

UNIVERSITY OF ROCHESTER

William E. Simon Graduate School of Business Administration

Finance 423
Corporate Financial Policy & Control

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Amazon IPO Case Problem: Deutsche Morgan Grenfell Underwriting Team

Study the red herring prospectus for the Amazon initial public offering (IPO). Amazon has hired the Underwriting Team (DMG) to represent it today, March 24, 1997. The proposed transaction is an initial public offering (IPO) of common stock. Your job is to negotiate a price for the newly issued stock. (Do not be influenced by actual events related to this transaction that occurred after March 24, 1997.)

Your compensation from DMG is tied to the success of the IPO. Your pay will be structured as follows:

There are a total of 25 points available for the negotiation portion of this project. If no deal is made you will receive 10 points. If a deal is made, you will receive 15 points plus additional points depending on the sale price, as follows:

Points = 15 + 10 * (Max Price - Your Price) / (Max Price - Min Price)
where Max Price and Min Price represent the highest and lowest negotiated prices arrived at by the various student groups.

Thus, if you achieve the lowest price in the class, you receive the full 25 points. If you achieve the highest negotiated price, you receive 15 points. Since this will be a firm commitment underwriting, Amazon receives the extra proceeds from higher sales prices, but the Underwriter bears more risk of losses if the IPO doesn't sell. Both Amazon and DMG face potential litigation risk if the price of Amazon stock falls substantially after the IPO.

Your assignment includes: (a) perform a formal valuation of Amazon, determining a range for the IPO price that is financially justified, and (b) negotiate with a management team from Amazon. [Note: it is illegal to rebate any part of your fees to Amazon management.] Your legal advisor has informed you that there is a general legal prohibition against fraudulent misrepresentations in these types of dealings. When (and if) a deal is consummated, you should get a sign-off on the terms of the deal from the opposing team.

REQUIRED:

- (1) **Before the negotiation day:** Prepare a formal report showing the financial basis for the range of prices for Amazon, complete with explanatory text, calculations, formulas and assumptions. For more details about the structure of the report, see the attached list of requirements. This report is *highly confidential*. It is due in class on **Wednesday April 23**. After your report is turned in, you will be provided with a list of opposing teams with which you may negotiate.
- (2) **On or before the negotiation day:** You must submit a completed Negotiation Form (attached at the end of this material) in class on **Wednesday April 30**. You must also submit a brief final report describing the negotiations at that time. What factors moved you away from your original price range? Justify the difference between your beginning price range and the final price.
- (3) **Grading:** Your group grade will be determined as follows:
 - 50% based on the quality of the analysis in your written report.
 - 25% based on the quality of the presentation of your report (organization, clarity, brevity, style, graphics, etc.)
 - 25% based on negotiation points.

REPORT REQUIREMENTS

FIRST SECTION: Should discuss your overall opinion of Amazon. You should mention the main reasons or assumptions supporting your overall opinion.

SECOND SECTION: Should describe the types and results of analyses performed on Amazon's financial data. Examples would be:

- current conditions in the IPO market
- pro-forma financial statements
- present value of free cash flow
- option value of investment opportunities
- value changes due to changes in financial structure
- price/earnings ratio analysis
- cost of capital for Amazon
- competitive conditions in the retailing industry, and particularly on the internet
- regulatory and labor market factors that would affect firm value, if any

Note that some of these factors may not be relevant to the analysis of Amazon.

THIRD SECTION: Should discuss your negotiation strategy. What will be the main arguments supporting your price range? What defenses can you raise against the weaknesses in your analysis?

IT IS ABSOLUTELY PROHIBITED TO DISCUSS THIS CASE WITH ANYONE OTHER THAN MEMBERS OF YOUR OWN GROUP. VIOLATING THIS RULE CAN RESULT IN A ZERO GRADE BEING ASSIGNED TO THE VIOLATING GROUPS. (Besides, sharing information can destroy your bargaining position.)

Amazon Negotiation Form

Names of people in your group:

Names of people in Management group:

Initial price offered *to* Management group: \$

Initial price requested *by* Management group: \$

Final negotiated price: \$

If no deal was reached, enter the *LOWEST PRICE ASKED*: \$

HIGHEST PRICE OFFERED: \$