Professor Crocker H. Liu May 16, 2001
Strategic Options II

Comments

Gaming: Overall, your group did a nice job at explaining Park Place Entertainment's (PPE's) current strategy and what strategies the firm should consider going forward.

Strategy considerations:

- Branding: You might want to consider a softer approach to branding wherein the customers gradually become acquainted with your "new" brand. For example, consider using a hyphenated name initially such as Caesar's – Bally Resorts. You can then switch to the name Caesar's over time as customers get use to the name. This is just a suggestion.

- Cost controls: Please elaborate (see cost controls discussion under Financial considerations below)

- Repositioning properties: On page 55, if you look at the EBITDA per square foot of gaming, Caesar's Tahoe has an EBITDA/SQFT that is 33% to 50% below the other properties (excluding Glory of Rome which is not really comparable because it doesn't have rooms). Does the Tahoe property have rooms or is it only a casino. If it is only a casino, should you consider adding rooms to it? Should the firm keep this property or continue to have a presence in Tahoe? Point: Can anything be done to "juice" the returns on Tahoe?

- Strategic option or simply an alternative: For strategic options #2 - #4, isn't the strategic option to acquire another firm? Buying IGT, etc are merely alternative possibilities. Am I missing something?

Financial considerations:

- Earnings accretion: after each merger, has PPE had earnings accretion? Have the revenue growth and/or cost savings that were announced prior to each merger been realized within one (or two) years after the merger?

- Cost controls: On page 52, you discuss revenues per employee and net income per employee. The difference between these two ratios (which should also be reported and discussed) is the operating expense per employee. You could also provide SGA per employee for each company. This gives us a better idea what the implication is to reducing the headcount by 5,000 people. Related to this, one of your recommendations is to increase advertising as well as have a Marketing exec position. This suggests that rather than "reducing expenses" what you are really doing is reallocating expenses from having more employees to having more marketing. Is this correct? How does this reduce cost? You need to elaborate more

on cost control strategies. As your initial point of departure, do a more detailed analysis of PPE's SG&A expenses. Why are they proportionately higher as a percentage of sales relative to the rest of the industry?

- Optimal capital structure: Although you recognize that PPE's interest burden is partly responsible for their poor financial performance (see page 40), you do not put debt reduction as a strategic option. What is PPE's optimal capital structure? How much should they reduce debt by in order to reduce their interest burden?

- Relative Valuation (page 87): Please do the relative valuation ala our example in class. Among the ratios to use are Total enterprise value (TEV) relative to Sales, EBITDA, and EBIT. Other ratios include Price to TTM EPS, Expected EPS, and Book Value of Equity. (Also look at PEG ratio)

Mutual Funds: Your group continues to improve with respect to refining this project. However, your group still has a ways to go to be on par with some of the other groups such as gaming (above) and drugs (below).

<u>Strategy considerations</u>:

- Alternative to merger: There is no discussion of hiring away the best talent (portfolio managers) from another firm to start a new series of growth funds. This might be a cheaper/more profitable alternative than acquiring Stilwell Financial especially if the investors follow an all-star fund manager like Peter Lynch (like patrons follow a good chef from one restaurant to another restaurant). At the very least, you should consider this option.

- Sell of company: who would be a likely acquirer of this firm? Why? From the acquirer's perspective, is it a NPV positive venture? If not, why would they want to acquire BEN?

- Product line enrichment: You correctly look at net outflows and fund performance e.g. it should be the case that if the aggregate performance of all their mutual funds is performing poorly, investors should be pulling money out of Franklin. However, you relate net flows with contemporaneous returns. This is why your group is surprised that there is no relationship between outflows and performance. What you need to do is relate net flows to lag returns e.g. net outflows in year 2000 vs. performance in 1999. You also need to provide the statistics on page 102 over time so that one has a historical perspective.

- Product line enrichment and incubator funds: You STILL haven't answered my question of how well Franklin's hit rate has been with respect to incubator funds relative to the competition. This is analogous to new product development or R&D in other industries.

Financial considerations:

- Valuation + NPV: The report is STILL missing the relative valuation and absolute valuation calculations. In addition to this, even though you talk about NPV numbers in the text, there are no NPV calculations in your appendix. What assumptions did you use to do the NPV?

- Ratio analysis: This section is too brief. Please elaborate. Also, you STILL don't use the 5 categories of ratios that we discussed in class (see www. Marketguide.com for what these categories are). Why?

Housekeeping chores:

- Charts: Your group needs to put some charts/graphs in the report to accompany your ratio analysis in order to give the reader a better perspective of the situation.

Drugs: Except for the fact that the calculations are not complete (and thus your analysis), your report is definitely going in the right direction. I like how you laid out the ratios on page 72 according to the 5 major categories and the accompanying analysis. You're correct in observing that LLY has to improve its inventory turnover ratio.

Strategy considerations:

- Options at a glance: Is the do nothing option what you are proposing? You need to state up front what your proposed best strategy is as well as other feasible options. Add a decision tree to your report so that I can see your options with the NPVs associated with these options at a glance.

- Increasing sales reps: One recommendation that your group makes is for LLY to increase the number of sales reps. Towards this end, what is the sales per employee (or more preferably sales reps) over time relative to its competitors. Ditto for earnings per employee (or more preferably sales reps).

- Have you considered a merger with AHP as a possibility? Given the LLY already collaborates with AHP and rumors persist that AHP is a potential takeover play (see page 77), have you explored this possibility? You point out that AHP has expertise in areas where LLY has none. It might provide a better fit than the BMY option that you explore. (I know that you said that LLY won't merge with another big pharma, OTC margins are smaller, and M&A doesn't seem to work for big pharma but see if AHP has the synergies to make it work. Also, what is the price for AHP that would make the merger work? Mergers will work at the right price. Especially since drugs are going off patent… if these drugs can be converted to OTC you might have another strategy to consider)

Financial considerations:

- Valuation: The report is missing the relative valuation calculations. Be sure to include the PEG ratio. Please finish up the absolute valuation calculations.

Housekeeping chores:

- Comparison to biotech: What percentage of LLY is the result of biotech?

- Relationship between R&D expenses (lagged one year to 3 years) and Sales. Since LLY has the largest R&D expenses as a percentage of sales for big pharma, you should give the reader some sense of how $1 of R&D translates to $X of future sales. There should be a lagged effect because of the time to bring a drug to market.

Genomics: On page 97, your group claims that "the company is doing fairly well right now." What metrics are you using? It can't be ROA, ROE, or profit margins. Please elucidate.

Strategy considerations:

- M&As in the past and going forward: In any M&A, one question that arises is what to do with the management of the target firm. Has MDCC kept the management of the target firm? Why or why not, especially if they don't have the core competency in this area? A more important question is that if you look at ROA for MDCC, it has been DECLINING over time going from 14.2 in 1995 to –1.8 in the last twelve months. Ditto for MDCC's profit margin. Isn't this a concern if you're suggesting that MDCC do an M&A? Why or why not? Following up on this comment, on page 103, you note that an M&A will "increase sales immediately" but WHO CARES? Does it increase the bottom-line?

- Reagent kit strategic option: I'm somewhat confused about this option. Isn't this a strategy that MDCC has already implemented? On March 27, 2001, they announced the introduction of 4 new reagent kits. Am I missing something?

- Service-based model (page 92): Have you considered what your "customer lock-in strategy" – that of the movement of MDCC towards a service-based model – does to future profit margins?

Financial considerations:

- Ratio analysis: I couldn't find the ratio analysis based on the 5 categories for your firm vs. its competitors. You need to have this in your report

- Return of equity vs. cost of equity: Check to see if MDCC's ROE is greater than the cost of equity. Discuss the implications. If in fact ROE < cost of equity, what can be

done to increase ROE (hint: look at the 5 drivers of ROE in the DuPont model). In calculating the cost of equity, use a built-up beta approach in addition to using their historical beta. Using the historical beta is valid only if the product mix and leverage has remained stationary. As an aside, Bloomberg doesn't arbitrarily adjust the beta so that it becomes closer to one. It is based on a study by a Wharton professor. We know in the long run that beta of a firm will regress towards the beta of the market which is one. What bloomberg does is provide a weighted average beta that you can use for the long run e.g. stationary growth period.

Housekeeping chores:

- On page 32, show the market cap of MDCC (your firm) for comparison purposes.

- Diversification away from Pharma: Since there is a relationship between MDCC and pharma and this relationship is the primary reason why MDCC missed earnings expectations (drug companies delayed purchases on worries about the economy), please plot out on the same graph the revenues for MDCC and the revenues for drug companies in the aggregate for the last several years.