INITIAL PUBLIC OFFERING VALUATION AND UNDERWRITING ISSUES FOR PHARMCORP, LLC – A CASE STUDY

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This hypothetical case study assesses whether Pharmcorp should issue an initial public offering through underwriters on a commission or guaranteed price basis. Senior and graduate business Students are also required to determine its cost of capital and the value of the firm before competitive bids are solicited from investment bankers and recommend solutions.

Pharmcorp is a closely held pharmaceutical company that has been owned and operated by family members and friends most of whom are renowned medical research scientists. The owners were able to use their skills, talents personal fortune from their previous work experience to set up state of the art research and manufacturing facility. Over the past 10 years, their company has been successful in obtaining a number of patents for its products while another breakthrough drug is in the pipeline waiting final approval by the FDA. The company has, so far, been able to extract economic rent from its proprietary drugs and faces no threat of competition in the immediate future.

As the company's operations grew rapidly both in size and complexity, the need for substantial financial and human resources has become dire than ever. On a different front, some tension has also started brewing among the owners as to how the value and the benefits from its potential growth opportunities could be divvied up and determined. The owners were left with no better choice but to take their company public to address these issues.

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Pharmcorp Inc. is a closely held company owned and controlled by a group of family members and friends most of whom are medical doctors with stellar medical research credentials. The owners were able to use their skills and talents from their previous experience in their newly formed company and establish their credentials from the get go by setting up state of the art research lab and manufacturing facility. As a result of their concerted effort, their company has been successful in obtaining a number of patents for its pharmaceutical drugs by the Food and Drug Administration (FDA).

The rising demand for its existing products as well as its potential to obtain a new patent for a highly promising drug that it has applied for is causing capacity constraints in its existing manufacturing facilities.

Over the past ten years, the company has been growing its revenues and its operating profits by a compound annual growth rate of 20 and 25 percent, respectively. Its net profit margin has also

consistently been above 10 percent each year. Moreover, the company was able to generate and grow its free cash flows (FCF) by more than 15 percent each year. These financial metrics are above average for the industry. The income statement for the 2009 and 2010 and additional data are provided in tables 1 and 2.

While the company has been expanding rapidly, year over year, and its prospects, going forward, looks good and the threat of competition for its products does not appear to be too severe. The company has, so far, been able to extract economic rent from its proprietary drugs and will continue to do so into the foreseeable future. The owners are, however, feeling the pinch from the financial pressure needed to keep up with the blistering pace of the company's growth trajectory.

As the company grew in size and complexity, some tension has also started brewing on a different front among the existing founding members as to how the value of the firm and the benefits from its potential growth opportunities could be divvied up and determined fairly. The case is much more complicated since the owner managers operate at different capacities and their relative contribution as well as productivity varies greatly. They are all convinced that the performance measures from the financial reports do not reflect such distinction. After much deliberation and in the interest of unlocking the potential value of the firm, they each agreed on using the market as the final arbiter to determine the value of the firm through the issuance of an initial public offering.

It has been a while since the owners have realized the constraints the company has been facing in terms of its human infrastructure and its need to hire more skilled labor, especially scientists, and expand their research and development facility. The company's challenges have, however, currently become even more acute with the advent of a new drug that could be added to its existing product line. This requires tremendous resources and streamlining of the firm's production capacity.

In order to capitalize on the company's future growth opportunities, its proven track record of profitability and widely accepted and renowned products, the owners finally reached a decision to explore the possibility of hiring an investment banker to go public. They were, however, hesitating whether they should only seek and use the advice and assistance of an investment banker to raise the maximum amount of money through an initial public offering or otherwise solicit competitive bids for a guaranteed offer price from a number of underwriters. The owners also expressed their willingness to either maintain a controlling interest or even relinquish control and assume a minority stake in the company, as the case may be, to advance and promote the long-term goals of their company.

As word of the company's pending plan was leaked to the press, a major brokerage firm, which had prior knowledge about the company's success story, approached the owners and expressed its interest to underwrite the entire issue for a guaranteed offer price of $13.50 per share. It also expressed its willingness and interest to raise as much money as possible by soliciting the best price from the investing public on a commission basis.

Early in 2010, Harold Marcus, the chief financial officer for Pharmcorp Inc. was given the task of assessing what the company is worth before considering any underwriters' offer. In order to determine the value of the shares, Harold came up with a very conservative estimate of the free cash flows (FCF) to be generated by the company over the following four-year period. Based on the company's past performance and its future prospects, free cash flows are expected to increase

by 20 percent each year for 2011 and 2012 and 10 percent each year for 2013 and 2014 from the actual level in 2010. The key values used to assess the company's worth are given as follows:

$Year_t$	FCF_t (000's)
2011	$631
2012	759
2013	833
2014	917

Harold also estimated an annual growth rate in free cash flows, beyond 2014, of 5 percent into the foreseeable future. This is slightly lower than the industry average.

The company has two outstanding loans, a $1 million, 6% coupon, due in 5 years and a $2 million, 8% coupon, due in 20 years, interest payable semiannually. If the company goes public, it has the opportunity, to raise more capital for its expansion needs by issuing bonds of similar risk at much lower yields of 4 and 6 percent, respectively. The company does not, however, have immediate plans to do so.

Since Pharmcorp is not a publicly listed company, Harold plans to use the weighted average cost of capital for its peers of 13 percent as a reasonable discount rate for his company's future cash flow streams. The average cost of equity for the industry is 15 percent. Harold is confident that because of his company's proven track record of operating performance, he could possibly raise equity under better terms. The company has plans to issue 500,000 shares.

Senior or graduate finance students are required to fill in the shoes of the chief financial officer, Mr. Harold, and address the following questions and recommend solutions.

1. Mention and justify at least three alternative valuation models that the company can use to determine the value of the company. Which of these models is the most plausible?
2. Determine the actual free cash flows generated by the company for 2009 and 2010.
3. Assess the weighted average cost of capital that Pueblo Pharmcorp could have used to discount its future cash flows other than the industry average. Based on your results, discuss the pros and cons of using the industry average.
4. Determine the overall value of the company. Provide all the relevant assumptions under which such value could be realized
5. What are the market value of the company's common shares and its outstanding debts?
6. Determine the highest possible offer price that the firm may obtain from its IPO.
7. Should the owners accept a guaranteed offer from the underwriting firm or solicit other bids? Discuss briefly if this is a good strategic approach.

8. Should the company only seek advice and assistance from an underwriting firm in promoting its IPO as against receiving a guaranteed offer? What are the risks associated with such strategy?

9. Are the owners' concern about determining the relative value of their ownership interest justifiable? How does the market serve as the final arbiter for the allocation of capital between the owners?

10. Assess the company's prospects in its ability to raise a substantial amount of capital to meet its expansion needs. Provide convincing arguments from the case why the market may or may not be receptive to absorb all the shares offered in its IPO.

Table 1

Income Statement

	2009 ($000's)	2010 ($000's)
Net Sales	2,958	3,550
Cost of Goods Sold	1,775	2,110
Gross profit	1,183	1,440
Operating Expenses	355	450
Depreciation	100	100
Earnings before Interest and Taxes	728	990
Interest Expense	220	220
Taxable Income	508	750
Taxes (30%)	152	225
Net Income	356	525

Table 2

	2009	2010
Increase in Capital Expenditure	150	250
Increase in Net Working Capital	74	89
Average Beta for the Industry		1.5
Risk free rate		3%
Market risk premium		8%