Fairness Opinion for the Acquisition of a Development Stage Pharmaceutical Company

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In August of 1995, a manufacturer of diagnostic medical tests (the "Acquirer") proposed to acquire a developer of transdermal drug delivery systems (the "Target"). Consideration consisted of a $12 million swap of common shares and the assumption of a $5 million promissory note issued previously by the Target, resulting in a total purchase price of $17 million (the "Offer"). The Offer was based on quoted stock prices for the two public companies during the most recent 30 days. Although receptive to the Offer, the Target's Board of Directors (the "Board") recognized the existence of certain issues that might foment contention upon completion of the Transaction. Thus, the Board retained the San Francisco office as an independent financial advisor ("the Firm"), to examine the terms of the Offer and to opine as to the fairness of the transaction from a financial perspective.

Issues and Considerations

As a consequence of the Target's tenuous financial condition, the Board held very little negotiating power near the date of the Offer. Regardless, the stockholders expected the Board to solicit and review competing offers, and to pursue only those offers deemed to be fair. As is true of most development stage pharmaceutical companies, the Target generated no significant revenues or net profits, but consumed considerable cash in advancing its research and products. Nearly all of the Target's cash had been depleted by the Offer date, and the Target had only enough cash to meet working capital needs for another 11/2 months. The Board and the Acquirer were well aware of the Target's predicament. The Board might be persuaded to accept terms that would preserve the company, but that would not be equitable to the existing stockholders. Also, the Board might agree to the Offer without conducting a thorough investigation of possible alternatives.

In accepting the terms of the Offer, the Board would be expected to justify a significant departure from the typical terms of a round of financing for a pharmaceutical company. Specifically, the Acquirer sought to purchase the entire company, rather than the more common practice of buying a percentage of the company. Further, the terms of the Offer would dilute the Target's existing stockholders without providing an immediate cash infusion. The Offering involved payment using the Acquirer's stock, a non-cash asset. Corporate transactions involving pharmaceutical companies typically entail various rounds of cash infusions, which are necessary for advancing products through development phases. Once cash from a prior round of financing is exhausted, research will cease without a new capital infusion. Thus, the survival of the Target and its products was the fundamental reason for sharing equity with outside investors.

Stockholders who purchased the Target's shares near the date of the IPO (about seventeen months earlier) paid approximately five times the per-share price offered by the Acquirer. Although the Offer was based on recent trading prices for the two companies, the Board was concerned that the per-share Acquisition price would have the appearance of being unfair to existing stockholders.

The Board was aware of certain anomalies in the Target's historical stock price and believed these stock price movements were associated with stock manipulation by certain traders and brokers. The Board was concerned that the looming menace of stock manipulation might undermine the transaction, or challenge any reliance upon the quoted stock price as an accurate measure of the stock's fair market value. The Target's stock price movement typified that of many development stage pharmaceutical companies in that the per-share stock price was low and was very volatile. Trading volume was thin and sporadic. Thus, an averaging of quoted stock prices was not necessarily representative of the fair market value of the Target's stock on the Offer date.

According to the terms of the Offer, the Target would exchange its stock for the Acquirer's stock, which was rapidly increasing in price. If the Acquirer's stock were inflated and subsequently corrected in the market, the existing investors might fault the Board for accepting a stock swap in lieu of a cash transaction. When viewed differently, such a correction in the Acquirer's stock might imply that the Target's stockholders were underpaid for their shares. In contrast to the Target's stock, the Acquirer's stock price on the date of the acquisition announcement had grown to four times its IPO price, as offered about seven months earlier.

Analysis and Conclusions

After valuing the Target's common stock, the Firm determined that the Target's weak bargaining position did not result in an unfair offer being made by the Acquirer. During the months before the Offer, the Board fulfilled its fiduciary duty to solicit and consider competing bids, but no other reasonable offers were submitted. The pricing of the Target's stock, as implied by the terms of the Offer, was consistent with the fair market value of the Target's stock, as determined through an independent valuation analysis conducted by the Firm. The Target's Board and Officers actively sought other financing sources and strategic alliances. Less than a year before the Offer date, a Canadian company suspected that the Target was in dire need of cash, and that the Board would not refuse any offer. Ultimately, the Target rejected a very low bid made by the Canadian company.

Although the terms of the Offer were atypical, the Acquisition met the objectives of both parties without unnecessarily diluting the Target's present stockholders. Companies having complementary lines of business will occasionally merge or form strategic alliances to promote information sharing and to achieve other mutual benefits, and such was the case for the parties to the Acquisition. The Acquisition would create a strategic alliance between the Target and a vigorous company that had a vested interest in the success of the Target. Although no additional cash was provided directly through the Acquisition, the parent would provide working capital, as needed, to sustain its new subsidiary's R&D projects.

Although the per-share price offered was a fifth of the price paid by investors near the Target's IPO, the per-share price was representative of the fair market value of the Target's stock on the Offer date. In addition to valuing the Target's stock, the Firm created a stock price index (the "Index") composed of publicly traded pharmaceutical companies that had products and R&D projects that were similar to that of the Target. During the eight-month period after the Target's IPO, the Index dropped to approximately 60% of the Index value on the IPO date. This general decrease in the market pricing of similar pharmaceutical companies explained, in part, the drop in the price of the Target's stock.

The Firm concluded that the Target's IPO price was not representative of its stock price on the date of the Offer. Market forces had quickly converged on a lower price and remained near that price during the twelve months prior to the Offer date. Since the Acquirer's stock price was increasing rapidly, the stock-swap transaction exposed the Target's stockholders to a potential loss in value in the event of a subsequent correction in the Acquirer's stock price. In the alternative, the Target's stockholders would benefit from any further increases in the stock of the combined company. In addition, the Acquisition provided the Target's stockholders with stock that was more liquid and that had greater float. The increase in the Acquirer's stock price correlated highly with the rapid, continual growth in the aggregate market for equity securities through August of 1995. Also, several significant events (e.g., positive test results) had occurred since the Acquirer's IPO, and these achievements increased the prospects and fundamental condition of the Acquirer. The Acquirer's stock price rose accordingly. With heavy trading volume, the market appeared to support the Acquirer's quoted stock prices. Consequently, the swap-rate was based upon market dynamics that provided a reliable indication of the fair market value of the Acquirer's stock, thereby facilitating an important aspect of the fairness analysis.