Mylan Laboratories’ Proposed Merger with King Pharmaceutical

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Overview of the Case

Mylan Laboratories

- Founded in 1961
- In late 1980's, the company aimed to diversify and the success of this strategy led to $1 billion sales in 2002
- Net revenue was down 7% over the last 6 months, margins had fallen to 48.9%
- On July 26,2004, Mylan Management announced a proposal to merge with King Pharmaceuticals

King Pharmaceuticals

- A contract manufacturer of prescription medicines founded in 1993
- Acquired more than 50 branded prescription product lines
- In early march 2003, king's shares dropped 24%
- In july 2003, the firm's share is down from 97 cents to 74 cents per share

Shareholders

Carl Icahn (High River)

- He labeled the deal "stupid"
- Its hedge fund holds 9.8% of Mylan's share

Richard Perry (Perry Capital)

- Perry was in favor of the merger
- Holds 9.9% of Mylan's share and several million shares of King's

Whether the Merger creates value for Mylan and King

Whether it would be valuable for King

Valuation Model

Enterprise Value (NPV)	**3,538**
Plus: Cash	146.10
Less: Debt	345.00
Equity Value	**3,338.98**
Value of Single Stock	12.28469016

- King is under investigation by SEC for alleged Medicaid pricing valuation
- King was suffering in cash and has more long term debt
- Its value of a single stock is $12.3/share

Conclusion:
The merger would benefit King

King’s DCF

A	B	C	D	E	F	G	H	I	J	K
Year			2001	2002	2003		Exit	**Terminal Value**		
EBITDA				314.50	288.30			3,016	EBITDA Multiple	
EBIT				255.20	163.70			11,138	Perpetual Growth	
Less: Taxes				85.10	71.20					
Plus: D&A				59.30	124.60					
Less: Chg in NWC				(194.50)	(614.20)					
Less: Capex				53.00	40.50					
Unlevered Free Cash Flow				371	791		3,016			
EBITDA Multiple	10.46									
Terminal Growth Rate	2.0%									
Discount Rate (WACC)	9.1%									
Unlevered FCF				371	3,806					
			Sensitivity Analysis							
					Discount Rate					
Enterprise Value (NPV)	**3,538**			**3,339**	8.0%	9.0%	10.0%	11.0%	12.0%	
			Exit Multiple	7.0	2,553	2,506	2,460	2,415	2,371	
Plus: Cash	146.10			8.0	2,800	2,748	2,698	2,649	2,601	
Less: Debt	345.00			9.0	3,047	2,991	2,936	2,883	2,831	
Equity Value	**3,338.98**			10.0	3,294	3,234	3,174	3,117	3,061	
				11.0	3,541	3,476	3,413	3,351	3,291	
Value of Single Stock	12.28469016			12.0	3,789	3,719	3,651	3,585	3,521	
				13.0	4,036	3,962	3,889	3,819	3,750	

Whether the Merger creates value for Mylan and King

Whether it would be valuable for Mylan

Valuation Model

Enterprise Value (NPV)	**4,111**
Plus: Cash	101.70
Less: Debt	0.00
Equity Value	**4,213**

- Mylan has approximately 101.7 million in cash, no debt
- Its equity value is higher than King's
- King's value of one single stock is $12.3. The price offered by Mylan is too high. Resulting in a premium of $4.4 of every share purchased by Mylan

Conclusion:
The deal is not good for Mylan

Mylan’s DCF

Year			2001	2002	2003	2004	Exit	Terminal Value	
EBITDA				408.40	426.60	512.60		4,921	EBITDA Multiple
EBIT				408.40	426.60	512.60		1,021	Perpetual Growth
Less: Taxes				148.10	154.20	178			
Plus: D&A				-	-	-			
Less: Chg in NWC				299.00	75.40	181.60			
Less: Capex				(1.90)	11.80	94.80			
Unlevered Free Cash Flow				(37)	185	58	4,921		
EBITDA Multiple	9.6								
Terminal Growth Rate	2.0%								
Discount Rate (WACC)	7.7%								
Unlevered FCF				(37)	185	4,979			
Enterprise Value (NPV)	4,111								
Plus: Cash	101.70								
Less: Debt	0.00								
Equity Value	4,213								

Sensitivity Analysis

		Discount Rate				
	4,213	8.0%	9.0%	10.0%	11.0%	12.0%
Exit Multiple	7.0	3,121	3,040	2,961	2,885	2,812
	8.0	3,528	3,435	3,346	3,260	3,177
	9.0	3,935	3,831	3,731	3,635	3,542
	10.0	4,342	4,227	4,116	4,010	3,906
	11.0	4,749	4,623	4,501	4,384	4,271
	12.0	5,156	5,019	4,887	4,759	4,636
	13.0	5,563	5,414	5,272	5,134	5,001

How should both companies vote for the merger?

- Shareholders of Mylan: vote against
- Shareholders of King: vote for

What is the value of anticipated synergies?

Mylan's Offer			**VS**	Fair Offer we Calculated			
cost of synergy (million)		100		cost of synergy (million)		100	
tax rate		36%		tax rate		36%	
post tax		64		post tax		64	
mylans PE ratio	exhibit 7	16.95		mylans PE ratio	exhibit 7	16.95	
mkt capitalisation (million)		**1084.8**		**mkt capitalisation (million)**		**1084.8**	
mylans offer		16.65		mylans offer		12.28	
kings price		10.37		kings price		10.37	
total shares		271800000		total shares		271800000	
total premium of acquisiton (million)		**1706904000**		**total premium of acquisiton (million)**		**519138000**	
profit or loss		-622104000	Loss of 622 Million	profit or loss		565662000	Profit of 565 Million

Why does it make sense that beta of Mylan is lower than beta of King?

- Because the King’s equity is more volatile than Mylan’s equity.
- “High risk-high return” principle : If the venture where investment is required has a high level of risk, the return required by the investor would also be very high to compensate the risk. In this case, we see that King has higher level of risk.
- Mylan has more stable cash flow → reduced risk of bankruptcy → lower cost of capital

Is Mylan overpaying? Could undervaluation of King make up the difference?

If Mylan offers to **pay $16.659** to acquire King then they are overpaying. Mylan would be paying a **premium of about $6.52**. This would also lead to **loss of ~ $622 million in Synergies**.

According to DCF calculation the Equity value of King is $3398.98 million and number of outstanding shares are 271.8 million. Therefore the value of stock is $12.28.

If Mylan and King agree to the deal on calculated **fair value of $12.28 or lower**, then undervaluation of King can make up the difference as this will **result in positive synergies of about $565 million.**

What would the EBITDA multiple be if the acquisition was consummated at the offered price?

EBITDA multiple for Kings		
total shares	271.8	
share price - offered price	16.659	tot share* price per share
market capitalisation	4527.9162	
LT debt (from exhibit 1)	345	
cash and cash equivalent (from exhibit 1)	146.1	
Enterprise value	4,726.82	Mark capitalization + Long Term Debt - Cash and Cash Equivalent
EBITDA	288.3	
EBITDA multiple	**16.39547763**	EBITDA Multiple = Enterprise Value / EBITDA

Perry Capital is trying to achieve:

"Empty Voting"

Background

- Perry Capital had already established a large position in King's stock.
- As a result, Perry has a large economic stake in the transaction if the transaction is completed and a significant economic exposure if the transaction failed.
- When Icahn acquired 9.8% of Mylan stock and publicly opposed the merger (Mylan is paying too much), Perry protects the investment by establishing 9.9% "empty voting" position, that insulated Perry from the economic risks of its ownership of Mylan stock. (ie; **Perry hedged out its economic exp to mylan's share price using derivatives**)

What is “empty voting”?

“Empty voting is a generic term embracing a variety of factual circumstances that result in a partial and often total separation of the right to vote at a shareholders' meeting from beneficial ownership of the shares on the meeting date”

Basically, a shareholder with reduced risk exposure retains its voting power and its influence in the company, but it does not bear the risk of negative returns.

When do investors “empty vote”?

When shareholders’ interests are no longer aligned with those of the corporations (in this case, Perry Capital to reduce the risk that was associated with an equity investment.).

Why is it bad?

It **undermines shareholder democracy** and **decouples risk and economic exposure**. Not only it is harmful to financial markets and corporations, but It may also reduce the company’s share price.

Risk Management that Perry capital takes

Even though Perry throws costs to establish its “empty voting” position in Mylan, **it would have benefited Mylan shareholders economically if they voted in favor of the merger and the transaction went through.** Moreover, because Perry had no residual economic stake in Mylan, **it did not have any economic exposure if Mylan was, in fact, over-paying for King.**

In sum, Perry acquired its ~10% “empty voting” position in Mylan **to protect its economic stake in completing the merger,** no matter if the transaction was value creating or value diminishing for Mylan’s shareholders.

Thank You!