

Does Merger Deliver Value? A Case of Glaxo Smith Kline Merger

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Abstract:

Mergers and acquisitions often referred to as M&A is also a tool for expanding ones business or get around different laws or regulations such as tax laws or monopoly regulations (Ross et al., 2002). Merger and acquisition (M &A) has been the most debatable issue in the field of management and finance. There are arguments for and against corporate restructuring and mergers. Lambrecht (2005) argued that although M&A activities occur in waves but M&A activities are as a result of the economic environment.

This paper examines whether such corporate marriages long lasting and productive in term of value? We have analyzed the pre and post merger performance of Glaxo Smith Kline by applying the net present value approach of valuation. From the very beginning, Barron's (2000) called this merger as “a marriage of convenience-with lots of tough issues to be worked out ... SmithKline is wedding itself to a slow-moving company with a lacklustre pipeline of new drugs coming to market”. We found that mega pharmaceutical merger haven't delivered value. The stock prices underperform both in absolute and relative terms against the index. The merger has resulted into a substantial R&D reduction and downsizing instead of a potential employment haven.

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1. Background:

“All Marriages are Happy. It’s the life afterwards that creates troubles”

(Anonymous)

A merger or acquisition happens when two or more companies join together, often to share costs, increase efficiency or gain market power. Mergers and acquisitions often referred to as M&A is also a tool for expanding ones business or get around different laws or regulations such as tax laws or monopoly regulations (Ross, Westerfield & Jaffe, 2002). The mergers and acquisition (M&A) wave has become the most debatable issues for investors particularly the regulators and academics. The purpose of this course work is to find the rational for merger in term of management incentives, post merger value creation and industry position of the new entity e.g. merger between Glaxo Wellcome and SmithKline Beecham.

2. Introduction:

GlaxoSmithKline is a UK based second largest pharmaceutical & healthcare company in the world Headquartered in the UK and having listing on both New York stock exchange and London stock exchange. GSK is one of the industry leaders, with an estimated seven per cent of the world's pharmaceutical market; GSK is the only pharmaceutical company researching both medicines and vaccines for the World Health Organization’s three priority diseases HIV/AIDS, tuberculosis and malaria.

GSK employs over 100,000 people, has more than 80 manufacturing sites in 37 countries, and makes almost four billion packs of medicines and healthcare products each year. GSK spends £8 million (US\$14 million) on research and development each day – that’s around £300,000 (US\$562,000) every hour (GlaxoSmithKline, 2008). Moreover in 2007 the turnover decreased from 23.2 % in 2006 to 22.7 % a very challenging year for the company as GSK unexpectedly faced a severe decline in sales of *Avandia*, the second biggest product (GlaxoSmithKline, 2007).

3. Glaxo Wellcome:

Glaxo originates in New Zealand, where it was founded in 1873 by Joseph Nathan. Glaxo already knows the merger game as before Glaxo welcome was created in 1995

when Glaxo took over Wellcome for £9bn, in what was then the biggest merger in UK corporate history.

Wellcome Foundation was financing medical research and was established in 1936, Wellcome owned a 40% stake in Zantac, Glaxo struggled to find a replacement for its blockbuster, whose patent has expired in the US, and for Zovirax, Wellcome's anti-herpes drug which has already become available without a prescription. (BBC News, 2000). However before this Wellcome has rejected this \$14 billion unsolicited takeover offer (Stevenson, 1995)

4. SmithKline Beecham:

The mergers wave in the pharmaceutical industry started Late in the decade of 1980 when SmithKline Beckman and Beecham merged. SmithKline Beckman itself was the result of the 1982 merger of SmithKline (originally Smith, Kline & French) and Beckman Instruments (Hand, 2000). Authors like Bauman et al. (1997) categorize this merger as 'Merger of equal' because both companies had equal capitalization of £3.5 billion.

SmithKline was unable to restore the income from its core drug, *Tagamet*, but had an aggressive sales force in the US. Beecham, a consumer goods Company, got success in its early research attempt on antibiotics, but had no competencies to become a major pharmaceutical player. Their merger resulted in an organization with a international marketing presence. Glaxo's acquisition of Wellcome produced only short-term savings but no long-term growth.

5. The Consolidation:

In January 2000, Glaxo Wellcome and SmithKline Beecham announced their \$76bn proposed merger and shareholders approved by 99 per cent majority of shareholders, which was expected to give the combined company a global market share of 7.3 per cent and an R&D budget of \$4bn. Sir Richard Sykes became the non-executive chairman, while Jean Paul Garnier became the CEO of the GlaxoSmithKline under

the new corporate governance structure. Theoretically it was a horizontal merger. (See Appendix).

6. Why they merged?

In the first sentence of their famous book on merger Bauman et al. (1997) stated that “when individuals seek personal change in pursuit of a higher goal, it often means they must change a particular mindset, learn from others about how they succeeded, or acquire some new skills”. Although Lambrecht argued that although M&A activities occur in waves, but M&A activities are as a result of the economic environment. Thus it seems that GSK merger was part of the pharmaceutical merger wave, but keeping in view (Economic environment) future prospects and growing market potential pharmaceutical firms started looking for partners, because the growing trend in the industry could affect their future cost.

R&D investment was rising with increasing proportion to sales from \$20 billions in 1990s to \$35 billion in 1999. Similarly huge capital expenditures like R&D specially in genetic medicine have along and uncertain payback and firm believed that only large size firm can do so. Another reason was patent expiration as patent expiry can reduce innovator sale up to 80 percent, hence it was argued that merging research laboratories and product pipelines would result into added knowledge from which potential blockbuster drug could emerge (Heracleous and Murray 2001).

CEOs of both companies declared that merger will improve the two groups’ ability to generate sustainable long-term growth and is expected to enhance shareholder value in an increasingly competitive environment. They also added that the deal will also result into a substantial operational cost savings (GlaxoSmithKline, 2000). Similarly drug companies also needed marketing muscle to sell their medicines.

7. Terms and Conditions of the Merger:

Copeland et al. (2004) stated that the mode of payment for the target company shares may be either cash, stock or hybrid securities, however Martin (1996) found that firm with higher growth opportunities prefer stock as a mode of acquisition. Keeping in

view the underlying growth, GlaxoSmithKline plc acquired the whole of the issued share capital of Glaxo Wellcome plc and SmithKline Beecham plc in exchange for shares in GlaxoSmithKline plc. Under this arrangement shareholders of Glaxo Wellcome plc and SmithKline Beecham plc received shares in GlaxoSmithKline plc as follows:

For each Glaxo Wellcome share – 1 GlaxoSmithKline share

For each SmithKline Beecham share- 0.4552 GlaxoSmithKline Shares (See appendix for detail).

However GlaxoSmithKline plc issued 6,222,462,894 ordinary shares of 25p each at par on the merger date to acquire 3,653,435,656 ordinary shares of 25p each of Glaxo Wellcome plc and 5,643,732,950 ordinary shares of 6.25p each of SmithKline Beecham plc. The nominal value of the shares issued was £1,556 million and the market value of the shares at that date was £119 billion. (GlaxoSmithKline, 2000).

8. Methodology:

NPV, the simplest method of valuation is used. Under the NPV approach the present value of both firms is calculated individually before merger and it is compared with the present value of combined entity after merger. If the gain is positive the economic justification for merger exist (Myers et al, 2006)

$$\text{GAIN} = \text{PV}_{\text{GSK}} - (\text{PV}_{\text{GW}} - \text{PV}_{\text{SK}})$$

$$\text{PV}_{\text{GSK}} = 85,000,000,000 / (1.05)^3 = £66,599,701,000$$

GSK market capitalization for the year of 2003 is £85 billion. (GlaxoSmithKline, 2003)

$\text{PV}_{\text{GW}} = \text{Glaxo Wellcome Share price month before merger (Quoted Price)} * \text{Number of Glaxo Wellcome's shares on December 27, 2000}$

$$= 17.5 * 3,653,435,656$$

$$= £63,935,123,980$$

$\text{PV}_{\text{SK}} = \text{SmithKline Share Price month before merger (Quoted Price)} * \text{Number of SmithKline' shares on December 27, 2000}$

$$= 7.9 * 5,643,732,950$$

= £44,585,490,305

COST= Percentage of ownership acquired in SmithKline of total new common stocks * $PV_{GSK} - PV_{SK} = 41.25\% * 66,599,701,000 - 44,585,490,305$

= - 17,113,113,643 GBP

GAIN = $PV_{GSK} - (PV_{GW} - PV_{SK}) = - 41,920,913,285$ GBP

NPV = GAIN – COST

= - 41,920,913,285 – (- 17,113,113,643)

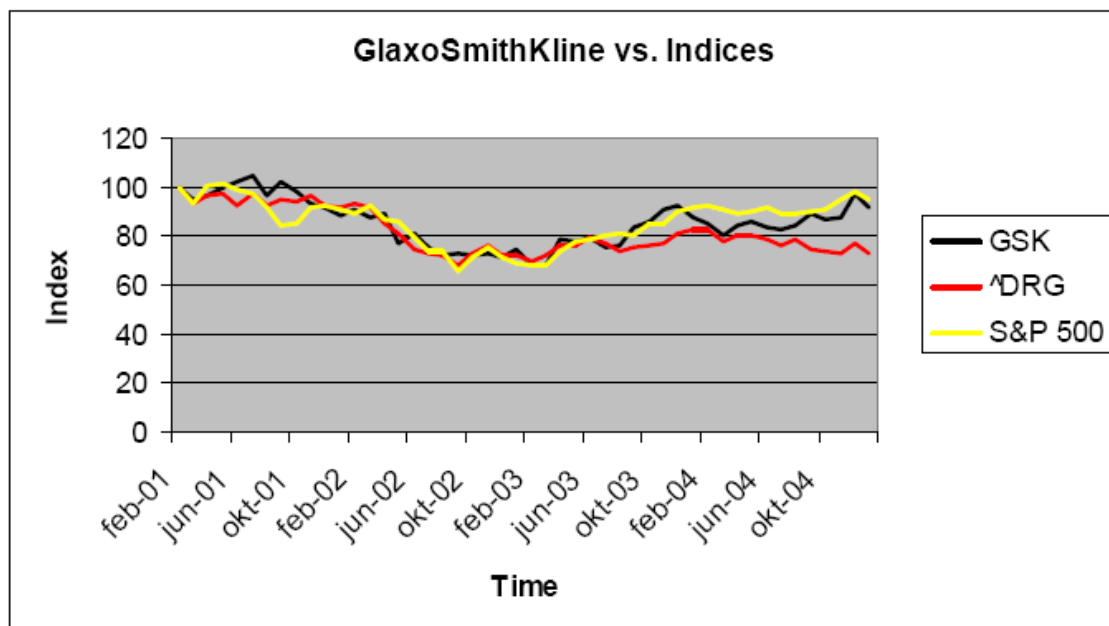
= - 24,807,799,642 GBP

9. Results and discussions:

9.1 Have this merger created value to shareholders?

Even at the time of merger many analyst citizen the future prospects of Glaxo SmithKline merger as (Barron's, 2000) called this merger as “a marriage of convenience — with lots of tough issues to be worked out ... SmithKline is wedding itself to a slow-moving company with a lacklustre pipeline of new drugs coming to market”. After two and half years cost savings had in fact amounted to £1.8 billion by 2003, cost reductions had taken GSK trading profit margin to 35 per cent. GSK has under-performed the FTSE All-Share Index, S&P by any measure, relative or absolute, this company is not doing well. Compare to pre acquisition stock

Figure 1 : GlaxoSmithKline post merger Performance against Index.



Shareholders were not happy as most pharmaceuticals linked their CEO's pay to share-price movements; they considered that short-term stock price performance was a poor reflection of management quality and ultimately they vote against the proposed remuneration scheme. At the end of 2003, the share price was trading just above £13 per share while, at the same time, many employees were demoralized as they had found the remuneration debacle terrible.

10. Conclusion and Recommendations:

Recent research on mega pharmaceutical merger shows that they haven't delivered value. The stock prices underperform both in absolute and relative terms against the index. Besides this previously executive remunerations were based on stock performance, which was supporting short termism on the part of management.

Contrast to that company has substantially reduced the cost \$1.8 a year, to be comprised of combining their R&D operations, manufacturing consolidation and substantial headcount reduction. Any how the debate of value creation in future is still questionable.

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Appendices:

1. Mode of Payment:

In the case of shares held as American Depository Shares (ADSs) evidenced by American Depository Receipts (ADRs), each Glaxo Wellcome ADS represented two Glaxo Wellcome shares, each SmithKline Beecham ADS represented five SmithKline Beecham shares and each GlaxoSmithKline ADS now represents two GlaxoSmithKline shares. Accordingly holders of Glaxo Wellcome ADRs and holders of SmithKline Beecham ADRs receive:

For each GlaxoWellcome ADS- 1 GlaxoWellcome ADS

For Each SmithKline Beecham ADS- 1.138 GlaxoSmithKline ADS

On the merger date GlaxoSmithKline plc issued 6,222,462,894 ordinary shares of 25p each at par to acquire 3,653,435,656 ordinary shares of 25p each of Glaxo Wellcome plc and 5,643,732,950 ordinary shares of 6.25p each of SmithKline Beecham plc. The nominal value of the shares issued was £1,556 million and the market value of the shares at that date was £119 billion. (Annual report, 2000).

2. Accounting for Merger

Reflecting the intentions and the respective sizes of the merging parties, the combination of Glaxo Wellcome plc and SmithKline Beecham plc has been treated as a merger at 27th December 2000, under UK GAAP.

Under merger accounting, the shares issued by GlaxoSmithKline plc to acquire Glaxo Wellcome and SmithKline Beecham are accounted for at par and no share premium arises; the shares acquired by GlaxoSmithKline in Glaxo Wellcome and SmithKline Beecham are similarly accounted for at the nominal value of the shares issued. In the consolidated accounts of GlaxoSmithKline, the results and net assets of Glaxo Wellcome and SmithKline Beecham are combined, at their book amounts, subject to the alignment adjustments discussed below.

Each of GlaxoSmithKline plc, Glaxo Wellcome plc and SmithKline Beecham plc has an accounting reference date of 31st December. In view of the proximity of the merger date to the financial year-end date, and the relative insignificance of any business activity between 27th December 2000 and 31st December 2000, the

accounting date of the merger has for practical purposes been taken as 31st December 2000. The whole of the profit for the financial year 2000 of each of Glaxo Wellcome plc and SmithKline Beecham plc is deemed to relate to the period prior to the merger date. (Annual report, 2000).

3. Consolidation adjustment:

Royalties paid by Glaxo Wellcome to SmithKline Beecham have been eliminated on consolidation, a hard copy of consolidated balance sheet is attached.

4. List of abbreviations:

AIDS:	Acquired immune deficiency syndrome
CEO:	Chief Executive Officer
GSK:	GlaxoSmithKline
HIV:	Human Immunodeficiency Virus
M&A:	Mergers and Acquisition
R&D:	Research and Development
S&P:	Standard and poor
FTSE:	The Financial Times Stock Exchange index