MINICASE

THE BIRDIE GOLF–HYBRID GOLF MERGER

Birdie Golf Inc. has been in merger talks with Hybrid Golf Company for the past six months. After several rounds of negotiations, the offer under discussion is a cash offer of $550 million for Hybrid Golf. Both companies have niche markets in the golf club industry, and both believe that a merger will result in synergies due to economies of scale in manufacturing and marketing, as well as significant savings in general and administrative expenses.

Bryce Bichon, the financial officer for Birdie, has been instrumental in the merger negotiations. Bryce has prepared the following pro-forma financial statements for Hybrid Golf assuming the merger takes place. The financial statements include all synergistic benefits from the merger.

If Birdie Golf buys Hybrid Golf, an immediate dividend of $150 million would be paid from Hybrid Golf to Birdie. Stock in Birdie Golf currently sells for $94 per share, and the company has 18 million shares outstanding. Hybrid Golf has 8 million shares outstanding. Both companies can borrow at an 8 per cent interest rate. Bryce believes the current cost of capital for Birdie Golf is 11 per cent. The cost of capital for Hybrid Golf is 12.4 per cent, and the cost of equity is 16.9 per cent. In five years, the value of Hybrid Golf is expected to be $600 million.

Bryce has asked you to analyse the financial aspects of the potential merger. Specifically, he has asked you to answer the following questions:

	2015 $	2016 $	2017 $	2018 $	2019 $
Sales	800 000 000	900 000 000	1 000 000 000	1 125 000 000	1 250 000 000
Production costs	562 000 000	630 000 000	700 000 000	790 000 000	875 000 000
Depreciation	75 000 000	80 000 000	82 000 000	83 000 000	83 000 000
Other expenses	80 000 000	90 000 000	100 000 000	113 000 000	125 000 000
EBIT	83 000 000	100 000 000	118 000 000	139 000 000	167 000 000
Interest	19 000 000	22 000 000	24 000 000	25 000 000	27 000 000
Taxable income	64 000 000	78 000 000	94 000 000	114 000 000	140 000 000
Taxes (40%)	25 600 000	31 200 000	37 600 000	45 600 000	56 000 000
Net income	38 400 000	46 800 000	56 400 000	68 400 000	84 000 000
Additions to retained earnings	0	34 000 000	27 000 000	27 000 000	25 000 000

QUESTIONS

1. Suppose Hybrid shareholders agree to a merger price of $68.75 per share. Should Birdie proceed with the merger?
2. What is the highest price per share that Birdie should be willing to pay for Hybrid?
3. Suppose Birdie is unwilling to pay cash for the merger but will consider a share exchange. What exchange ratio would make the merger terms equivalent to the original merger price of $68.75 per share?
4. What is the highest exchange ratio Birdie should be willing to pay and still undertake the merger?