

Microsoft's Acquisition of Nokia's Mobile Business Unit

Case Synopsis

Financial media was abuzz with the latest string of acquisitions within the Silicon Valley led by the IT Mogul – Microsoft. In the ever expanding scope of technological innovations and market disruptions led by the likes of Apple and faced with the unenviable task of lifting the spirits of the investing community; Microsoft decided to take-over the mobile business unit of Nokia. Analysts were somewhat divided about the possible ramifications of the deal given the enormous financial consideration with the uncertainty prevailing over the likely impact on the earnings of Microsoft. While Microsoft was saddled with enormous cash to take the 'all-cash route' to finance its acquisition, financial pundits were concerned about the potential 'opportunity costs' lending the impression that cash could have been deployed more gainfully elsewhere to maximize the interests of shareholders. Empirical evidence suggests that of all the mergers and acquisitions (M&A), $\frac{3}{4}$ end-up being failures. Was the management at the helm of Microsoft even acutely aware of these findings? Or was it the classic 'agency problem' at work? In any case, it seemed that the management was certainly aspiring to be not among the " $\frac{3}{4}$ ".

Strategic Imperatives for M&A

M&A continues to be one of the most favoured routes adopted by corporations to further expand their market, shareholder, and other



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strategic interests. In scenarios where expansion into virgin markets come with significant risks encompassing time and effort in gaining a foothold, M&A prove to be an instant success mantra to catapult into a dominating force within the market. Curiously though, chances of success remain extremely low. Plausible reasons attributed to failures in M&A range from over-optimism to outright extravagance displayed by the management leading to an exacerbated purchase consideration to the target firm with scant regard to realization of synergy¹.

Notwithstanding the historical evidence suggesting overwhelmingly large number of failures, corporations that have engaged in M&A while being thoroughly mindful of the aspirations of the shareholders of the acquiring firm have tasted enormous success. Such corporations have avidly resisted the temptation to overpay and also built strategies to lead harmonious integration across people, processes, and resources subsequent to acquisition of target entities.

Microsoft's Narrative towards Acquisition of Nokia

Microsoft has traditionally been associated with production of highly efficient software product with the ubiquitous "*Windows*" that has virtually become a household name in respect of computing technology. However, the rapid strides made by "open software" and competitors like Apple giving the conventional market leader a run for its money explains the urgency on part of Microsoft in proceeding ahead with the acquisition. With smartphone almost becoming an equivalent of a hand-held "computer", companies like Apple have found themselves in a brilliant spot where they are dispensed with the ability to embed their proprietary software into the smartphone. With Apple itself manufacturing the smartphone, it becomes a natural extension of their backward integration strategy.

While the transition to a product-led growth seemed natural for Microsoft, it must be noted that Apple always had a superior competitive advantage with Apple already having tasted stupendous

¹ Synergy refers to the excess of the value of the combined firm over the arithmetic sum of the value of acquiring and target firms independently. In order for M&A to be successful, one essential criterion is that the value derived from synergy must necessarily exceed the premium offered to the target corporation.

success on the front of i-pods and i-pads. Microsoft, on the other hand, was relatively a new entrant in the technology-led product space from a strictly conventional sense. The fact that Nokia was too late in adapting to the latest innovations engineered by its competitors only meant that the company was staring at the unenviable prospect of a complete rout of the market leadership that it once championed.

Financial Ramifications of M&A – The Earnings Factor

Analysts have conventionally sought to gauge the success or failure involving M&A events by looking at two variables – Earnings and Stock-price performance. The latter has been subject to much controversy given the vagaries of the stock-markets compounded by the influence yielded by investors' sentiments influencing the deal; in particular, when deals are fashioned as an 'all-stock deal'². Another significant attention wielded by analysts relates to the financial measures as demonstrated by earnings measure captured within the financial statements. While this too has courted much controversy in recent times owing to the widely divergent accounting practices prevalent across geographies, earnings nevertheless, represent as the most widely tracked variable to derive inferences on success or failure of M&A deals. Here, there are two popular approaches that have attracted much greater attention from both corporate and academic community alike.

Approaches to Earnings Management – the Accounting Way! Pooling-of-Interest Method

This method envisages acquisition of all the assets and liabilities of the target company entirely at their book value. A significant implication is that the balance sheet of the combined firm subsequent to acquisition of the target firm is represented as a mere arithmetic sum of the balance sheets of acquiring and target corporations.

Consider an illustration.

² Given the enormous complexities involving stock-price reactions, in this case, we restrict to the ramifications on the earnings as represented by financial statements

Table I :
Pooling-of-Interest Method (all Figures in Millions of USD)

Balance Sheet	A Ltd.	T Ltd.	AT Ltd (merged)
Net fixed assets	500	300	800
Liabilities	300	200	500
Equity	200	100	300
Total Liability + Equity	500	300	800

(Source: Hypothesized data)

Observe that as fallout of the application of the pooling method, there is no scope for deriving any 'goodwill' or 'capital reserve'. Also, legal providence requires that pooling method may be applied only when the following conditions are strictly satisfied.

- a) Acquiring firm takes 100% control over the target firm.
- b) Shareholders of the target firm subsequent to merger become the shareholders of the combined firm in the same proportion of shareholding.
- c) Purchase consideration is only by virtue of stock.
- d) Assets and liabilities are carried only at the book-value.

Could Microsoft have possibly adopted the "pooling method" in accounting for the take-over of Nokia's mobile unit? After-all, much of the growth in the IT industry in Silicon Valley has been attributed to the burgeoning growth in M&A with acquiring corporations having fully benefitted from the 'earnings surprises' created by the pooling method.

Purchase Method

Even if a single condition listed under the pooling method is not met, acquiring corporations are required to adopt the purchase method. In reality, it is the purchase method that is most predominantly employed in dealing with M&A activities. Purchase method also makes imminent business sense as it allows the acquiring corporations to assume the assets and liabilities of the target at realizable values rather than book values. It also permits dispensation of purchase consideration by cash or using some combination of stock and cash. Perhaps, the most significant aspect of this method pertains to the generation of 'goodwill' or 'capital reserve' on the balance sheet of an acquiring corporation.

Purchase consideration in excess (deficit) in relation to the net assets (defined as the difference between assets and liabilities) of the target corporation is defined as a goodwill (capital reserve). Goodwill represents as an intangible asset that is subject to an 'impairment test'³. In keeping with the 'lobbied interests', accounting conventions, particularly in US, have jettisoned the practice of 'amortization'⁴, which was subject to criticism in part for the repugnant impact caused on the earnings of the acquiring corporations. Impairment was therefore adopted as it was considered a 'lesser evil'.

Consider the same illustration.

Table II :
Balance Sheets of Acquiring (A Ltd.) and Target (T Ltd.)
Corporations (all Figures in Millions of USD)

Balance Sheet	A Ltd.	T Ltd.
Net fixed assets	500	300
Liabilities	300	200
Equity	200	100
Total Liability + Equity	500	300

(Source: Hypothesized data)

³ Impairment represents the value when the realizable value of the asset is exceeded by the book value of the asset.

⁴ Unlike impairment, amortization requires compulsory charging of the goodwill over its useful life as an expense, which in turn causes an unfavorable impact on the earnings of the acquiring corporation.

Let's say, in this case, A has taken over the net assets of T Ltd. for a total purchase consideration of 150 in an all-cash deal. Note that the excess of 150 over the net asset value of 100 leads to the generation of goodwill of 50.

The balance sheet subsequent to the acquisition process will reflect as shown below.

Table III :

Purchase consideration method (all figures in millions of USD)

Balance Sheet	AT Ltd.
Net fixed assets	650 ⁵
Goodwill	50
Total Assets	700
Liabilities	500
Equity	200
Total Liability + Equity	700

(Source: Hypothesized data)

Did Microsoft end up paying a premium to acquire the mobile business unit of Nokia while being fully-aware that it would have the comfort of 'goodwill'? But couldn't the management also realize that in the event of the acquisition ending up as a failure, the epitaph of the target corporation would not be written without suffering the deleterious consequences on the earnings of the acquiring corporation.

The Epilogue

Microsoft acquired Nokia's phone unit in April 2014 for \$9.5 billion including \$1.5 billion in acquired cash. The addition of the unit – a deal struck under CEO Steve Ballmer, Nadella's predecessor – was a

⁵ Case reader is invited to carry out appropriate computations to arrive at the figure.

flop, and Microsoft's smartphone business continued to lose money while gaining little ground with mobile users. Microsoft reported its largest-ever quarterly net loss, hurt by a \$7.5 billion write-down after the purchase of Nokia's handset unit failed to rescue the software maker's mobile business. The net loss in the fourth quarter ending June 30, 2015 amounted to \$3.2 billion, and sales fell 5.1% to \$22.2 billion. (Bloomberg Business, 2015)⁶.

Exhibit I

Microsoft IV Quarterly Income Statements, June 30th, 2015

Microsoft Corporation

Quarterly Income Statements

(In millions, except earnings per share)

	Q4-15
Revenue	\$ 22,180
Cost of revenue	7,468
Gross margin	14,712
Research and development	3,094
Sales and marketing	3,961
General and administrative	1,272
Impairment, integration, and restructuring	8,438
Other expenses (income)	0
Operating income (loss)	-2,053
Other income (expense), net	297
Noncontinuing items	0
Income (loss) before income taxes	-1,756
Provision for income taxes	1,439
Income (loss) before accounting change	-3,195
Cumulative effect of accounting change	0
Net income (loss)	\$(3,195)
Preferred stock dividends	0
Net income (loss) available for common shareholders	\$ (3,195)
Basic earnings (loss) per share before accounting change	\$ (0.40)
Diluted earnings (loss) per share before accounting change	\$ (0.40)
Basic earnings (loss) per share	\$ (0.40)
Diluted earnings (loss) per share	\$ (0.40)

⁶ Source: <http://www.bloomberg.com/news/articles/2015-07-21/microsoft-posts-largest-ever-net-loss-after-nokia-writedown>

