on the buyer or seller.

The LOI formally stipulates the reason for the agreement and major terms and conditions. It also indicates the responsibilities of both parties while the agreement is in force, a reasonable expiration date, how all fees associated with the transaction will be paid, and a purchase price, which may be expressed as a specific dollar figure, range, or formula (e.g., a multiple of some measure of value such as operating earnings or cash flow). The LOI also specifies the types of data to be exchanged and the duration and extent of the initial due diligence.

Price or other provisions are generally subject to ***closing conditions***, which could include the buyer having full access to all of the seller's books and records; having completed due diligence; obtaining financing; and having received approval from boards of directors, stockholders, and regulatory bodies. Other standard conditions include the requirement for signed employment contracts for key target firm executives and the completion of all necessary M&A documents. Failure to satisfy any of these conditions will invalidate the agreement.

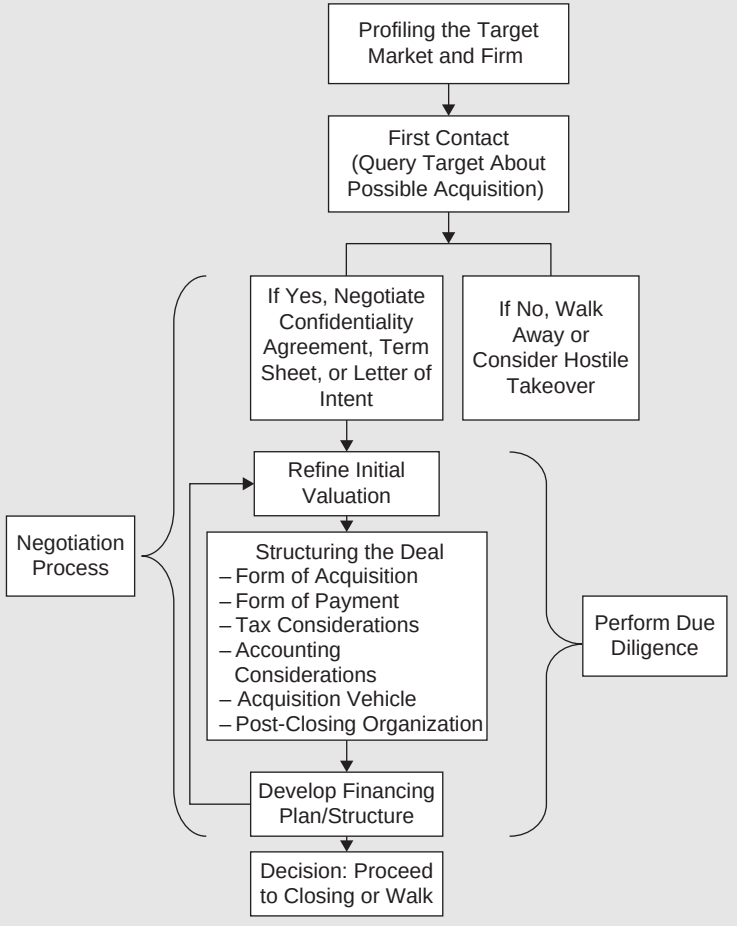
In recent years, some letters of intent have included a ***go-shop agreement*** that allows the seller to continue to solicit higher bids for several months. However, if the seller accepts another bid, the seller would have to pay a ***breakup fee*** to the bidder with whom it has a signed agreement. This fee often equals 3 to 5 percent of the purchase price. The less-common ***reverse breakup fee*** is paid to the seller by a buyer that wishes to break a signed contract, and compensates the seller for damages if the buyer cannot obtain adequate financing.[9]

NEGOTIATION

Unlike the prenegotiation activities just described, the negotiation phase is an interactive, iterative process, as shown in Exhibit 1-4. It formally begins after initial contact and the target's expression of interest in exploring the possibility of being acquired. Many activities are conducted concurrently by various members of the acquisition team. The actual purchase price paid for the acquired business is determined during negotiation and often is considerably different from the initial valuation of the target company, which was based on limited publicly available information.

[9] Reverse breakup fees became much more common in 2008 and 2009 due to the extreme difficulty in buyers obtaining financing.

EXHIBIT 1-4 Viewing Negotiation as a Process



Developing a Negotiating Strategy

Negotiating is essentially a process in which two or more parties, representing different interests, attempt to achieve a consensus on a particular issue. It is useful to start a negotiation by determining any areas of disagreement, which can be done by having all parties review the facts pertaining to the deal at the beginning. Generally, parties reach agreement on most facts

relatively easily. From there, it is easy to identify areas in dispute. Each party then determines whether there are any issues that could be a *deal breaker*—something that a party to the negotiation cannot concede without making the deal unacceptable.

Good negotiators make concessions on issues not considered deal breakers, but only if they receive something in return. By the time only a few remain, all parties to the negotiation have invested a great deal of money, time, and emotional commitment to the process and will be looking forward to resolving any remaining issues quickly. All positions should be explained logically. Unreasonable demands at this point in the negotiation are likely to evoke frustration by the other party and encourage someone to end discussions. If the parties can reach a point where one side is at least willing to state a price range, final agreement is in sight.

Sound planning is the key to successful negotiation. Prior to negotiating, each party should determine its own goals (i.e., highest priority needs) and prioritize those goals. Is money the major issue, or is it more about gaining control? Each party should also make an effort to identify the other party's goals and priorities based on public statements and actions, as well as information uncovered during due diligence. With clearly identified goals, each party can develop strategies for achieving those goals. Each party needs to recognize that allowances must be made so other parties can achieve—or at least *believe* they have achieved—their primary goals.

All moves in a negotiation should be supported by the most objective rationale possible; a well-reasoned and well-structured proposal is difficult to counter. The first move of any negotiation can set the tone for the entire process. A reasonable offer is more likely to appeal to the other side and more likely to elicit a reasonable counteroffer. Skilled negotiators often employ a series of techniques to reach consensus. For example, negotiators may try to determine the minimum outcome the other party will accept and then adjust their demands accordingly, without giving up their highest priority objectives.

Traditional negotiating has been referred to as the "win-lose" approach, based on the assumption that one's gain is necessarily another's loss. This is true when only one issue is at stake. For example, if a seller accepts a lower cash purchase price, and if cash is a high-priority concern to the buyer and the seller, the buyer gains at the seller's expense. "Win-win" negotiations, in contrast, presume there are outcomes in which both parties to a negotiation gain; these negotiations involve multiple related issues. In a win-win negotiation, one party can concede what it believes to be a relatively

low-priority item in exchange for the other party's acceptance of something else that is highly important.

When it comes to issues of money, it can be important to reach agreement first on a formula or framework for determining what both parties believe is a fair value. This may require intense discussion. A formula might be that the purchase price will be some multiple of earnings or cash flow; a framework might comprise a series of steps, such as the extent of due diligence to be allowed, before a purchase price is proposed. The formula or framework can help avoid the thorny issue of how much to offer at the outset and enables negotiators to proceed to the data collection or due diligence stage.

Concurrent Activities

The negotiation phase comprises four iterative activities that may begin at different times but tend to overlap. One activity is refining the preliminary valuation, which provides the starting point for negotiating the agreement of purchase and sale. This is based on new information uncovered as part of due diligence, another of the four activities, which provides additional information to enable the buyer to understand better the nature of the liabilities that may be assumed and to confirm perceived sources of value. Deal structuring involves meeting the needs of both parties by addressing issues of risk and reward by constructing an appropriate set of compensation, legal, tax, and accounting structures. The fourth of these activities is developing a financing plan, which provides a reality check for the buyer by defining the maximum amount the buyer can reasonably expect to finance and, in turn, pay for the target company.

Refining Valuation

The starting point for negotiation is to update the preliminary target company valuation, based on new information. A buyer requests and reviews at least three to five years' worth of historical financial data. Although it is highly desirable to examine data that have been audited in accordance with GAAP, such data may not be available for small, privately owned companies. In fact, small companies rarely hire outside accounting firms to conduct expensive audits unless they are required to do so as part of a loan agreement.

The historical data should be normalized, or adjusted for nonrecurring gains, losses, or expenses. Nonrecurring gains or losses can result from the sale of land, equipment, product lines, patents, software, or copyrights.

Nonrecurring expenses include severance payments, employee signing bonuses, and settlements of litigation. These adjustments allow the buyer to smooth out irregularities in the historical information and better understand the underlying dynamics of the business. After the data have been normalized, each major expense category should be expressed as a percentage of revenue. By observing year-to-year changes in these ratios, sustainable trends in the data are more discernable.

Deal Structuring

Fundamentally, the ***deal-structuring process*** is about satisfying as many of the primary objectives (or needs) of the parties involved as necessary and determining how risk will be shared. Common examples of high-priority buyer objectives include paying a "reasonable" purchase price, using stock in lieu of cash (if the acquirer's stock is believed to be overvalued), and having the seller finance a portion of the purchase price by carrying a seller's note. Buyers may also want to put a portion of the purchase price in an escrow account, defer a portion of the price, or make a certain percentage of the purchase price contingent upon realizing some future event to minimize risk. Common closing conditions desired by buyers include obtaining employee retention agreements and noncompete agreements. Sellers that are also publicly traded companies are typically driven to maximize purchase price. However, their desire to maximize price may be tempered by other considerations such as the perceived ease of doing the deal or a desire to obtain a tax-free transaction—those in which the seller receives primarily buyer stock for its stock. The transaction is tax free for the selling firm's shareholders until they actually sell the buyer's stock. Private or family-owned firms may be less motivated by price than by other factors such as protecting the firm's future reputation and current employees, as well as obtaining rights to license patents or to utilize other valuable assets.

Risk sharing refers to the extent to which the acquirer assumes all, some, or none of the liabilities, disclosed or otherwise, of the target. The appropriate deal structure is that which satisfies, subject to an acceptable level of risk, as many of the primary objectives of the parties involved as necessary to reach overall agreement. The process may be highly complex in large transactions involving multiple parties, approvals, forms of payment, and sources of financing. Decisions made in one area inevitably affect other areas of the overall deal structure. Containing risk associated with a complex deal is analogous to catching a water balloon. Squeezing one end of the balloon simply forces the contents to shift elsewhere.

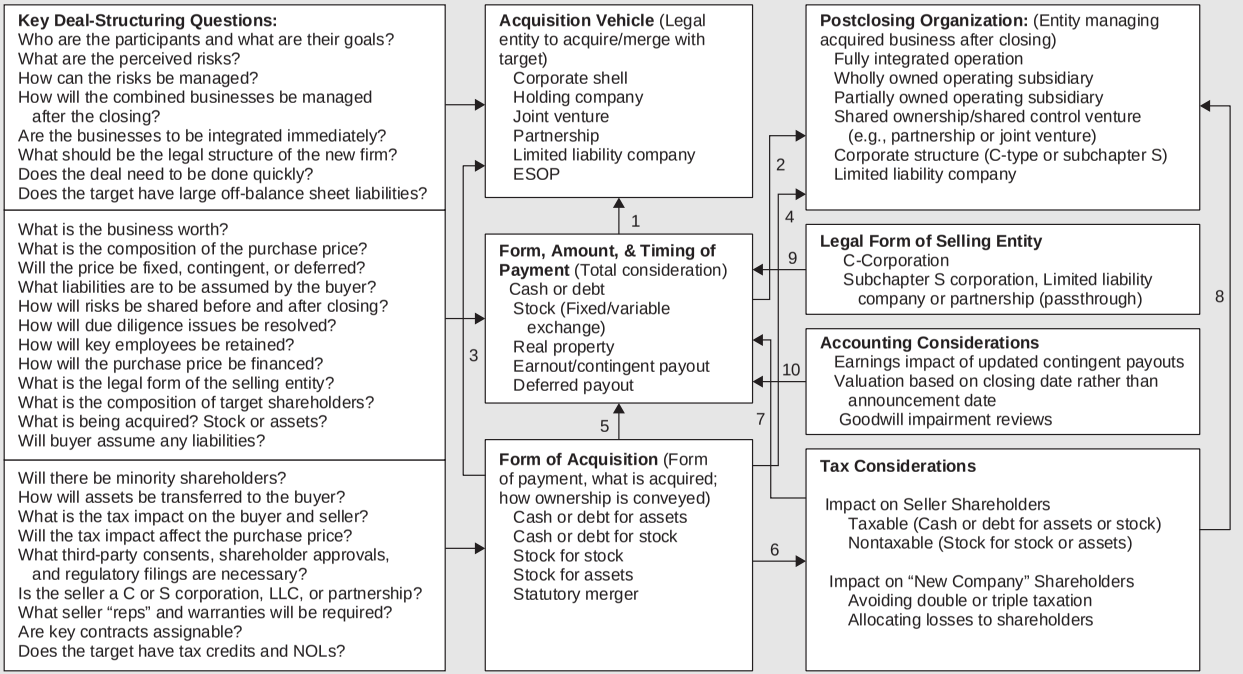
Key Components of the Deal-Structuring Process

Exhibit 1-5 summarizes the deal-structuring process, which begins with addressing a set of key questions that help define initial negotiating positions, potential risks, options for managing risk, levels of tolerance for risk, and conditions under which the buyer or seller will "walk away" from the negotiations. These questions are listed on the left side of Exhibit 1-5 and grouped according to the part of the deal-structuring process to which they apply.

The various components of the deal-structuring process denoted in Exhibit 1-5 are defined next. The ***form of payment*** or total consideration may consist of cash, common stock, debt, or a combination of all three. The payment may be fixed at a moment in time, contingent on future performance of the acquired unit, or payable over time. The form of payment influences the selection of the appropriate form of acquisition and postclosing organization. The ***form of acquisition*** reflects what is being acquired (stock or assets) and, as such, tax considerations. The form of acquisition also defines how the ownership of assets will be conveyed from the seller to the buyer, either by rule of law as in a merger or through transfer and assignment as in a purchase of assets. ***Tax considerations*** entail tax structures and strategies that determine whether a transaction is taxable or nontaxable to the seller's shareholders and influence the choice of postclosing organization, which affects the potential for double taxation and the allocation of losses to owners. Transactions in which the form of payment is primarily acquirer stock generally are tax free to the selling firm's shareholders. ***Accounting considerations*** refer to the potential impact of financial reporting requirements on the earnings volatility of business combinations due to the need to periodically revalue acquired assets to their fair market value as new information becomes available. The ***legal form of the selling entity*** (i.e., whether it is a C or S chapter corporation, LLC, or partnership) also has tax implications.

The ***acquisition vehicle*** refers to the legal structure created to acquire the target company. The ***postclosing organization*** or structure is the organizational and legal framework used to manage the combined businesses following the consummation of the transaction. Commonly used structures for both the acquisition vehicle and postclosing organization include the corporate or divisional, holding company, joint venture (JV), partnership, limited liability company (LLC), and employee stock ownership plan (ESOP) structures. The choice of acquisition vehicle and postclosing organization has liability, tax, and financing implications that are discussed in more detail later in this book.

EXHIBIT 1-5 Mergers and Acquisitions Deal-Structuring Process



Although the two structures are often the same before and after completion of the transaction, the postclosing organization may differ from the acquisition vehicle depending on the acquirer's strategic objectives for the combined firms. An acquirer may choose a corporate or divisional structure to purchase the target firm and to rapidly integrate the acquired business to realize synergies. Alternatively, the acquirer may opt to undertake the transaction using a JV or partnership vehicle to share risk. When the operation of the acquired entity is better understood, the acquirer may choose to buy out its partners and to operate within a corporate or divisional structure. Similarly, the acquirer may complete the transaction using a holding company legal structure. The acquirer may operate the acquired firm as a wholly owned subsidiary to preserve the attractive characteristics of its culture for an extended time period and later move to a more traditional corporate or divisional framework. All of these terms in bold type will be explained in considerably greater detail in the remaining chapters of this book.

Common Linkages within the Deal-Structuring Process

For simplicity, many of the linkages or interactions that reflect how decisions made in one area affect other aspects of the deal are not shown in Exhibit 1-5. Common linkages or interactions among various components of the deal structure are illustrated through examples described next and are explained in more detail later in this book.

Form of Payment Influences Choice of Acquisition Vehicle and Postclosing Organization (Exhibit 1-5: Arrows 1–2)

If the buyer and seller agree on a price, the buyer may offer a purchase price that is contingent on the future performance of the target. The buyer may choose to acquire and operate the acquired company as a wholly owned subsidiary within a holding company during the term of the "deal-structuring process," which facilitates monitoring the operation's performance and minimizes the potential for litigation following the deal-structuring process initiated by deal-structuring process participants.

Form of Acquisition (Exhibit 1-5: Arrows 3–6) Affects Numerous Components of the Deal Structure

- *Choice of Acquisition Vehicle and Postclosing Organization:* If the form of acquisition is a statutory merger, all known and unknown or contingent liabilities are transferred to the buyer. Under these circumstances,

the buyer may choose to change the type of acquisition vehicle to one better able to protect the buyer from the liabilities of the target, such as a holding company arrangement. Acquisition vehicles and postclosing organizations that facilitate a sharing of potential risk or of the purchase price include JV or partnership arrangements.

- *Form, Timing, and Amount of Payment:* The assumption of all seller liabilities through a merger also may induce the buyer to change the form of payment by deferring some portion of the purchase price to decrease the present value of the cost of the transaction. The buyer also may attempt to negotiate a lower overall purchase price.
- *Tax Considerations:* The transaction may be tax free to the seller if the acquirer uses its stock to acquire substantially all of the seller's assets or stock in a stock for stock or stock for assets purchase.

Tax Considerations (Exhibit 1-5: Arrows 7–8) Affect Purchase Price and Selection of Postclosing Organization

- *Amount, Timing, and Composition of the Purchase Price:* If the transaction is taxable to the target's shareholders, it is likely that the purchase price will be increased to compensate the target's shareholders for their tax liability. The increase in the purchase price may affect the form of payment. The acquirer may maintain the present value of the total cost of the acquisition by deferring some portion of the purchase price by altering the terms to include more debt or installment payments.
- *Selection of the Postclosing Organization:* The decision as to what constitutes the appropriate organizational structure of the combined businesses is affected by the desire to minimize taxes and passthrough losses to owners. The S corporation, LLC, and partnership eliminate problems of double taxation. Moreover, current operating losses, loss carry forwards or carry backs, or tax credits generated by the combined businesses can be passed through to the owners if the postclosing organization is a partnership or a LLC.

Legal Form of Selling Entity Affects Form of Payment (Exhibit 1-5: Arrow 9)

Because of the potential for deferring shareholder tax liabilities, target firms that qualify as C corporations often prefer to exchange their stock or assets for acquirer shares. In contrast, owners of S corporations, LLCs, and partnerships are largely indifferent as to whether the transaction is taxable or nontaxable because 100 percent of the proceeds of the sale are taxed at the shareholders' ordinary tax rate.

Accounting Considerations Impact Form, Amount, and Timing of Payment (Exhibit 1-5: Arrow 10)

Earnouts and other forms of contingent considerations are recorded at fair value on the acquisition date under changes in financial reporting guidelines (i.e., SFAS 141R and SFAS 157) that became effective in December 2009 and are subsequently adjusted to fair value as new information becomes available. Such changes can increase or decrease reported earnings. Because earnouts must be recorded at fair value on the acquisition date and subsequently adjusted, the potential for increased earnings volatility may make performance-related payouts less attractive as a form of payment. Furthermore, the use of equity securities to pay for target firms may be less attractive due to recent changes in financial reporting requirements. The value of the transaction will not be known until the closing because the value of the transaction will be measured at the close of the deal rather than at the announcement date. If the length of time between announcement and closing is substantial due to the need to obtain regulatory approval, the value of the deal may change significantly. Finally, the requirement to review periodically the book or carrying value of such assets as goodwill for impairment (e.g., fair market value is less than book value) may discourage acquirers from overpaying for a target firm due to the potential for future asset write downs. Exhibit 1-6 provides a summary of these common linkages.

Conducting Due Diligence

Although some degree of protection is achieved through a well-written contract, legal documents should never be viewed as a substitute for conducting formal due diligence. While most often performed by the buyer on the seller, the seller also may be well advised to perform due diligence on both itself and the buyer. Finally, lenders also are likely to perform due diligence on the target company if that firm's assets are going to be used to collateralize loans made to the acquirer.

Note that Exhibit 1-4 implies that the due diligence activity spans the entire negotiation period. In practice, this may not always be the case. The length, timing, and extent of due diligence is negotiated early in the process, usually in the letter of intent, and is largely determined by the relative leverage of the buyer and seller. In some cases, due diligence may precede formal negotiations and may be very limited or in rare instances nonexistent.

Buyer Due Diligence

Buyers use due diligence to validate assumptions underlying valuation. The primary objectives of buyer's due diligence are to identify and confirm

EXHIBIT 1-6 Summary of Common Linkages within the Deal-Structuring Process

Component of Deal-Structuring Process	Influences Choice Of
Form, Amount, and Timing of Payment	Acquisition vehicle Postclosing organization Accounting considerations
Form of Acquisition	Acquisition vehicle Postclosing organization Form, amount, and timing of payment Tax structure (taxable or nontaxable)
Tax Considerations	Form, amount, and timing of payment Postclosing organization
Legal Form of Selling Entity	Tax structure (taxable or nontaxable)

sources of value or synergy and mitigate real or potential liability by looking for fatal flaws that reduce value. Exhibit 1-7 identifies potential sources of value and how they may affect a firm's financial performance.

Due diligence involves three primary reviews: (1) a strategic/operational/marketing review conducted by senior operations and marketing management; (2) a financial review directed by financial and accounting personnel; and (3) a legal review conducted by the buyer's legal counsel. A rigorous due diligence requires the creation of comprehensive checklists. The strategic and operational review questions focus on the seller's management team, operations, and sales and marketing strategies. The financial review questions focus on the accuracy, timeliness, and completeness of the seller's financial statements. Finally, legal questions deal with corporate records, financial matters, management and employee issues, tangible and intangible assets of the seller, and material contracts and obligations of the seller such as litigation and claims. The interview process provides invaluable sources of information. By asking the same questions of a number of key managers, the acquirer is able to validate the accuracy of their conclusions.

An expensive and exhausting process, due diligence is, by its nature, highly intrusive and places considerable demands on managers' time and attention. Frequently, the buyer wants as much time as necessary to complete due diligence, whereas the seller will want to limit the length and scope as much as possible.

EXHIBIT 1-7 Identifying Potential Sources of Value

Potential Source of Value	Examples	Potential Impact
Operating Synergy:		
• Eliminating functional overlap	• Reduce duplicate overhead positions	• Improved margins
• Productivity improvement	• Increased output per employee	• Same
• Purchasing discounts	• Volume discounts on material purchases	• Same
• Working capital management	• Reduced days in receivables due to improved collection of accounts receivable	• Improved return on total assets
	• Fewer days in inventory due to improved inventory turns	• Same
• Facilities management		
– Economies of scale	• Increased production in underutilized facilities	• Improved return on total assets
– Economies of scope	• Data centers, R&D functions, call centers, etc., support multiple product lines/operations	• Same
• Organizational realignment	• Reducing the number of layers of management	• Improved communication • Reduced bureaucratic inertia
Financial Synergy:		
• Increased borrowing capacity	• Target has little debt and many unencumbered assets	• Increased access to financing
• Increased leverage	• Access to lower-cost source of funds	• Lower cost of capital
Marketing/Product Synergy:		
• Access to new distribution channels	• Increased sales opportunities	• Increased revenue
• Cross-selling opportunities	• Selling acquirer products to target customers and vice versa	• Same
• Research & development	• Cross-fertilization of ideas	• More innovation
• Product development	• Increased advertising budget	• Improved market share
Control:		
• Opportunity identification	• Acquirer sees opportunities not seen by target's management	• New growth opportunities
• More proactive management style	• More decisive decision-making	• Improved financial returns

Due diligence rarely works to the advantage of the seller because a long and detailed due diligence is likely to uncover items the buyer will use as an excuse to lower the purchase price. Consequently, the seller may seek to terminate due diligence before the buyer feels it is appropriate.

In some instances, buyers and sellers may agree to an abbreviated due diligence period on the theory that the buyer can be protected in a well-written agreement of purchase and sale in which the seller is required to make certain representations and warrant that they are true. These could include the seller's acknowledgement that it owns all assets listed in the agreement "free and clear" of any liens, with a mechanism for compensating the buyer for any material loss (defined in the contract) should the representation be breached (i.e., found not to be true).

One way sellers try to limit due diligence is to sequester the acquirer's team in a ***data room***. Typically, this is a conference room filled with file cabinets and boxes of documents requested by the buyer's due diligence team. Formal presentations by the seller's key managers are given in the often cramped conditions of the data room. In other instances, the potential buyer may have limited access to information on a password-protected website. Not surprisingly, the data room is a poor substitute for a tour of the seller's facilities. Virtual data rooms are becoming more commonplace, with potential buyers allowed to access a password-protected website containing financial and other data relevant to the seller.

Seller Due Diligence

Although the bulk of due diligence is performed by the buyer on the seller, the prudent seller should also perform due diligence on the buyer. In doing so, the seller can determine whether the buyer has the financial wherewithal to finance the purchase. Frequently, as part of its own due diligence, a seller will require its managers to sign affidavits attesting (to the "best of their knowledge") to the truthfulness of what is being represented in the contract that pertains to their areas of responsibility.

Prudent sellers also conduct internal due diligence. Through an investigation of its own operations, the seller hopes to mitigate liability stemming from inaccuracies in the seller's representations and warranties made in the definitive agreement of purchase and sale.

Lender Due Diligence

If the acquirer is borrowing to buy a target firm, the lender or lenders will want to perform their own due diligence independent of the buyer's effort. Multiple lender due diligences, often performed concurrently, can

be quite burdensome to the target firm's management and employees, and the seller should agree to these disruptive activities only if confident that the transaction will be consummated within a reasonable period.

Developing the Financing Plan or Strategy: The Reality Check

The final activity of the negotiation phase is to develop balance sheet, income, and cash-flow statements for the combined firms. Unlike the financial projections of cash flow made to value the target, these statements should include the expected cost of financing the transaction. Developing the financing plan is a key input in determining the purchase price because it places a limitation on the amount the buyer can offer the seller.

The financing plan is appended to the acquirer's business and acquisition plans and is used to obtain financing for the transaction. No matter the size the transaction, lenders and investors will want to see a coherent analysis of why the proposed transaction is a good investment opportunity. It largely is used as a marketing or sales document to negotiate the best possible terms for financing the proposed transaction.

★ ★ ★

Of the various activities involved in the negotiating process, deal structuring is the most challenging. It involves satisfying as many of the primary objectives as necessary of the parties involved and determines how risk will be shared. After a set of key questions has been answered, the parties to the negotiation can define their initial negotiating positions, potential risks, options for managing risk, levels of tolerance for risk, and conditions under which one or the other will "walk away" from the negotiation. Then the deal structuring may begin, addressing the form of the acquisition vehicle, the postclosing organization, the form of payment, the form of acquisition, the legal form of the selling entity, and accounting and tax considerations.

A Case in Point: Pfizer Acquires Wyeth in an Attempt to Kick-Start Growth

On January 26, 2009, Pfizer Inc. announced it had reached an acquisition agreement with Wyeth Pharmaceuticals in a cash and stock deal valued at $66.8 billion ($68 billion including the value of Wyeth stock options exercised at closing). The purchase price was a 12.6 percent premium over Wyeth's closing share price the day before the announcement and a 29 percent premium over its closing price the same day one month earlier. The premium represented a combination

of anticipated synergy created in combining the two businesses and the amount paid to gain control of Wyeth. At about $52 billion in 2008, Pfizer's annual revenues were about double those of Wyeth. Wyeth's shares rose 12.6 percent and Pfizer's 1.4 percent on the news.[10]

Pfizer's record in making mega transactions is spotty. The firm acquired Warner-Lambert for $90 billion in 2000 and Pharmacia for $60 billion in 2003. Although substantial cost reductions were achieved in both instances, neither acquisition appears to have contributed to improved operating performance for Pfizer. In fact, at the time of the Wyeth announcement, Pfizer's stock had dropped by 50 percent since it completed the Warner-Lambert deal.

The Wyeth acquisition represents a departure from the general trend in recent years to avoid big horizontal mergers (i.e., those among competitors) and to focus on vertical mergers in which a big pharmaceutical firm acquires a smaller company. As is true of other large pharmaceutical companies, Pfizer faces serious revenue erosion as its patents expire on a number of major drugs; for example, patent rights on Lipitor, the cholesterol-lowering drug that accounted for 25 percent of Pfizer's 2008 revenue, expire in 2011, and 14 other patents expire through 2014 on drugs expected to generate $35 billion during that period. Pfizer is not alone in suffering from patent expirations. Diversification is one of Pfizer's tactics for offsetting this revenue erosion. In addition to its existing products, Wyeth brings to Pfizer a significant capability in biologics, which—unlike traditional chemical-based drugs such as tablets and capsules—are developed with live processes.

Pfizer's strategy was to acquire Wyeth—an attractive-looking acquisition because there is little overlap between the two firms' drug offerings, and hence few regulatory issues—when transaction prices were depressed because of the recession and tight credit markets. Pfizer projected $4 billion in annual savings from the combination through job eliminations and some plant closures, phased in over three years. The biggest issue Pfizer faced was how to achieve and maintain an innovative culture in the new firm and retain good people.

The negotiations were contentious, not because of differences over price or strategy but rather the circumstances in which Pfizer could back out of the deal. Many transactions announced during 2008 were never closed because buyers were unable to arrange financing due to the upheaval in the global capital markets. This deal established that Pfizer would be liable to pay Wyeth $4.5 billion if its credit rating dropped prior to closing and it could not finance the transaction. That made for a breakup fee around 6.6 percent—about twice the norm for similar transactions. Pfizer also agreed to pay $50.19 per Wyeth share: $33 in cash and the

[10] Although the expectation was that the deal would dilute earnings per share during the first full year following closing, because the increase in earnings of the combined firms would be less than the increase in Pfizer shares issued to buy Wyeth, Pfizer forecast that the deal would add to consolidated earnings per share by the second full year after closing.

remainder in 0.985 shares of Pfizer stock valued at $17.19 per share exchanged for each Wyeth share outstanding. Wyeth's management would be terminated.

Pfizer came to the negotiation with a $22.5 billion bridge financing commitment letter from Goldman Sachs, JPMorgan Chase, Citigroup, Bank of America, and Barclays, along with $26 billion in cash and marketable securities. The buyer cut its quarterly dividend in half to help finance the transaction.

The Pfizer-Wyeth deal allowed limited circumstances in which a financing failure could be claimed in limited circumstances. Specifically, Pfizer could renege only if its lenders refused to finance the transaction because of a credit downgrade of the company. If the condition was not satisfied and the lenders refused to finance primarily for this reason, Wyeth was permitted either to demand that Pfizer attempt to find alternative financing or terminate the agreement—creating an obligation that Pfizer pay Wyeth $4.5 billion.

Things to Think About:

1. What were the primary reasons Pfizer wanted to acquire Wyeth? Why do you think Wyeth found the deal attractive, despite the depressed state of transaction prices at that time? Be specific.
2. What do you believe is the risk associated with this deal for the Pfizer shareholders? For the Wyeth shareholders? Be specific.
3. Goldman Sachs was both an advisor and a lender on this deal. What is your opinion of the dual role played by Goldman? Be specific.
4. In view of the reaction of both firm's share prices immediately following the announcement of the deal, what do you think investors are assuming about the deal?
5. The reverse breakup fee represents 6.6 percent of purchase price. How would you as a negotiator for Wyeth justify such a large fee?

Answers can be found at:
www.elsevierdirect.com/companion.jsp?ISBN=9780123749499