MAKING M&A DEALS HAPPEN

SOURCE, NEGOTIATE, AND CLOSE MERGERS AND ACQUISITIONS

UNDERSTAND THE CRITICAL ELEMENTS THAT CAN MAKE OR BREAK ANY DEAL

UTILIZE THE MOST EFFECTIVE NEGOTIATION & TROUBLESHOOTING TECHNIQUES

LEARN FROM REVEALING CASE STUDIES INCLUDING TYCO, AOL, AND OTHERS

BERT STEFANOWSKI

MAKING M&A DEALS HAPPEN

ROBERT STEFANOWSKI

McGraw-Hill

New York Chicago San Francisco Lisbon London Madrid
Mexico City Milan New Delhi San Juan Seoul
Singapore Sydney Toronto

The McGraw·Hill Companies

1 2 3 4 5 6 7 8 9 0 DOC/DOC 0 9 8 7

ISBN-13: 978-0-07-144740-9
ISBN-10: 0-07-144740-7

MAKING M&A DEALS HAPPEN

To my parents, Bob Sr. and Eleanor, for realizing that a good education is one of the best gifts they could provide to their children, and to my sisters, Patty, Deb, and Sue for all of their support over the years. Finally, to Amy, Lauren, Rachel, and Megan for the love, understanding, and fun they provide every day!

This book is designed to give the reader a practical, businessperson's approach to M&A by providing a road map on how to source, negotiate, and close mergers, acquisitions, and joint ventures. We will discuss each stage of the typical deal process, highlighting the critical elements, risks, and opportunities of each. Whether you are a business professional in the M&A field, an investment banker, a chief executive officer with overall business responsibility, or a student who has an interest in learning about the deal process, this text should help to make you more effective in your work.

America's fascination with the stock market and the continued pressure on corporations to grow has resulted in a proliferation of M&A activity in recent years, both in the United States and abroad. As a result, the ability to understand M&A and get deals done has become a critical skill in corporate America. Whether someone is directly or indirectly involved in the deal process, a basic understanding of business combinations is essential to success in business today. Although this book is written from the perspective of a deal principal (i.e., a corporation that is contemplating some type of business combination: merger, acquisition, joint venture, and so on), the information is useful to a variety of constituencies including the following:

Corporate business development groups. The term *business development* will be used throughout the text to indicate those corporate professionals whose primary responsibility is to grow their companies by purchasing or merging with other firms. In some organizations, these efforts are referred to as the Strategic Development, Corporate Development, or simply M&A Department.

Related corporate roles. Although they are not directly responsible for M&A activity, it is essential that people in various senior corporate roles, such as chief executive officer, chief financial officer, and chief operating officer, have a working understanding of the M&A process and its risks and opportunities. As we will see in Chapter 1, failure of company managers to understand this process can have a dramatic effect, both on their companies and on their individual careers.

Investment banks. For larger or more complicated transactions, both the buyer and the seller generally hire investment bankers. Having a working understanding of the process and the issues facing the principals in these transactions is essential to the effectiveness of any investment banking professional. By guiding the reader through the M&A process and its potential pitfalls, this book will enable the current or future investment banker to be much better prepared to serve his or her clients.

Private equity professionals/LBO groups/hedge funds. The 1990s and 2000s have seen a proliferation of private equity groups and, more recently, hedge funds that have an interest in equity investing. The legendary firms such as Kolhberg, Kravis, and Roberts (KKR), with its hostile takeover of Nabisco (as popularized in the book/movie *Barbarians at the Gate*) have evolved into an extensive network of private funds focused on buying companies for their own account. These partnerships are generally formed by investment professionals financed by a group of wealthy investors, pension funds, or other institutions. The purpose of these equity funds is to locate attractive companies for purchase, run the companies for a period of time, and, hopefully, sell the company for a profit at some point in the future to provide a return on capital to the investors. As we will discuss later, the billions of dollars in capital raised by these funds have had a dramatic impact on the dynamics of the M&A industry. Most, if not all, of the issues faced by M&A professionals in a corporate environment are identical to those faced by private equity groups arranged to buy and run companies.

Other advisors. Employees of a wide variety of other players, including legal and tax advisors, appraisal firms, public relations firms, and other such organizations, need to understand the M&A process. Having an adequate understanding of the process can be critical to the success or failure of these individuals.

COMMON DEFINITIONS

"M&A" is a generic term that can have a variety of meanings, depending on the context. The discussion in this text is applicable to all forms of M&A transactions, as outlined here:

- *Acquisition.* The 100 percent purchase by one company of another. The target company is normally absorbed by the acquirer and no longer exists as a separate entity after the deal closes.
- *Merger.* The combination of two companies/legal entities into one. This normally occurs in situations where two companies of similar size and characteristics agree to combine their efforts.
- *Minority equity investment.* Something less than a 100 percent purchase. A minority equity investment provides the buyer with a portion of the equity value in the target without having operating control of the firm.
- *Joint venture/strategic alliance.* The process whereby two companies decide to work together on some portion of their existing or future business. For example, Dow

EXHIBIT I-1

The Dow Corning Joint Venture

Dow Corning Corporation (Dow Corning) was incorporated in 1943 by Corning Glass Works (now Corning Incorporated) and The Dow Chemical Company (Dow Chemical) for the purpose of developing and producing polymers and other materials based on silicon chemistry. Corning Incorporated provided the basic silicone technology and Dow Chemical supplied the chemical processing and manufacturing know-how. Both companies contributed key employees to the venture, while maintaining their own separate, distinct operating companies. Dow Corning became a wholly owned subsidiary, owned 50 percent by Dow Chemical and 50 percent by Corning, Inc. Dow Corning currently manufactures over 10,000 products and serves approximately 50,000 customers worldwide.

Discussion Questions

1. What are the benefits of this joint venture combination as opposed to a 100 percent purchase of one company by the other?
2. What are some issues that could arise from such a structure (that is, 50/50 ownership)?
3. Is there anything unique about this situation that lends itself to a joint venture arrangement?

> Chemical and Corning Incorporated formed a joint venture called Dow Corning to develop new products that leveraged the core competency of each business. The joint venture structure allowed the firms to work together on new product development, while still leaving the core operations of each business unit separate. (See Exhibit I-1, "The Dow Corning Joint Venture.")

We will also frequently refer to the concept of "due diligence" throughout the course of this book. Due diligence represents the financial, operational, and strategic analysis that a buyer undertakes when evaluating (1) whether to purchase a target company, (2) how to structure the deal, and (3) how much to pay. A detailed description of the due diligence process is provided in Chapters 4 and 5.

NOTES

Bryan Bullough and John Helyar, *Barbarians at the Gate: The Fall of RJR Nabisco* (New York: Harper Perennial Press,).

ACKNOWLEDGMENTS

I would like to thank the following people who were critical to the development of this book: Irene McGeachy, my outstanding assistant who helped in production; Pattie Amoroso at McGraw-Hill, for her editing and production expertise; Mark O'Leary, who "volunteered" to read the entire text and made great suggestions; and Dave Wente, Carl Lobell, Jane McDonald, and Bill Gutowitz, who taught me all I know about M&A.

CONTENTS

CHAPTER 1

The M&A Environment

Merger and acquisition activity has historically been cyclical, based upon certain macro factors involving

- The overall state of the economy in the United States and abroad
- Public stock prices
- Levels of liquidity in the financial markets
- The extent of antitrust pressure on mergers and acquisitions
- The amount of regulatory scrutiny of certain industries, such as airlines, telecommunications, banking, and other financial services
- Whether "conglomerates" (single corporations with multiple business lines, such as United Technologies, which has divisions producing jet engines, elevators, helicopters, and automotive parts) or "pure play" companies (firms like Wal-Mart, Kodak, and Exxon that are mainly in one line of business) are in favor among analysts and market "experts"

While there always seems to be a minimum amount of core activity in M&A, the number of companies bought and sold, as well as the prices paid for these deals, has varied widely over time.

THE ROARING NINETIES

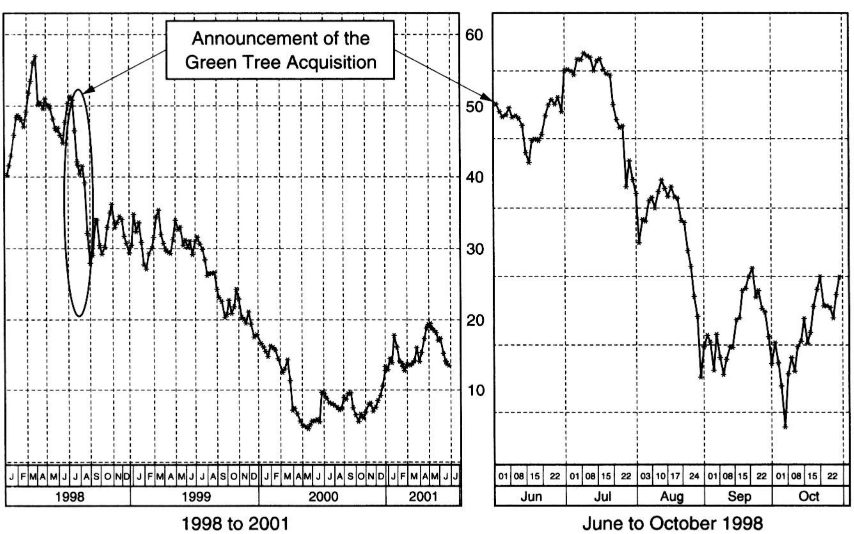
Take the case of Conseco Finance, which was trading near its highest level at $50 per share in June 1998. The company's CEO, Stephen

Hilbert, and the public markets were very confident about the company's prospects. However, that same month, Hilbert announced the acquisition of Green Tree Financial, a subprime mortgage and consumer lending company, for a whopping $7.6 billion. The price was seven times the net worth of Green Tree, or a $6.6 billion premium to tangible book value. Over the next two years, Conseco's stock price dropped from $50 a share to below $10 (see Exhibit 1-1); the company ultimately filed for bankruptcy in the spring of 2003. Analysts attributed the company's long, painful downfall directly to its overpayment for the Green Tree assets and the subsequent adverse impact of that purchase on Conseco's operations. This ill-advised acquisition not only cost Hilbert his job, but drove a very successful company out of business.

The popular press has reported many examples of acquisitions that have performed poorly because of a faulty business strategy or an overpayment for assets purchased in a merger or acquisition. In many cases, the overall financial and stock performance of the combined company is significantly worse after the acquisition. In fact, there appears to be a fairly strong negative correlation between the announcement of a major acquisition and an acquiring firm's stock performance after the acquisition.[1] Studies have shown that over 50

EXHIBIT 1-1

Conseco Stock Price, 1998 to 2001



percent of M&A transactions actually dilute the total shareholder value of the acquiring company within one year of closing.

A second example can be seen in the consolidation of the U.S. banking sector in the heyday of M&A activity, the late 1990s (see Exhibit 1-2). Despite the subpar returns realized on acquisitions, deal activity kept increasing at a faster and faster rate (see Exhibit 1-3). In many cases, overly aggressive M&A strategies actually reduced the acquirer's stock price.

Historically, neither the company's senior management team nor the board of directors has been held accountable for making faulty acquisitions. Firms essentially had a "free option"; if a particular deal worked, senior management and the company took all of the credit. If the deal failed, the company's poor postmerger performance was blamed on subpar operations, a bad market, or some other factor.

As we will see later, the twenty-first century has held senior executives more accountable when they fail to deliver on their deals. So, the logical question that arises is, why are CEOs and their boards of directors willing to put themselves and their companies at risk for a strategy that has so many potential pitfalls, as evidenced by historical data?

The largest single factor driving the growth in M&A activity in the twenty-first century is the increasing pressure on private and pub-

EXHIBIT 1-2

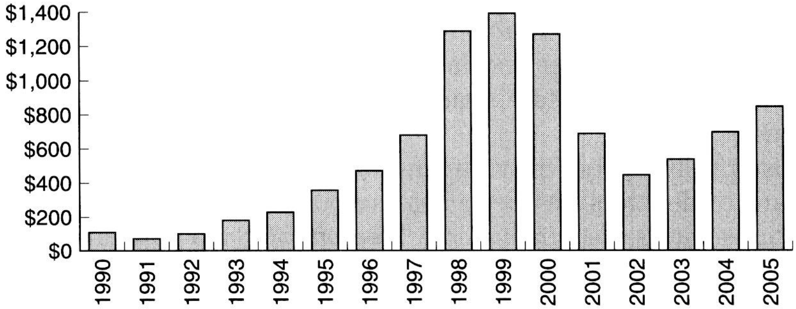
Excess Returns after Announcement for Largest U.S. Bank Deals

	Acquirer	Target	Weighted Avgerage
FirstStar/US BanCorp	(10%)	8%	0%
Travellers/CitiCorp	26%	18%	23%
NationsBank/BankAmerica	6%	5%	6%
Norwest/Wells	(7%)	1%	(3%)
BancOne/First Chicago	(1%)	2%	0%
Wamu/Ahmanson	2%	19%	7%
First Union/CoreStates	(3%)	10%	0%
NationsBank/Barnett	(5%)	25%	2%
Wells/First Interstate	0%	32%	14%
Chemical/Chase	11%	13%	12%
NationsBank/Boatman's	(7%)	25%	4%

Source: Robert Townsend, Jill Ferguson, and Craig Williams, "The US Is Growing Wary of Mega-mergers," Salomon Smith Barney Equity Research, October 6, 2000, pp. 13.

EXHIBIT 1-3

Total Transaction Value of M&A Transactions Closed (in Billions of Dollars)



Source: Bloomberg Professonal M&A Statistics.

lic companies to produce asset and income growth to feed investors' expectations. In most markets, the growth demanded by investors cannot be achieved with their existing lines of business. Chief executive officers have become increasingly dependent on acquisitions to increase their penetration of their existing markets, enter new markets, and produce the incremental income needed to meet investors' expectations. However, the ever-increasing pressure by investors has thrown the risk/reward equation out of balance. Although they fluctuate with economic cycles, M&A premiums consistently exceed 20 percent of the book value of assets acquired (see Exhibit 1-4). In other words, in order to induce a seller to sell, buyers consistently have to pay 20 percent more than the assets are "worth." These high premiums leave little margin for error and put enormous pressure on the operating results of a company postacquisition, forcing management to grow assets and income aggressively to achieve pro forma projections.

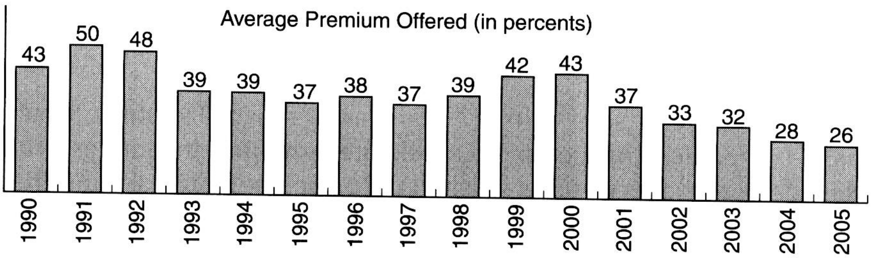
Other factors leading to the proliferation of M&A activity include the following.

Stock-for-Stock Acquisitions

The large P/E multiples of publicly traded companies in the late 1990s accelerated the use of stock as an acquisition currency and made some deals look relatively inexpensive compared to a cash purchase funded through debt issued by the purchaser. Take Webvan's acquisition of Homegrocer.com in September 2000. Webvan issued 138 million shares of common stock to retire all Homegrocer shares and recorded over $900

EXHIBIT 1-4

Premium over Target Book Value



Source: Thompson Financial

million in goodwill. Although the issuance of common stock diluted current Webvan equity holders' positions, this was a very efficient form of merger because the company did not have to pay any cash, or issue any incremental debt to complete the deal. However, from an investor's perspective, the true cost of the acquisition was not reflected in Webvan's financial statements. In fact, the stock ultimately proved to be worthless, as Webvan filed for bankruptcy in the second quarter of 2001.

Sellers' Market

The constant pressure for corporate growth at any cost has kept the demand for acquisitions high. The result has been a deal climate in which there are more "buyers" than there are companies willing to sell. In addition to driving up prices, this has resulted in a very cavalier approach by the investment bankers that are marketing companies. Even in major, multibillion-dollar acquisitions, the amount of time allowed for buyers to complete their due diligence on target companies has been compressed.

Shorter due diligence periods work to the advantage of the seller for a variety of reasons:

- Only one of the bidders completing due diligence will actually purchase the company. Therefore, sellers are motivated to release the least amount of information possible to protect the confidentiality of information.
- Better-educated buyers are usually smarter buyers. If the amount of information available is limited, the advantage in negotiations goes to the seller.