

Philip morris inc.:
seven up acquisition
(a) essay sample



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This case discusses Philip Morris Inc. intentions to acquire the Seven-up Company in an effort to diversify their consumer goods. The decision has already been made, however they must decide on an offer price to buy out the company. This report will discuss PM's acquisition strategy and its appropriateness, along with whether or not 7up fits the criteria of PM's strategy. The report will further discuss the methods used to determine the maximum amount that Philip Morris should pay for 7up, while also going into detail about the minimum price 7up should accept as a buyout.

Philip Morris Acquisition Strategy

Philip Morris bases its acquisition strategy off several principles that it follows. They seem to have a corporate strategy that attempts to diversify its operations by adding new and different businesses to the company. PM targets large and strong companies within various markets and industries. These companies should be able to greatly contribute to PM as a whole. PM derives most of its business from the cigarette industry, which generates large and steady cash flows for the company. This allows them to acquire companies that may not have high returns in the beginning, but seem to have a hopeful long term potential. They are allotted the ability to take a hit in the short term without completely ruining themselves. Further, PM is attracted to companies that produce consumer goods and expect to utilize their already existing marketing expertise to make their new acquisition grow even more than is expected. These conditions mean that PM is seeking the acquisition of companies that are significant players within a strong and attractive consumer goods market. Does 7up fit the strategy?

These criteria match with the acquisition of 7up. First, PM seeks to diversify existing business operations. Acquiring 7up would allow PM to enter the beverage market, which they have yet to be a part of. Next, PM is attracted to companies that are strong and hold a significant position within an industry. 7up meets this criterion because it holds the third largest share of the beverage market. 7up makes up 7.2% of the market, following Coca-Cola with 33.9% of the market and Pepsi with 22.3%. In regards to the third part of PM's acquisition strategy, 7up does not expect to shrink anytime soon, however there is potential to grow significantly in the long term. PM has the ability to acquire 7up and wait for it to grow within the soft drink market.

PM seeks companies within consumer goods market in order to synergize marketing expertise with the hopes of expansion. 7up is in a market that is strong within the consumer goods area, while also having strong seasonal demands, such as summertime when demands rise. Also, PM's marketing expertise would be beneficial to 7up because it would allow them to have more spending on the sector. In 1977, 7up only spent \$14.7 million on media and marketing, while Coca-Cola and Pepsi spent more than twice that amount. PM would allow 7up to be more competitive in terms of marketing and media spending.

Minimum price 7up should accept

The minimum price that 7up should accept from PM is the fair market value of the company before its acquisition. In order to calculate the FMV of 7up, we first projected their sales for the next eleven years by using a growth rate of 8%. This rate was calculated from information given to us in the case. We

were told there would be 6% industry growth rate and that 7up would have a rate that would be 2% higher than the industry. By using data from the previous year, (1977) and the percent of sales method, we were able to determine gross profit, EBIT, capital expenditures, and net working capital for those eleven years. Next we calculated the weighted average cost of capital for 7up. In order to do so, we used a risk free rate of 7.89% along with a risk premium of 5% and an 11.6% interest rate on debt. The risk free rate was based off of historical data for 10-year treasury bonds, while the risk premium was an average of 4.5% and 5.5% estimations that were stated by Higgins.

Lastly, the interest rate was calculated by dividing interest expense by long-term debt for the company. These numbers, along with equity and debt data given to us in the case, resulted in a WACC of 13.89%. The next step was to calculate the free cash flows for the eleven-year period. In order to do so, we used the following formula: $FCF = EBIT(1 - \text{tax}) + \text{depreciation} - \text{change in NWC} - \text{CapEx}$. From here, we used the WACC of 13.89% previously calculated, in order to find the present value of each FCF. Next, the terminal value at year ten was calculated. The following formula was used to do so: $\text{terminal value at year 10} = (\text{FCF at year 11}) / (\text{WACC} - g)$. This time we used the long-term growth rate of 7up, which was given by the case as 1% less than the industry rate. This resulted in a terminal value of \$848M with its present value calculation being \$231M.

In order to calculate the FMV of 7up, we took the sum of FCF present value, which equaled to \$248M, and added it to the present terminal value of

\$231M. This resulted in a fair market value of \$479M. This is believed to be the minimum amount that 7up should accept as an offer from PM.

Max price

In order to find the maximum price that PM should pay for 7up, we once again calculated the fair market value of 7up, however this time we used PM's expected growth rate of 14% and applied that to 7ups sales. This rate was used in order to calculate the expected sales of 7up after its acquisition, and therefore allow us to calculate the cash flows of the company under PM management. After forecasting the sales for the next eleven years, with the new growth rate, we repeated the previous steps taken to determine 7ups FMV. We decided that 7up was still its own company so the WACC we used remained the same.

Using the same formula as before for the FCF, we forecasted each years FCF and then again found their present values, using the 13.89% WACC as the discount rate. The present value sum of the FCF came out to \$293M. We then determined the new terminal value at year 10, again using the following formula: terminal value at year 10 = $(FCF \text{ at year } 11) / (WACC - g)$. Using the same rate for g, we determined 7up to have a new PV terminal value of \$369M. We determined the new FMV to be \$662M. This is the maximum price that PM should pay for the acquisition of 7up.