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Structuring Mergers & Acquisitions

A Guide to Creating Shareholder Value

Fourth Edition

Peter A. Hunt

Wolters Kluwer
Law & Business

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by

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INTRODUCTION

Pick up a newspaper on any given day and you will invariably read of a number of merger, acquisition, and restructuring transactions. From the noteworthy mergers of global industry leaders to the restructuring of multi-national conglomerates, we are reminded daily of the significance of mergers and acquisitions in corporate America. In good times and in bad, mergers, acquisitions and restructurings serve to shape the corporate competitive landscape on a local, regional, national and global basis, preserving and creating value for shareholders in the process.

To the uninitiated, however, the mere mention of the words "mergers and acquisitions" conjures up images of over-dressed investment bankers flying around in private jets and talking on cell phones. From Michael Douglas in the movie "Wall Street" walking along the shores of Long Island, speaking the words "This is your wake-up call" into his cell phone to the notorious Michael Milken, who became known as the man who made more money shaving each morning than the average family of four made in an entire year, the field of mergers and acquisitions has spawned movies, sitcoms, mysteries, legends, heroes, and criminals. And to many, despite the press, the topic is still largely misunderstood.

Recent History of Mergers and Acquisitions

Mergers, acquisitions, and restructurings have been prevalent in the United States for over a hundred years. Periods of intense M&A activity have usually been followed by periods where little M&A activity has taken place. The peaks and troughs have been driven by greed as well as by market, economic, and fiscal shifts. Likewise, each renewed period of merger and acquisition growth has led to regulatory and other changes designed to modify behavior and temper M&A activity. In recent history, there have been a number of discrete periods during which mergers and acquisitions have been strong: the conglomerate era of the 1960s, the hostile acquisitions of the 1980s, and the strategic mergers of the 1990s. Each of these periods can be characterized by certain factors, whether it's low interest rates, a booming stock market, or changes in the tax code.

In the new millennium, we entered a new period of merger and acquisition activity in which mergers and acquisitions have become relied upon for growth, the sins of the late 1990s and early 2000s have been unwound through restructurings, and, up until recently, private equity firms entered the mainstream as aggressive acquirors and consolidators. However, we entered a new phase of excess witnessed by the recent meltdown in the mortgage and hedge fund markets, which have resulted in a decline in mergers and acquisitions as the equity capital markets have lost significant value, banks have limited the availability of debt capital, and private equity firms have pulled back from making acquisitions. Despite this slowdown in overall M&A activity, even the recent economic crisis has resulted in its own discrete set of transactions driven by conditions specific to a given market or sector. Thus, while mergers and acquisitions are not expected to increase in the near term to levels seen in 2006 and 2007, activity is expected to continue with mini-booms in certain aspects of M&A, namely, restructurings, hostile acquisitions, and strategic M&A.

The 1960s Conglomerate Era and the P/E Game

The first of the merger spurts in recent memory occurred in the 1960s, which became known as the "conglomerate era." This period was characterized by a strong economy and stock market. Companies went beyond simply diversifying their business; they made acquisitions outside of their core business in far-flung sectors. Two companies symbolize the conglomeratization of the 1960s. Most notable of these was ITT, a multi-national conglomerate, which acquired businesses quite unrelated to its traditional business. These included companies in baked goods, hotels, rental cars, and insurance. Another example is LTV Corporation, started in the late 1940s as an electronics company in Texas. By the end of the 1960s, the company had acquired businesses in such far-flung industries as steel, airlines, meat packing, and sporting goods. At its peak, LTV was one of the largest companies in the world.

One of the significant forces behind this trend was strict antitrust regulations that were in place at the time. The antitrust climate was such that companies had a hard time making acquisitions if the resulting company served to reduce competition in the market. In addition, modifications to antitrust policy eliminated a company's ability to even acquire assets that were in the same industry if the end result was reduced competition. This tough stance on in-industry mergers was a driving factor behind companies acquiring outside of their core industries. Another factor responsible for the heightened merger activity in the 1960s was the strength of the stock market coupled with high interest rates. The rapidly expanding economy witnessed a tightening of the credit markets which made financing an acquisition with debt a difficult proposition. However, the strong stock market provided companies with an attractive currency with which to make acquisitions. As multiples tend to be an indicator of forward-looking growth, the high multiples conveyed on companies in the 1960s led them to capitalize on their currencies and make acquisitions.

Unfortunately, a pattern evolved where high multiples companies acquired lower multiple companies. Consequently, the 1960s became known as an era when the "P/E Game" was played. This game entailed companies with high multiples acquiring companies with low multiples and witnessing their earnings per share rise. This is a temporary phenomenon that results purely from the mathematics involved in combining two companies, rather than from making an attractive acquisition that results in increased earnings. Once an acquirer made a few low-growth—and low multiples—acquisitions, the core earnings of the surviving company became affected. Over time, the once high multiples proffered on the large acquirers contracted to match their growth rates.

Another factor that contributed to the 1960s merger phenomenon was certain accounting practices at the time. For example, it was possible to sell assets in order to generate accounting income that was used to prop up earnings. Another example was the accounting for convertible securities. It was possible to issue convertible debt to a target in a transaction, and consolidate the earnings of the target while using the same number of shares outstanding at the acquirer. Consequently, the accounting earnings for the acquirer would rise. The increased earnings would signal an increase in earnings growth, affording the acquirer a higher multiple.

The 1960s merger wave finally came to an end late in the decade. The P/E game took its toll as the market recognized the fallacy of the strategy. In 1969, the stock market took a sharp turn for the worse, and the high-flying stocks of the 1960s boom came back down to earth. Multiples began to reflect true earnings growth, and acquisition currencies no longer provided an attractive vehicle for acquisitions.

In 1968, the Williams Act was enacted, drastically altering the way acquisitions took place. The Act was designed to limit coercive or abusive takeover tactics. In addition, the Attorney General at the time, Richard McLaren, made a push to reduce the number of conglomerates that were forming because he felt they were anti-competitive. This further added to the downward pressure on stock prices. Furthermore, the 1969 Tax Reform Act brought to an end many of the detrimental accounting practices that had artificially inflated earnings. For example, the use of convertible debt in takeovers was severely restricted by forcing companies to account for this debt as common stock for earnings per share purposes.

The conglomerate era was a period of rising stock prices, diversification, and mergers and acquisitions driven by paper returns, not real economic gains. These disappointments coupled with a depressed stock market resulted in a fairly prolonged period of declining merger and acquisition activity that lasted through the 1970s. The 1970s are noted, however, for a number of precedent setting transactions that set the stage for aggressive hostile M&A activity in the 1980s.

Three transactions in particular opened the doors for what became considered an acceptable means to acquire or take over a transaction. The first of these transactions was the 1974 announcement by International Nickel Company that it would launch a tender offer for Electronic Storage Battery Company. International Nickel was the largest firm in the nickel industry, controlling over 40% of the market. Electronic Storage was the world's largest maker of batteries in the world, in particular automobile and consumer batteries.

At the time, International Nickel was faced with increasing competition in its core nickel business, and saw Electronic Storage as a way to diversify its cash flows and enter the more attractive battery business. Electronic Storage's stock price had been suffering, providing International Nickel with an attractive acquisition opportunity from a financial and a strategic perspective. The unwanted public tender offer was launched despite Electronic Storage having turned down a number of other suitors. International Nickel was backed by Morgan Stanley, one of the leading investment banks at the time, lending credence to the transaction. While Electronic Storage mounted a defense, hiring Goldman Sachs to assist it in looking at alternatives to the International Nickel deal, the company was essentially caught off guard and eventually capitulated to International Nickel, selling the company by the end of 1974. While the transaction ultimately was not viewed as a success, it was precedent setting in that the suitor was a large, internationally respected firm that was backed by a premier investment banking firm. This transaction opened the door to further hostile M&A activity.

In 1975, another well-respected firm, United Technologies, launched an unsolicited offer for Otis Elevator. United Technologies was a large manufacturing concern that had been involved in aircraft parts manufacturing. Otis manufactured and serviced elevators. Its stock was trading at a discount to its book value and was perceived as undervalued in the market. Its management team was strong and its cash flows were strong and stable, in part because of its servicing component as well as its international focus. For United Technologies, an acquisition of Otis added a strong international component without acquiring overseas, brought a well-managed company into the fold, and could be achieved at an attractive price. It launched the tender offer in late 1975, despite having been rebuffed in a friendly transaction. The tender offer led to a hotly contested transaction with Dana Corporation being brought in by Otis to serve as a white knight. Ultimately, United Technologies prevailed when it substantially increased its offer price and closed the transaction in early 1996.

The United Technology hostile acquisition of Otis Elevator built on the International Nickel acquisition of Electronic Storage partly because it validated the approach as a viable acquisition technique and also because, unlike the International Nickel transaction, the Otis acquisition turned out to be a success from a financial and strategic standpoint. Otis and United went on to build a highly successful company.

In 1975, Colt Industries launched a hostile tender offer for Garlock Industries. Colt was a diversified conglomerate that had made numerous acquisitions in the 1960s, resulting in a company with over $1 billion in revenue. During the early 1970s, the company had divested many of the poorly performing businesses in its portfolio, optimizing its financial performance and hording a lot of cash in the process. Garlock, a manufacturer of packing and sealing products, had revenues of less than $200 million and a book value less than its stock price. Its earnings per share had steadily grown but were not reflected in its stock price.

As a result of the prior hostile takeovers, Garlock had put in place various takeover defenses including a staggered board. Colt launched its offer, and instantly the transaction became hotly contested, with Garlock pursuing all the means then at its disposal to defend itself. It filed suit against Colt in federal court, alleging that Colt had not abided by federal disclosure laws. In addition, it maintained that the transaction would be anti-competitive. Finally, Colt prevailed, as the litigation and other tactics proved to be no match for a fully priced offer. These three precedent-setting transactions set the stage for the resurgence in takeover activity in the 1980s.

The 1980s Hostile M&A Era

The 1980s became an era when mergers and acquisitions came into full bloom. Sophisticated financing structures, hostile M&A, and litigation became mainstream. During the early 1980s, the weak economy served to limit the growth in the stock market and the volume of M&A transactions did not pick up until 1983–1984. The mid- to late 1980s witnessed some of the largest transactions ever completed. Among others, these transactions included the Kohlberg Kravis & Roberts $25 billion leveraged buyout of RJR Nabisco, the largest LBO ever completed; Gulf Oil's $13 billion acquisition of Chevron; and Kraft's $13 billion acquisition of Philip Morris.

Leveraged buyouts became de rigeur with the advent and rise of the junk bond market in the 1980s. In addition, the Tax Reform Act of 1986 facilitated corporate restructurings, resulting in numerous restructurings of companies in tax-free transactions. Conglomerates were disassembled and divisions were sold, spun off, or split off. As these companies restructured, the divested subsidiaries were then acquired by companies in stock-for-stock transactions, creating integrated companies that could exploit internal synergies.

Hostile acquisitions became everyday events with corporate raiders leading the charge. Individuals like Victor Posner, Paul Bilzerian, T. Boone Pickens, and Carl Icahn acquired company after company, financing their acquisitions with substantial amounts of leverage with the use of the increasingly popular junk bonds or high-yield debt, and busting these companies up, reaping huge profits in the process. In the 1980s, the investment bank Drexel Burnham Lambert is credited with inventing the modern junk bond market. Michael Milken, the firm's West Coast chief, was hailed as the "junk bond king" and the central figure responsible for financing much of the corporate raider activity of the 1980s.

The hostile transactions of the 1980s were driven by short-term profits rather than strategic merit. The excesses of this period came to an end as Milken was later charged with securities fraud, and Drexel Burnham, the company, folded. The outstanding Drexel Burnham high-yield bonds, which largely had been invested in by savings and loan institutions, went into financial distress and were partly responsible for the savings and loan crisis of the late 1980s. As a symbol of the greed of the 1980s hostile environment, Ivan Boesky emerged as yet another villain in the drama, the most renowned insider trader, first making millions on insider trades and then being convicted of securities fraud and going to jail.

Despite the negative undertone and short-term profit mentality of the 1980s, the era was helpful in developing the mergers and acquisitions market from a number of perspectives. First, there was a critical mass of legal precedents that were established, setting the framework for acceptable and unacceptable mergers and acquisitions practices, and reinforcing disclosure requirements that were designed to protect shareholders. Second, even though the junk bond market was tainted by the savings and loan crisis, it created a financing vehicle that today is legitimized and has become widely used in mergers and acquisitions. Third, it established investment bankers as necessary players in the M&A equation. Whether in financing the transaction, devising a takeover strategy, or defending the target, investment bankers became central figures in the business.

The 1990s Strategic Driven Era

The 1990s merger era saw a strong rise in M&A activity that was strategic minded rather than short-term profit driven. As the economy emerged from a recession in 1991, mergers and acquisition became popular again as a way to spur growth. Exhibit 1 shows the trend in domestic mergers and acquisitions between 1990 and 2008.

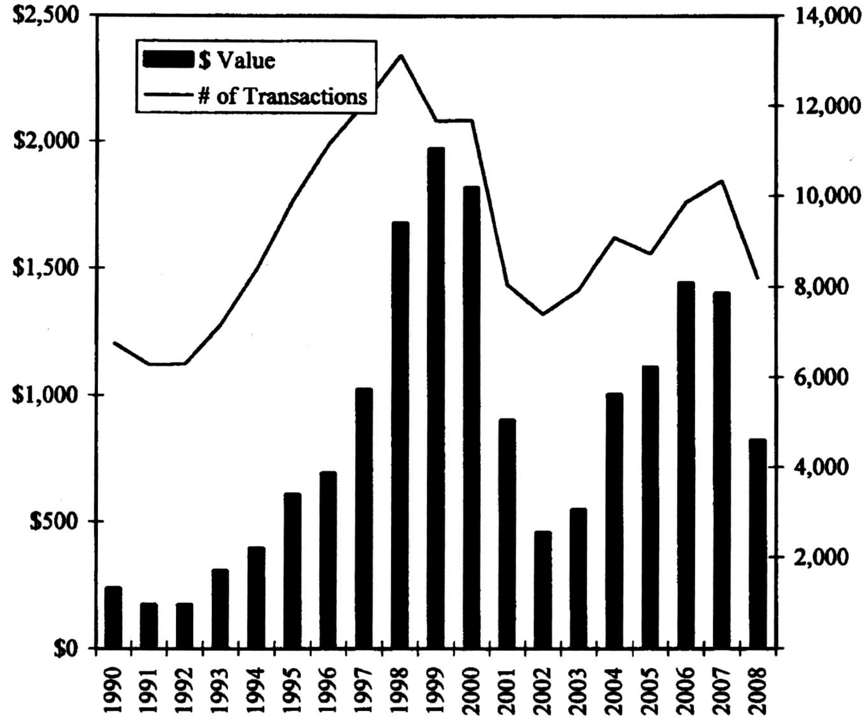
The pace of mergers and acquisitions in the United States accelerated in the mid-1990s thanks to a number of factors. The strong economy produced an overabundance of investment capital, driving the stock market higher and fueling acquisition activity. Regulatory changes across industries and a relaxing of antitrust regulations spurred inter- and intra-industry mergers. International competition encouraged economies of scale. Technology innovation created a slew of new companies ripe for acquisition, and forced older companies to stay apace with change. Finally, higher stock prices created strong acquisition currencies, further spurring mergers and acquisitions. At all levels, corporations were excited about the opportunities to capitalize on joint synergies.

In addition to these macro factors, there were numerous industry specific trends that led to consolidation. For example, in the auto industry, severe excess capacity led to large-scale mergers, e.g., Chrysler/Daimler. In the banking industry, deregulation spurred a number of mergers and acquisitions, most notably, Citicorp's merger with Travelers to create CitiGroup. In the pharmaceutical industry, the high cost of drug research and development led to numerous mergers, including the SmithKline Beckman merger with Beecham to form SKB.

Mergers & Acquisitions in the New Millennium

Since entering the new millennium, a number of trends have served to drive mergers, acquisitions, and restructurings. First, as the world economy has become more global, there has been a rise in overall global mergers, for example, the recent $52 billion acquisition of Anheuser Busch by InBev. Second, there has been a flurry of restructuring activity, unwinding the misguided diversification

Exhibit 1
Domestic Announced Mergers and Acquisitions: 1990–2008[1]
($ in billions)



strategies of companies such as Tyco International. Third, as a result of misdeeds at Tyco and other companies, the Sarbanes-Oxley Act of 2002 was implemented. This has had a marked impact on M&A activity, as boards and management teams have come under increased scrutiny. Fourth, creating shareholder value has become a central focus of managers and boards of directors, as institutional investors or other activist shareholders like Carl Icahn have put pressure on companies to deliver returns. M&A has become a prime strategy for enhancing shareholder value. Fifth, there have been many hostile or quasi-hostile transactions that have resulted in significant market share shifts, for example, Oracle's acquisition of PeopleSoft. Sixth, increasingly, strategic acquisitions have dominated the landscape as companies have scrambled for market share and growth through acquisition. Finally, and most important, private equity firms came to dominate the

1. Thomson Financial.