

Fi561 case study: merck



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Case Study: Merck Acquisition of Medco Professor Daniel Weiss FI561 January 23, 2011 Case Study: Merck Acquisition of Medco Abstract The purpose of this case study is to determine whether it would be beneficial to merge Merck Corporation with Medco Containment Services Incorporated. The merger and acquisition between the world's largest drug manufacturer and the largest prescription benefits management company (PBM) and marketer of mail order medicines in the United States would result in a successful campaign to take over the drug industry if handled appropriately.

As Chairman and CEO of Merck Corporation, I have to consider all sides of the arguments, financially, marketing and cultural wise and come to a conclusion as to whether this merger would be a good idea for the company. Like any other investment and merger, there are risks, and I have to decide what would be best in the interest of this company. The details as to whether the decision to acquire or not acquire Medco will be described in this paper. Along with data that helps make that final decision. There are a few things one must take into account before making a decision.

You have to look at the long term run, whether or not the merger and acquisition will be successful. You also have to take synergy into account; it is the most important reason why there are a lot of mergers and acquisitions. Synergy would be when two companies join forces to create additional value and cut costs that would be unnecessary. You would also have to take into account changes in forces, like technological changes, economies of scales, type of merger you want to have and the process it takes to make a decision especially when it comes to a merger and acquisition worth millions if not billions of dollars.

In the case of Merck and Medco, the role of prescription benefits management companies are to “ manage the provision of prescription drugs which include managing insurance claims, negotiating volume discounts with drug manufacturers and encouraging the use of less expensive generic substitutes” (Weston, Mitchell and Mulherin, 2004, p. 124). The management is enhanced through lists of drugs that are compiled by committees or pharmacists and physicians. With Medco’s database, Merck will be able to have an advantage; they’ll be able to identify prescriptions that could be switched from that of a competitor’s to Merck.

The database will also allow Merck to identify patients who fail to refill prescriptions. Medco’s patient record system will also be used a lab with the goal of proving that some of Merck drugs are worth the price. As was stated earlier, there are definitely a few things to consider before the final recommendation is made. We at Merck want to expand and create a competitive advantage that will allow for longer life and survival of the company. We know that managed care is a growing industry and will keep expanding over the years.

It has been estimated that by the turn of the century, 90% of Americans will have drug costs that include some kind of managed health care plan. It’s also been said that 60% of all outpatient medications will be purchased by managed care programs. Some of the responsibilities that PBM companies will have when contracted will be the management of insurance claims, negotiations of discounts with drug manufacturers and managing the lists of drugs that are gathered by pharmacists and physician committees.

The benefits of merging with Medco, which is the largest PBM Company and marketer of mail order medicines in the United States, are convincing to go ahead with this acquisition. By merging with Medco, Merck will have a strong competitive advantage in the drug industry. There are plenty of opportunities that are waiting for Merck if we use the database that Medco has accordingly. That database will help identify possible prescriptions that can be switched to our drugs, when this happens the pharmacists will be suggesting doctors to switch drugs.

The database will also allow Merck to keep track of patients who don't refill their prescriptions; this will help save money since that's millions of dollars lost annually in sales when prescriptions aren't refilled. The marketing sector of the company will also be saving money once and if the acquisition takes place. Looking at Merck's financial statements, the annual consolidated sales are currently at \$27, 428. 3 million and the Earnings Per Common Share are currently at \$5. 5, total assets are currently at \$112, 089. 7 (Merck Annual Report, 2009), stock is currently selling at \$33. 90 per stock and net income is at \$340. 40 million dollars, Medco's current stock price is at \$63. 93, their current sales are at \$16, 319. 80 million, at the moment (Google Finance), Merck are at a good standing to acquire Medco, earnings per share will definitely increase. There is the fear that there won't be synergy or the integration of different organizational designs and cultures might clash.

The premium that will be paid is based on future expectations of synergies. If synergy fails, the premium of \$6. 6 billion dollars will be money lost, so that is cause for concern and have another look at this acquisition. To be able to have a successful merger and acquisition, there are phases that you go

through thoroughly to make sure the right decision was reached. In the book *Valuation: Measuring and Managing the value of Companies*, the authors noted the following (Evans, 2000 P.): “ Even in situations where the acquired company is in the same line of business as the acquirer and is small enough to allow for easy post-merger integration, the likelihood of success is only about 50%. ” That is true, even when it seems like the two companies are a perfect match, there are problems that may arise which will prevent them from forming a perfect union among themselves. As long as the foreseen problems are avoided, there is a good chance the acquisition of Medco would be a successful one. Some of the potential weaknesses would be that more and more pharmacies would partner with other PBMs.

Other companies could follow in Merck’s footsteps and the competitive advantage would dissipate and would have to compete with prices, advertising and marketing which would end the economies of scales and scope of saving costs through synergy. There are three forms of synergy, the first are revenues, which will either increase or decrease when the two companies join forces. The revenue realization should typically be higher once combined. Expenses are the second type, and when the two companies combine, typically these expenses are lower than before, lastly the cost of capital which should also be decreased and lower overall costs of both companies. But the main focus would be on expenses because that is probably the main and most important task of every company when they have a merger or acquisition: cut costs where ever possible. In order for synergy to be completed and successful, Merck would need to make sure that this would be a strategic fit. If both companies have different objectives

and strategies, there will be conflict and tension among each other unless the companies are willing to meet half way and compromise.

Changes in forces are other areas that would need to be looked at and used as an advantage, things like technological changes including computers, computer services, software, advances in information systems and of course the internet. Using these technological advances would help create better synergy and profit. When considering a merger or acquisition, there is a process to go through. The first step is the reviewing process, assessing the position and situations. From there you decide whether to go through with the process.

A reason why a company might consider acquiring or merging with another is because they might foresee difficulty in the future with return on capital or market shares. The company would also have to verify if it is undervalued and whether an M & A would help improve their standing. During the review process, a plan should also be put into place, one that details how through an M & A the acquiring company will develop and grow. This plan should also include who will have what responsibilities and how will information be gathered. The second step is when the acquiring company starts to search for potential candidates.

In Merck's case, the company would have to decide what it's looking for in its target company, Medco. How will Medco help them improve their standing and whether or not it'll be a good fit. Merck will basically be conducting a screening and background check on Medco. The third step would be to start the investigation and valuing the targeted company. In order to determine

whether or not it'll be a good fit, a review of the financial statements will be done, as well as the strategies, operations, marketing and management as well. This would also be known as the due diligence process.

Due diligence can have two parts the first part is started when a target company is selected. In Merck's place its Medco, from there Merck would then consider and figure out how much synergy both companies will have once combined. You calculate this information by taking in the value of Merck and that of Medco, adding them together and then subtracting any costs like legal work and investment banking if it was used, once you calculate this information, the remaining balance would be the Synergy amount that would result in the merger and acquisition with such companies.

Once you've determined whether things would work, you go into the fourth step which is the negotiating process. Here, you would have to consider if the target will put up any resistance, the benefits to acquiring, and figure out a strategy on how to bid and whether you would have to go into tender offer. If an agreement is made, part two of due diligence comes in. Just because there was an agreement in the negotiations doesn't mean things are good to go.

There's still a chance to back out once an intense audit of the target's company and financial statements is made and the acquiring company doesn't like what it found out. In the case of the acquisition of Medco by Merck, taking into considerations of the possible risks the company is taking in case things don't work out, the decision is to go ahead with the acquisition. The concerns of the Chief Operating Officer and Chief Financial

Officers have been weighed in and as Chairman and CEO of the company; I believe that it's safe to go on with the acquisition.

It's a great opportunity, and by not taking a chance, we are risking more. We can have a competitive advantage because you are combining the largest Pharmaceutical Researcher and manufacturing company with the largest PBM in the United States. This will help the company expand organizational boundaries and will also add value to operations. This type of merger will be considered as a vertical merger, which are usually done for competitive advantages and that's exactly our case here, we are trying to make Merck the number one distributor.

Instead of having a full integration once this M&A happens, Medco will become a subsidiary of Merck Corporation. With their database, the threats and weaknesses that we have will decrease, they'll help us determine how to switch from competitors drugs to ours as well with the marketing strategies, and the market share of Merck will increase. Strategies that could be put into effect once this M&A is completed are: reducing health care costs through better use of cost effective drugs, the technological changes like the internet would be a major asset to the company now with online ordering and tracking.

We could also figure out some sort of pattern within the database clientele and orders which will help us create a better strategy for that. There could be some sort of compensating program for the pharmacists who help and contribute. Since this will be the combination of two of the largest companies within the same field, Merck and Medco will be able to service millions,

working with patients, doctors, health care, pharmacies, etc. The mission will be to reduce medical costs for patients, improve patient care quality through improved management of the prescription drugs.

The strengths of this acquisition would first start with converting Medco into a subsidiary. There will also be cost saving and management capabilities, advances of information technology used to our advantage, creation of better communication with customers which would then improve our supply chain coordination, and increase control. The major force that is driving this acquisition as was stated earlier was so Merck Corporation could obtain the upper hand and have a competitive advantage. It's beneficial for Merck to commit to this acquisition, especially with the extensive database Medco possess that includes over 33 million customers.

Among them are Fortune 500 companies, Federal and State benefits plans, insurance companies, etc. Even if other companies try to imitate us once we announce this merger, it is still considered the best option for the company at the current moment. Alexandra Reed Lajoux says something in her book *The Art of Merger and Acquisition Integration* that describes it best when it comes to mergers and acquisitions and the reality behind them (Evans, 2000, P. 1): Virtually every major company in the United States today has experienced a major acquisition at some point in history.

And at any given time, thousands of these companies are adjusting to post-merger reality. For example, so far in the decade of the 1990's (through June 1997), 96, 020 companies have come to under new ownership worldwide in deals worth a total of \$3. 9 trillion- and that's just counting acquisitions

valued at \$5 million and over. Add to this the many smaller companies and nonprofit and governmental entities that experience mergers every year, and the M&A universe becomes large indeed. References Evans, M. (2000, March). Course 7: mergers & acquisitions (part 1).

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