MERGERS, ACQUISITIONS, AND OTHER RESTRUCTURING ACTIVITIES

AN INTEGRATED APPROACH TO PROCESS, TOOLS, CASES, AND SOLUTIONS

SIXTH EDITION

DONALD M. DEPAMPHILIS, Ph.D.

College of Business Administration Loyola Marymount University Los Angeles, California





Contents

Contents of the Companion Site xvii List of Business Case Studies xix Preface xxiii Acknowledgments xxviii About the Author xxix

Part I

THE MERGERS AND ACQUISITIONS ENVIRONMENT

1. Introduction to Mergers and Acquisitions

Inside M&A: Dell Moves into Information Technology Services 3 Chapter Overview 4 Mergers and Acquisitions as Change Agents 4 Why Mergers and Acquisitions Happen 5 Merger and Acquisition Waves 13 Why It Is Important to Anticipate Merger Waves 19 Alternative Forms of Corporate Restructuring 19 Friendly versus Hostile Takeovers 22 The Role of Holding Companies in Mergers and Acquisitions 24 The Role of Employee Stock Ownership Plans in M&As 24 Business Alliances as Alternatives to Mergers and Acquisitions 25 Participants in the Mergers and Acquisitions Process 26 Alternative Investors and Lenders 29 Activist Investors and M&A Arbitrageurs 32 Do M&As Pay Off for Shareholders, Bondholders, and Society? 35 Why Some M&As Fail to Meet Expectations 44 Long-Term Performance 44

Some Things to Remember 45

Discussion Questions 45
Chapter Business Cases 47
Case Study 1.1 Xerox Buys ACS to Satisfy
Shifting Customer Requirements 47
Case Study 1.2 Assessing Procter & Gamble's
Acquisition of Gillette 49

2. Regulatory Considerations Inside M&A: The Limitations of Regulation and the Lehman Brothers Meltdown 51 Chapter Overview 52 Federal Securities Laws 54 Case Study 2.1 A Federal Judge Reprimands Hedge Funds in Their Effort to Control CSX 57 Antitrust Laws 61 Case Study 2.2 Justice Department Requires Verizon Wireless to Sell Assets before Approving Alltel Merger 65 Dodd-Frank Wall Street Reform and Consumer Protection Act 69 Case Study 2.3 Google Thwarted in Proposed Advertising Deal with Chief Rival Yahoo! 70 State Regulations Affecting Mergers and Acquisitions 75 National Security-Related Restrictions on Direct Foreign Investment in the United States 76 The U.S. Foreign Corrupt Practices Act 77 Fair Disclosure (Regulation FD) 77 Regulated Industries 78 Environmental Laws 80 Labor and Benefit Laws 80 Cross-Border Transactions 81 Case Study 2.4 BHP Billiton and Rio Tinto Blocked by Regulators in an International Iron Ore Joint Venture 82 Some Things to Remember 83 Discussion Questions 83 Chapter Business Cases 84 Case Study 2.5 Global Financial Exchanges Pose

Regulatory Challenges 84

Case Study 2.6 The Legacy of GE's Aborted

Attempt to Merge with Honeywell 86

xii CONTENTS

 The Corporate Takeover Market:
 Common Takeover Tactics, Antitakeover Defenses, and Corporate Governance

Inside M&A: Kraft Sweetens Its Offer to Overcome Cadbury's Resistance 91 Chapter Overview 92 Alternative Models of Corporate Governance 94 Factors That Affect Corporate Governance 94 Alternative Takeover Tactics in the Corporate Takeover Market 99 What Makes the Aggressive Approach Successful? Other Tactical Considerations 106 Developing a Bidding or Takeover Strategy 107 Alternative Takeover Defenses in the Corporate Takeover Market 108 The Impact of Takeover Defenses on Shareholder and Bondholder Value 121 Some Things to Remember 124 Discussion Questions 125 Chapter Business Cases 126 Case Study 3.1 Mittal Acquires Arcelor-A Battle of Global Titans in the European

Part II

Corporate Takeover Market 126

Strategies 128

Case Study 3.2 Verizon Acquires MCI—

The Anatomy of Alternative Bidding

THE MERGERS AND ACQUISITIONS PROCESS: PHASES 1 THROUGH 10

4. Planning: Developing Business and Acquisition Plans: Phases 1 and 2 of the Acquisition Process

Inside M&A: Nokia's Gamble to Dominate the Smartphone Market Falters 135 Chapter Overview 136 A Planning-Based Approach to M&As 137 Phase 1: Building the Business Plan 139 Case Study 4.1 CenturyTel Buys Qwest Communications to Cut Costs and Buy Time as the Landline Market Shrinks 145 Case Study 4.2 HP Redirects Its Mobile Device
Business Strategy with the Acquisition of
Palm 152

The Business Plan as a Communication
Document 154

Phase 2: Building the Merger–Acquisition
Implementation Plan 156

Some Things to Remember 162

Discussion Questions 162

Chapter Business Cases 163

Case Study 4.3 Adobe's Acquisition of
Omniture: Field of Dreams Marketing? 163

Case Study 4.4 BofA Acquires Countrywide

5. Implementation: Search through Closing: Phases 3 through 10

Appendix: Common Sources of Economic,

Industry, and Market Data 167

Financial Corporation 165

Inside M&A: Bank of America Acquires Merrill
Lynch 169
Chapter Overview 170
Phase 3: The Search Process 170
Phase 4: The Screening Process 173

Phase 5: First Contact 174

Phase 6: Negotiation 178
Phase 7: Developing the Integration Plan 186
Phase 8: Closing 188
Phase 9: Implementing Postclosing Integration 191
Phase 10: Conducting a Postclosing Evaluation 193
Some Things to Remember 194

Discussion Questions 194
Chapter Business Cases 196
Case Study 5.1 Oracle's Efforts to Consolidate
the Software Industry 196

Case Study 5.2 Exxon Mobil Buys XTO Energy in a Bet on Natural Gas 198

Appendix A: Thoughts on Negotiating

Dynamics 200

Appendix B: Legal Due Diligence Preliminary
Information Request 202

6. Integration: Mergers, Acquisitions, and Business Alliances

Inside M&A: General Electric's Water Business Fails to Meet Expectations 203

CONTENTS **xiii**

Chapter Overview 204 The Role of Integration in Successful M&As Viewing Integration as a Process 206 Case Study 6.1 HP Acquires Compaq— The Importance of Preplanning Integration 208 Case Study 6.2 Integrating Supply Chains: Coty Cosmetics Integrates Unilever Cosmetics International 217 Case Study 6.3 Culture Clash Exacerbates Efforts of the Tribune Corporation to Integrate the Times Mirror Corporation 222 Case Study 6.4 Panasonic Moves to Consolidate Past Acquisitions 224 Integrating Business Alliances 225 Some Things to Remember 227 Discussion Questions 227 Chapter Business Cases 228 Case Study 6.5 The Challenges of Integrating Steel Giants Arcelor and Mittal 228 Case Study 6.6 Alcatel Merges with Lucent, Highlighting Cross-Cultural

Part III

Issues 230

MERGER AND ACQUISITION VALUATION AND MODELING

7. A Primer on Merger and Acquisition Cash-Flow Valuation

Inside M&A: The Importance of Distinguishing between Operating and Nonoperating Assets 235 Chapter Overview 235 Required Returns 236 Analyzing Risk 242 Calculating Free Cash Flows 247 Applying Income or Discounted-Cash-Flow Methods 250 Valuing Firms Subject to Multiple Growth Periods 256 Valuing Firms under Special Situations 258 Using the Enterprise Method to Estimate Equity Value 259 Valuing Nonoperating Assets 266 Putting It All Together 270 Some Things to Remember 274

Discussion Questions 274
Practice Problems and Answers 275
Chapter Business Cases 279
Case Study 7.1 Hewlett-Packard Outbids Dell
Computer to Acquire 3PAR 279
Case Study 7.2 Creating a Global Luxury Hotel
Chain 281

8. Applying Relative, Asset-Oriented, and Real-Option Valuation Methods to Mergers and Acquisitions

Inside M&A: A Real-Options Perspective on Microsoft's Dealings with Yahoo! 283 Chapter Overview 285 Applying Relative-Valuation (Market-Based) Methods 286 Applying Asset-Oriented Methods 297 The Replacement Cost Method 300 Valuing the Firm Using the Weighted-Average Method 300 Analyzing Mergers and Acquisitions in Terms of Real Options 302 Determining When to Use the Different Approaches to Valuation 314 Which Valuation Methods Are Actually Used in Practice 315 Some Things to Remember 316 Discussion Questions 316 Practice Problems and Answers 317 Chapter Business Cases 320 Case Study 8.1 Google Buys YouTube: Valuing a Firm in the Absence of Cash Flows 320 Case Study 8.2 Merrill Lynch and BlackRock Agree to Swap Assets 322

9. Applying Financial Modeling Techniques: To Value, Structure, and Negotiate Mergers and Acquisitions

Inside M&A: HP Buys EDS—The Role of Financial Models in Decision Making 325 Chapter Overview 326 Limitations of Financial Data 327 The Model-Building Process 329 Using Financial Models in Support of M&A Negotiations 349 xiv Contents

Alternative Applications of M&A Financial Models 353	Part IV
Some Things to Remember 354 Discussion Questions 355 Practice Problems and Answers 356	DEAL-STRUCTURING AND FINANCING STRATEGIES
Chapter Business Cases 357 Case Study 9.1 Cleveland Cliffs Fails to Complete Takeover of Alpha Natural	11. Structuring the Deal: Payment and Legal Considerations
Resources in a Commodity Play 357 Case Study 9.2 Mars Buys Wrigley in One Sweet Deal 360	Inside M&A: Pfizer Acquires Wyeth Labs Despite Tight Credit Markets 409 Chapter Overview 410
Appendix A: Utilizing the M&A Model on the Companion Site to this Book 361 Appendix B: M&A Model Balance Sheet Adjustment Mechanism 363	The Deal-Structuring Process 411 Form of Acquisition Vehicle and Postclosing Organization 415
 Analysis and Valuation of Privately Held Companies 	Legal Form of the Selling Entity 419 Form of Payment or Total Consideration 419 Managing Risk and Closing the Gap on Price 421
Inside M&A: Cashing Out of a Privately Held Enterprise 365 Chapter Overview 366 Demographics of Privately Held Businesses 367 Governance Issues in Privately Held and Family-	Using Collar Arrangements to Preserve Shareholder Value 427 Case Study 11.1 Flextronics Acquires International DisplayWorks Using Fixed Value and Fixed Share Exchange Collars 430
Owned Firms 368 Challenges of Valuing Privately Held Companies 369 Process for Valuing Privately Held Businesses 371	Form of Acquisition 431 Case Study 11.2 Buyer Consortium Wins Control of ABN Amro 437 Some Things to Remember 442
Step 1: Adjusting Financial Statements 371 Step 2: Applying Valuation Methodologies to Privately Held Companies 377 Step 3: Developing Discount (Capitalization)	Discussion Questions 443 Chapter Business Cases 444 Case Study 11.3 Boston Scientific Overcomes Johnson & Johnson to Acquire Guidant—A
Rates 380 Step 4: Applying Control Premiums, Liquidity, and Minority Discounts 383 Reverse Mergers 395	Lesson in Bidding Strategy 444 Case Study 11.4 Swiss Pharmaceutical Giant Novartis Takes Control of Alcon 446
Using Leveraged Employee Stock Ownership Plans to Buy Private Companies 397 Empirical Studies of Shareholder Returns 398	12. Structuring the Deal: Tax and Accounting Considerations
Some Things to Remember 399 Discussion Questions 400 Practice Problems and Answers 400	Inside M&A: Continued Consolidation in the Generic Pharmaceuticals Industry 449 Chapter Overview 449
Chapter Business Cases 401 Case Study 10.1 Panda Ethanol Goes Public in a Shell Corporation 401	General Tax Considerations and Issues 450 Taxable Transactions 450 Case Study 12.1 Cablevision Uses Tax Benefits
Case Study 10.2 Determining Liquidity Discounts—The Taylor Devices and Tayco Development Merger 403	to Help Justify the Price Paid for Bresnan Communications 455 Tax-Free Transactions 456

CONTENTS XV

Other Tax Considerations Affecting Corporate
Restructuring 463
Financial Reporting of Business Combinations 466
Impact of Purchase Accounting on Financial
Statements 469
International Accounting Standards 474
Recapitalization Accounting 474
Some Things to Remember 474
Discussion Questions 475
Practice Problems and Answers 476
Chapter Business Cases 477
Case Study 12.2 Teva Pharmaceuticals Buys
Barr Pharmaceuticals to Create a Global
Powerhouse 477
Case Study 12.3 Merck and Schering-
Plough Merger: When Form Overrides
Substance 480

13. Financing Transactions: Private Equity, Hedge Funds, and Leveraged Buyout Structures and Valuation

Inside M&A: Kinder Morgan Buyout Raises Ethical
Questions 485
Chapter Overview 486
Characterizing Leveraged Buyouts 487
How Do LBOs Create Value? 493
When Do Firms Go Private? 495
Financing Transactions 495
Common Forms of Leveraged Buyout Deal
Structures 500
Prebuyout and Postbuyout Shareholder
Returns 504
Using DCF Methods to Value Leveraged
Buyouts 509
LBO Valuation and Structuring Model
Basics 518

Some Things to Remember 526

Discussion Questions 526

Practice Problems and Answers 527

Chapter Business Cases 529

Case Study 13.1 TXU Goes Private in the Largest Private Equity Transaction in History—A Retrospective Look 529 Case Study 13.2 "Grave Dancer" Takes Tri

Case Study 13.2 "Grave Dancer" Takes Tribune Corporation Private in an Ill-Fated Transaction 532

Part V

ALTERNATIVE BUSINESS AND RESTRUCTURING STRATEGIES

14. Joint Ventures, Partnerships, Strategic Alliances, and Licensing

Inside M&A: Microsoft Partners with Yahoo!—An Alternative to Takeover? 539 Chapter Overview 540 Motivations for Business Alliances 540 Critical Success Factors for Business Alliances 545 Alternative Legal Forms of Business Alliances 547 Strategic and Operational Plans 554 Resolving Business Alliance Deal-Structuring Issues 555 Case Study 14.1 Determining Ownership Distribution in a Joint Venture 559 Empirical Findings 565 Some Things to Remember 567 Discussion Ouestions 567 Chapter Business Cases 568 Case Study 14.2 Estimating the Real Cost of Comcast's Investment in NBC Universal 568 Case Study 14.3 British Petroleum and Russia's Rosneft Unsuccessful Attempt to Swap Shares 572

15. Alternative Exit and Restructuring Strategies: Divestitures, Spin-Offs, Carve-Outs, Split-Offs, and Tracking Stocks

Inside M&A: Bristol-Myers Squibb Splits off the Rest of Mead Johnson 575 Chapter Overview 576 Commonly Stated Motives for Exiting Businesses 577 Case Study 15.1 British Petroleum Sells Oil and Gas Assets to Apache Corporation 579 Divestitures 581 Spin-Offs 587

Case Study 15.2 Motorola Bows to Activist
Pressure 588

xvi CONTENTS

Case Study 15.3 Anatomy of a Spin-Off 590 Equity Carve-Outs 591 Split-Offs and Split-Ups 593 Case Study 15.4 Anatomy of a Split-Off 593 Tracking, Targeted, and Letter Stocks 595 Voluntary Liquidations (Bust-Ups) 596 Comparing Alternative Exit and Restructuring Strategies 597 Choosing among Divestiture, Carve-Out, and Spin-Off Restructuring Strategies 597 Determinants of Returns to Shareholders Resulting from Restructuring Strategies 599 Some Things to Remember 609 Discussion Questions 609 Chapter Business Cases 610 Case Study 15.5 Kraft Foods Undertakes Split-Off of Post Cereals in Merger-Related Transaction 610 Case Study 15.6 Sara Lee Attempts to Create Value through Restructuring 613

16. Alternative Exit and Restructuring Strategies: Reorganization and Liquidation

Inside M&A: Calpine Emerges from the Protection of Bankruptcy Court 617 Chapter Overview 618 Business Failure 618 Voluntary Settlements with Creditors Outside of Bankruptcy 619 Reorganization and Liquidation in Bankruptcy 622 Case Study 16.1 Lehman Brothers Files for Chapter 11 in the Biggest Bankruptcy in U.S. History 625 Analyzing Strategic Options for Failing Firms Failing Firms and Systemic Risk 635 Predicting Corporate Default and Bankruptcy 637 Valuing Distressed Businesses 640 Empirical Studies of Financial Distress 644 Some Things to Remember 646 Discussion Questions 646

Chapter Business Cases 648

Case Study 16.2 The General Motors'
Bankruptcy—The Largest GovernmentSponsored Bailout in U.S. History 648

Case Study 16.3 Delta Airlines Rises from the
Ashes 652

17. Cross-Border Mergers and Acquisitions: Analysis and Valuation

Inside M&A: InBev Buys an American Icon

for \$52 Billion 655

Chapter Overview 656

Distinguishing between Developed and Emerging Economies 656 Globally Integrated versus Segmented Capital Markets 657 Motives for International Expansion 659 Case Study 17.1 Ford Sells Volvo to Geely in China's Biggest Overseas Auto Deal 660 Common International Market Entry Strategies 662 Structuring Cross-Border Transactions 665 Financing Cross-Border Transactions 667 Planning and Implementing Cross-Border Transactions in Emerging Countries 669 Valuing Cross-Border Transactions 670 Empirical Studies of Financial Returns to International Diversification 683 Some Things to Remember 686 Discussion Questions 686 Chapter Business Cases 688 Case Study 17.2 Overcoming Political Risk in Cross-Border Transactions: China's CNOOC Invests in Chesapeake Energy 688 Case Study 17.3 Wal-Mart's International Strategy Illustrates the Challenges and the Potential of Global Expansion 690

References 693 Glossary 715 Index 725