Slides and Presentations

Table 7-1. *Derivation of Asset-Weighted Deviations of Post-Merger from Pre-Merger Profitability in 634-Company Sample*

Pre-merger asset range (millions of dollars)	*Asset weight* (1)	Pooling acquisitions: *Predicted pre-merger return (percent)*[a] (2)	Pooling acquisitions: *MACRO-adjusted return (percent)* (3)	Purchase acquisitions: *Predicted pre-merger return (percent)*[a] (4)	Purchase acquisitions: *MACRO-adjusted return (percent)* (5)
Less than 1.0	0.0083	24.31	28.28	13.50	15.71
1.00–2.49	0.0212	22.67	26.37	13.41	15.61
2.50–4.99	0.0385	21.61	25.14	13.36	15.54
5.00–9.99	0.0456	20.71	24.09	13.31	15.48
10.00–14.99	0.0389	19.99	23.25	13.27	15.44
15.00–19.99	0.0295	19.53	22.72	13.25	15.41
20.00–29.99	0.0625	19.08	22.19	13.22	15.38
30.00–49.99	0.0865	18.48	21.50	13.19	15.34
50.00–99.99	0.1120	17.69	20.58	13.15	15.30
100.00–249.99	0.1260	16.69	19.41	13.09	15.23
250.00–500.00	0.1950	15.58	18.12	13.04	15.16
More than 500.00	0.2360	14.80	17.21	12.99	15.12
Resulting deviation	1.000[b]		6.20[c]		3.076[d]

a. Computed from the regression equation in text note 2.
b. Σ col. (1) = 1.000.
c. Σ col. (1) $\times$ [col. (3) $-$ 13.83] = 6.20.
d. Σ col. (1) $\times$ [col. (5) $-$ 12.19] = 3.076.

Table 6-3. *Deviations of Divested Lines' Profitability from the Average Operating Income/Assets Percentages of Nondivested Lines in the Same Industry, by Interval between the Date of Profit Report and Initiation of Sell-Off, 1974–81*

Years between profit report and first sell-off	*Lines with full sell-off*		*Lines with partial sell-off*	
	Number	*Deviation (percent)*[a]	*Number*	*Deviation (percent)*[a]
7	58	−1.54 (3.01)	57	−0.34 (1.78)
6	110	−3.48 (2.07)	104	−0.56 (1.59)
5	155	−3.72 (1.44)	155	−1.01 (1.36)
4	191	−6.40 (1.36)	189	−2.33 (1.18)
3	204	−9.92 (1.21)	218	−3.30 (0.95)
2	201	−10.60 (1.22)	226	−4.10 (1.11)
1	210	−13.54 (1.61)	219	−3.76 (0.99)
0	121	−12.73 (2.15)	198	−1.96 (1.12)
< 0[b]	39	−4.91 (3.80)	238	−1.34 (0.94)

a. Values in parentheses are the standard error of the mean.
b. Profits reported after first sell-off.

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Comments for Panel on Merger Outcomes
FTC Bureau of Economics Roundtable
December 9, 2002

Robert H. McGuckin
Director
Economic Research

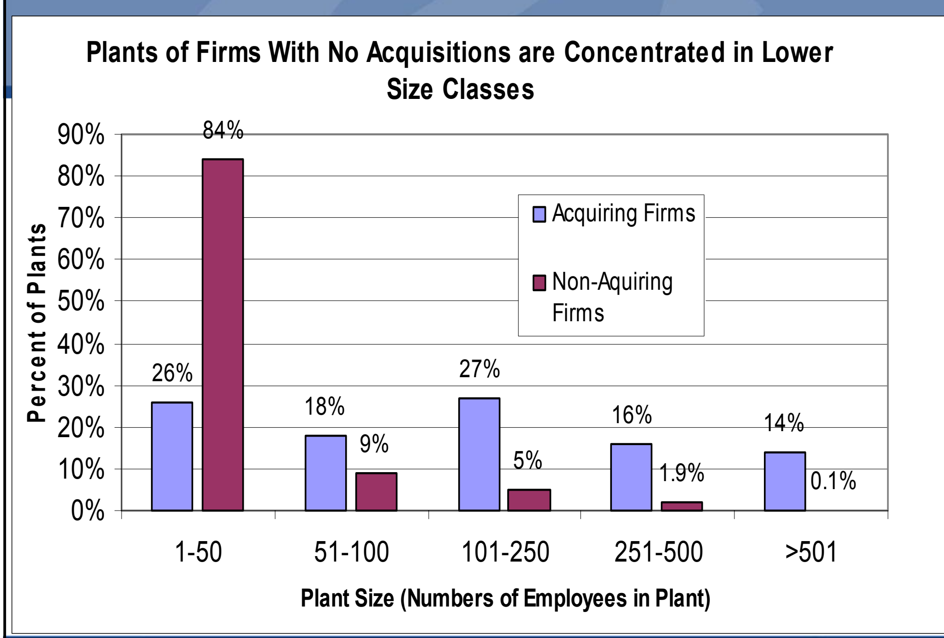
Overview of Comments

- Structural reform is not just about governments and deregulation
- M&A are key factor in business change and reorganization
- Successful firms build, close, buy, and sell plants and business units:so counterfactual analysis is crucial
- Most mergers exploit opportunities for “synergies”: Take a good performer and make them better
- But a significant fraction provide managerial discipline: Improve performance of a poor performer
- “Fix it first” approach to acquisitions makes sense for antitrust approach, efficiencies difficult to measure ex ante

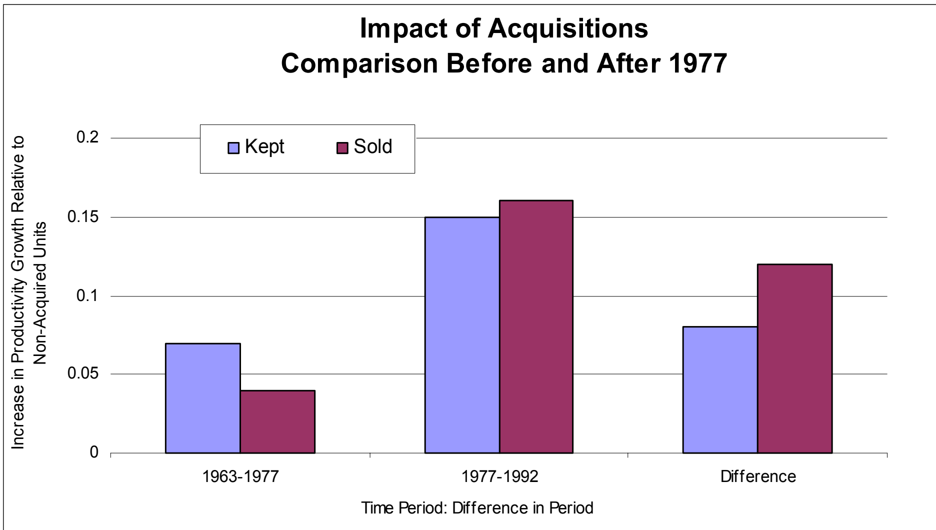
M&A Impacts Pervasive

Plants in Operation 1977-1987

Type of Firm	Plants		Employment , 1977	
	Number	Percent	Number in Millions	Percent of total
Firms with Acquisitions				
Acquired Between 1977-1987	16,061	11.0%	3.7	28.0%
Owned in 1977 by Firms With Acquisitions	12,487	8.5%	5.1	38.6%
Subtotal: Firms With Acquistions	28,548	19.5%	8.8	66.7%
Firms With No Acquisitions				
Plants Owned in 1977	118,171	80.5%	4.4	33.3%
All Firms	146,719	100.0%	13.2	100.0%



Ownership Change Improves Performance



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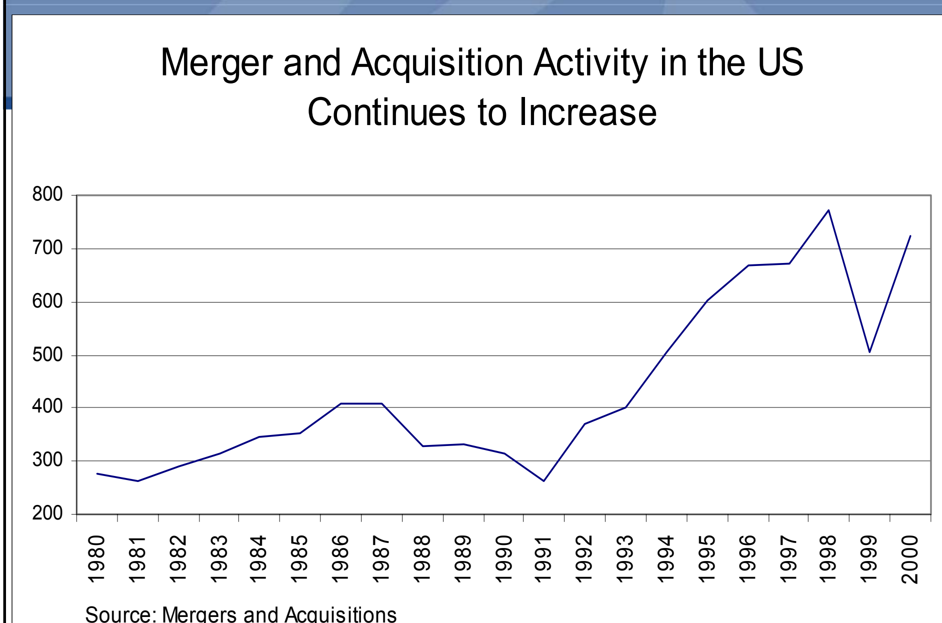

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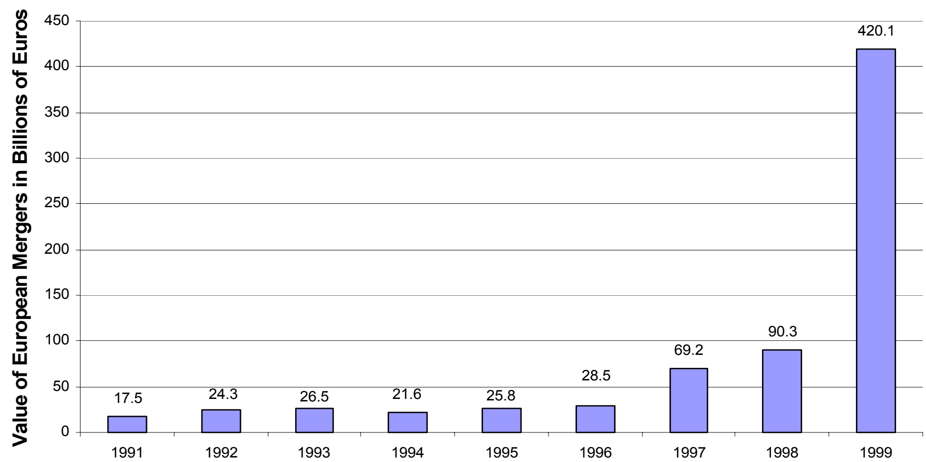
M&A Growing in Europe



Source:SDC-M&A, TCB

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Mergers: Changes Across Time

Dr. Susanne Trimbath, Ph.D.
Research Economist, Milken Institute
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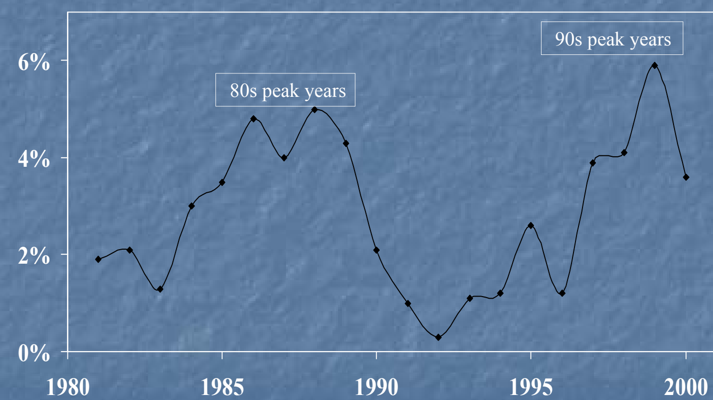
Prepared for Federal Trade Commission Roundtable, December 9-10, 2002

Determinants and Effects: Changes Across Time

- Relatively inefficient firms are chosen as targets.
- Post-takeover, the utilization of resources at the firm level is improved.
- Regardless of "mood" or type of buyer.
- Account for temporal changes in risk.

Volume: Changes Across Time



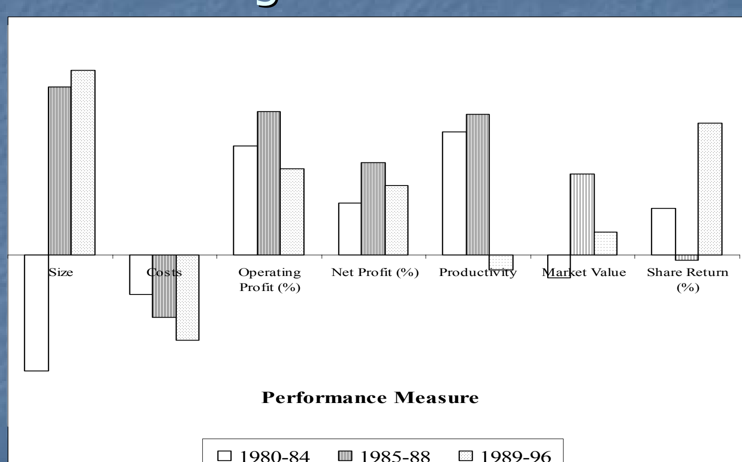
Studies: Changes Across Time

- **Methodology:**
  - 1970s: Multiple Discriminant and Univariate Analysis
  - 1980s: Probability Analysis (probit and logit)
  - 1990s: Hazard Analysis
- **Hypothesis:**
  - 1970s: Takeovers for economies of scale or scope
  - 1980s: Takeovers as wasteful endeavors (heterogeneity)
  - 1990s: Takeovers to enhance economic efficiency
- **Measuring Performance:**
  - 1970s: Accounting rates of return
  - 1980s: Shareholder returns
  - 1990s: Free Cash Flow, Transfers of Wealth, etc.

Evidence: Changes Across Time

- Ravenscraft and Scherer (1987): targets are more profitable
  - Matsusaka (1993): only if they are small
- Palepu (1986): incorrect models, poor prediction accuracy
  - Ambrose and Megginson (1992): some contradictory results in extended sample

Relative Performance: Changes Across Time



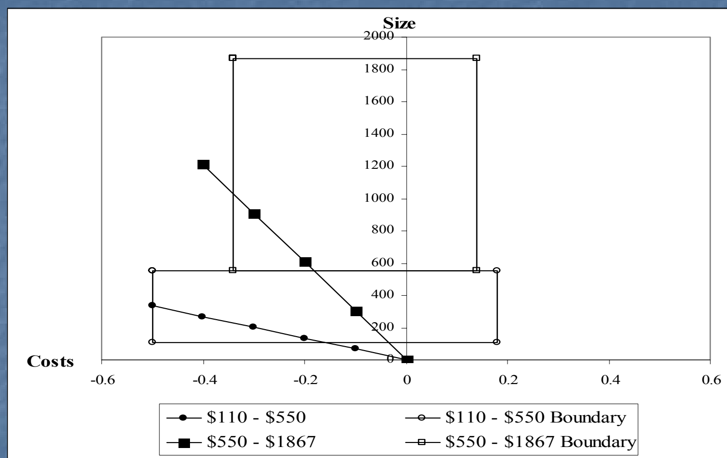
At the Median: Changes Across Time

		Inactive	Target	Buyer
1980-84	Size	484	789**	2760**
	Costs	-0.09	0.00**	-0.02*
1985-88	Size	644	726	1728**
	Costs	-0.15	-0.01**	-0.04**
1989-97	Size	946	901	2860**
	Costs	-0.22	-0.03**	-0.06*

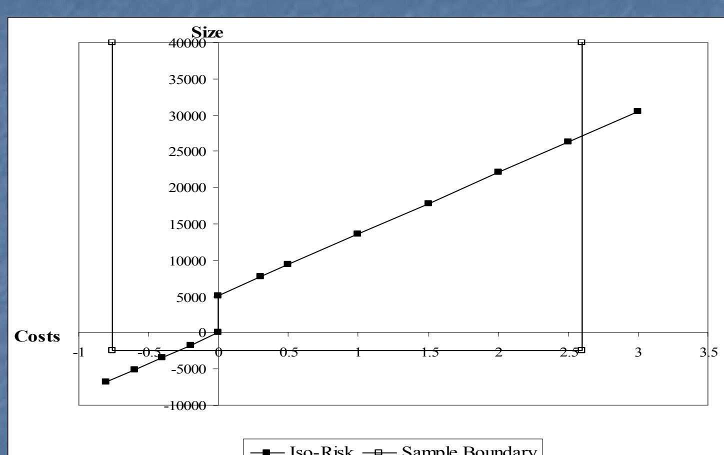
Relative Risk: Changes Across Time

1981-1985, 110 < Size ≤550	0.00233***
1981-1985, 550 < Size ≤1867	0.00053***
1986-1989, Size ≤ 1039	0.00188***
1986-1989, 1039 > Size	-0.00008**
1990-1997, Size	-0.00018***
Costs	1.66540***
Costs Above Industry	0.87686***

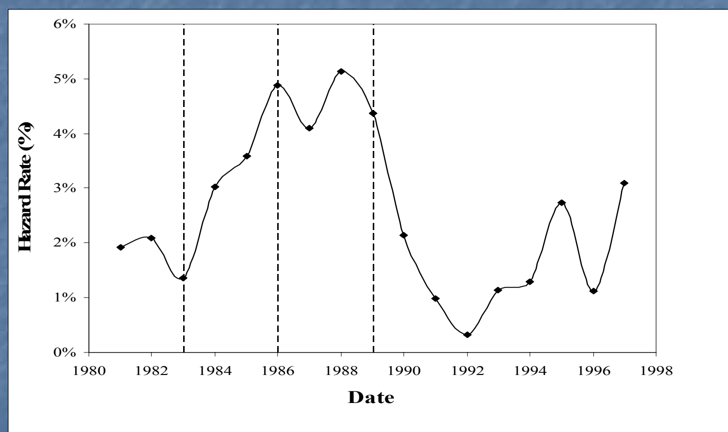
Iso-Risk: Changes Across Time



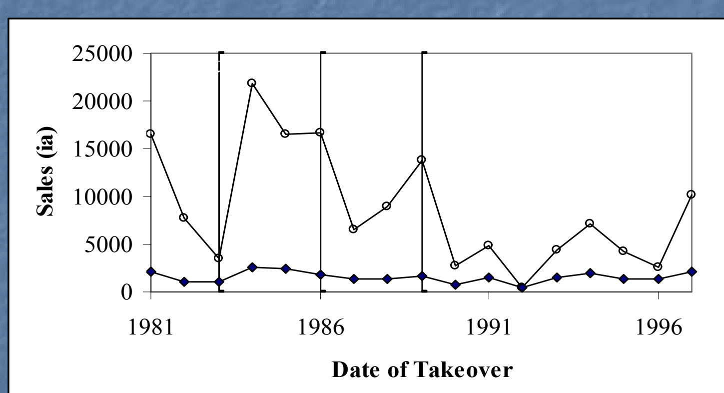
Iso-Risk: Changes Across Time



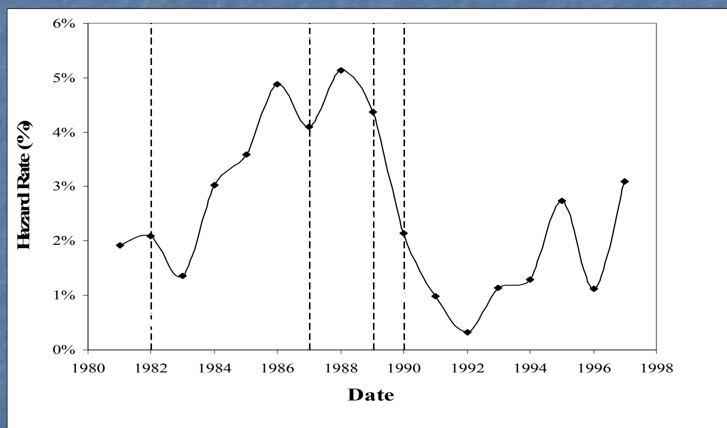
Financing: Changes Across Time



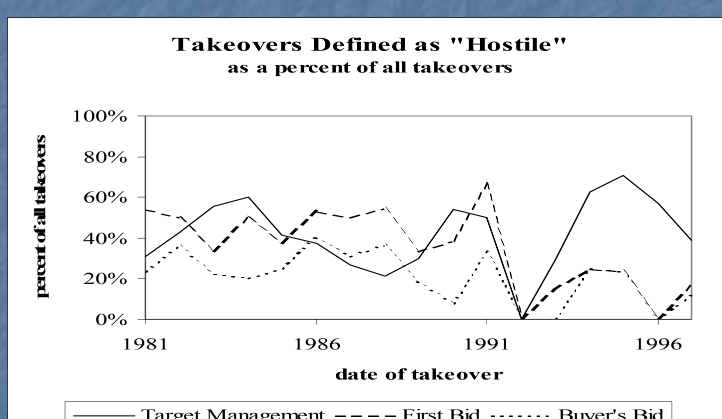
Target Size: Changes Across Time



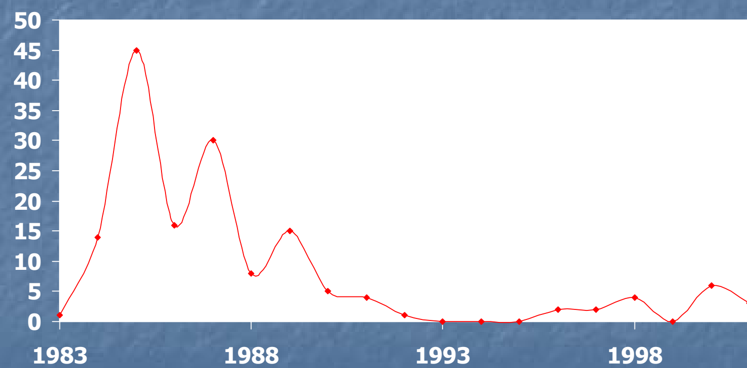
State Laws: Changes Across Time



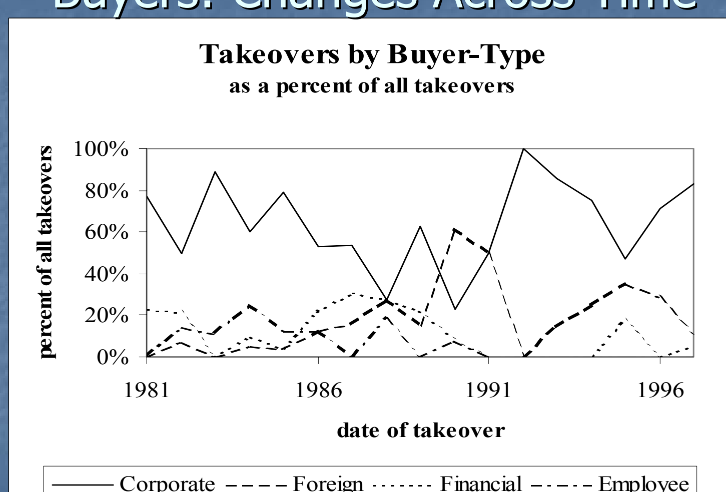
Mood: Changes Across Time



Congress: Changes Across Time



Buyers: Changes Across Time



Outcomes: Changes Across Time

- Before 1990: 3% gain; on average cost savings $46 million per merger
- After 1990: 1% gain; on average cost savings $15 million per merger

Savings are per year per merger!

Restructuring:Changes Across Time

- 1900: transcontinental railroad enabled national firms
- 1920: automobile transportation enabled extended local markets, financial market stimulus
- 1960: Stock market premium for growth

Restructuring:Changes Across Time

- 1980: financial innovations enabled large mergers and reduced advantage of internal capital market
- 1990: global competition, technological change, deregulation
- 2000: blurring of industry boundaries, shorter product cycles

Sectors: Changes Across Time

Basic	64%	36%
Cyclical	75%	25%
Non-Cyclical	77%	23%
Energy	82%	18%
Industrial	73%	27%
Technology	52%	48%

Identifying Changes Across Time

- Population Growth: Food, household products
- Product Life Cycles: Technology, pharmaceuticals
- Customer Preferences: Environmental or Ecological Impact, Demographic Shifts
- Post-Exuberance: Excess Capacity, Inefficient Scale

Mergers: Changes Across Time

Dr. Susanne Trimbath, Ph.D.
Research Economist, Milken Institute
www.milkeninstitute.org

Prepared for Federal Trade Commission Roundtable, December 9-10, 2002

What Do We Know About Merger Outcomes?

Steven Kaplan
University of Chicago Graduate School of Business

Prepared for FTC Merger Outcomes Roundtable
December 9, 2002

Overview

- How can one evaluate merger success?
- What is the empirical evidence in the finance literature re merger success on average?
  - Stock returns.
    - Short-term
    - Long-term
  - Operating / accounting / productivity / divestiture performance.
  - Clinical studies?
- What is the source of gains / losses?
- What micro factors drive merger success / the attainment of those gains?

How can one evaluate merger success?

- Stock price change at announcement.
  - Measures market expectations of change in value from merger.
  - Appropriate measure is combined change in value.
    - Care about bidder and target, not just bidder. (Index fund).
    - Bidder overpayment is irrelevant for policy.
  - Implicit assumptions:
    - Market is well informed on average.
    - No other information released.
- Stock price change over longer run (3 years typical).
  - Implicit assumptions:
    - Merger is important enough to drive stock price.
    - No other information released.
- Change in operating margins over longer run (1 to 3 years typical).
  - Implicit assumptions:
    - Merger is important enough to drive overall operating margins.
    - No other factors important on average.

Evaluate - 2

- Change in productivity at the plant level over longer run (1 to 3 years).
  - Measures outcome of merger at plant level.
  - Implicit assumptions:
    - Total productivity changes of merger are largely determined by productivity changes at the plant level.
- Analysis of subsequent divestiture.
  - Cannot evaluate non-divestitures.
- Measure actual / expected present value using actual / expected changes in cash flows / values.
  - Implicit assumptions:
    - Expected equals actual.
    - One can measure actual.
- Additional implicit assumption:
  - Merger effects are exogenous. Do not affect behavior of non-merging companies – no disciplinary effects.

Evaluate - 3

- Assessment:
  - Finance literature measures success using stock market values or measures of cash flow.
    - Does not look at effect on consumers.
  - All of these measures problematic / rely on assumptions.
  - All are potentially informative.
  - Prefer announcement returns as most informative about expected values / ex ante success.
  - Prefer measure of actual cash flows of mergers as ex post measure of success.
    - Difficult to calculate.

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Do ann. returns measure expected merger value? Not exactly

- Total changes to value after acquisition announcement:
  - $[A^A - A^0] + [T^A - T^0]$
  - Change in acquirer value plus change in target value.
  - A^A = value of acquirer after the acquisition.
  - A^0 = value of acquirer before the acquisition announcement.
  - T^A = value of target after the acquisition.
  - T^0 = value of target before the acquisition announcement.

- Can be further decomposed:
  - $= [A^A - A^N] + [T^A - T^N] + [A^N - A^0] + [T^N - T^0]$.
  - Each of the four bracketed terms carries a distinct interpretation:
    - Total synergies: $[A^A - A^N] + [T^A - T^N]$
    - New information about Acquirer: $[A^N - A^0]$
    - New information about Target: $[T^N - T^0]$

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Summary of finance literature

- Stock return results based on Andrade, Mitchell, Stafford (2001): "New Evidence and Perspectives on Mergers"
  - CRSP Merger Database
  - U.S. acquirers and targets.
  - 1973 – 1998
- Stock returns.
  - Measures change in expectations of value of target and acquirer.

Announcement Returns - 2

- Over 3 day period around announcement:
  - Combined returns positive, economically and statistically significant.
    - Roughly 2% of combined value.
      - Equivalent to 10%+ of target value.
    - Consistent across all 3 decades.
  - Target returns are clearly positive. 16%.
  - Acquirer returns are insignificantly negative. -0.7%.
- Over period from 20 days before until close:
  - Combined returns are positive, but not significant.
    - Roughly 2% of combined value.
  - Target returns are clearly positive. 24%.
  - Acquirer returns are insignificantly negative. -4%.

Announcement Returns

Table 4

Announcement Period Abnormal Returns by Decade, 1973-1998

	1973-79	1980-89	1990-98	1973-98
Combined				
[-1, +1]	1.5%	2.6% ***	1.4% ***	1.8% ***
[-20, Close]	0.1%	3.2%	1.6%	1.9%
Target				
[-1, +1]	16.0% ***	16.0% ***	15.9% ***	16.0% ***
[-20, Close]	24.8% ***	23.9% ***	23.3% ***	23.8% ***
Acquirer				
[-1, +1]	-0.3%	-0.4%	-1.0%	-0.7%
[-20, Close]	-4.5%	-3.1%	-3.9%	-3.8%
No. Obs.	598	1,226	1,864	3,688

Note: Statistical significance at the 1% and 5% levels are denoted by *** and **, respectively.

- Recall that acquisitions reveal information about acquirer and target that may change expectations of stand alone values.
  - Clearly relevant for stock performance studies.
  - Potentially relevant for accounting-based studies.
- Information about acquirer likely to be conveyed by financing.
  - Equity issues more likely when acquirer fully- / over-valued.
    - Equity as "currency."
    - $[A^N-A^0] < 0$.
    - Combined returns will underestimate value created.
- Acquisitions funded by at least some stock:
  - Combined returns are essentially 0.
    - Target returns are positive. Acquirer returns are negative.
- Acquisitions funded without stock:
  - Combined returns are positive.
    - Target returns are positive. Acquirer returns are zero.

Table 5
Announcement Period Abnormal Returns for Sub-Samples, 1973-1998

	Stock	No Stock	Large Target
Combined			
[-1, +1]	0.6%	3.6% ***	3.0% ***
[-20, Close]	-0.6%	5.3%	6.3%
Target			
[-1, +1]	13.0% ***	20.1% ***	13.5% ***
[-20, Close]	20.8% ***	27.8% ***	21.6% ***
Acquirer			
[-1, +1]	-1.5% ***	0.4%	-1.5%
[-20, Close]	-6.3%	-0.2%	-3.2%
No. Obs.	2,194	1,494	511

Note: Statistical significance at the 1% and 5% levels are denoted by *** and **, respectively.

Are announcement returns meaningful?

- Yes. Announcement returns are related to subsequent outcomes.
  - Kaplan and Weisbach (1992).
    - Related to subsequent divestiture at a loss.
  - Mitchell and Lehn (1990).
    - Related to subsequent hostile takeover.

Bottom Line of Event Studies:

- Stockholders appear to view acquisitions as creating value, on average. Combined returns are positive, particularly for non-stock mergers.
  - Investors holding the market – index fund investors – should favor acquisitions.
  - Targets capture most of the value.
- Announcement returns predictive of subsequent outcomes.
- Event studies not so helpful re:
  - Sources of value changes.
  - Determinants of success.

Longer run returns

- Look at returns to acquirers post-acquisition over following 3 years.
- A number of studies with often conflicting results.
- Most reliable: Mitchell and Stafford (2000).
- Equal-weighted:
  - Negative returns to stock acquisitions (-9.0%).
  - Insignificant returns to non-stock acquisitions (-1.4%).
- Value-weighted:
  - Insignificant returns to stock acquisitions (-4.3%).
  - Insignificant returns to non-stock acquisitions (3.6%).

- Bottom line of longer-term studies
  - Acquirers representing largest part of economic value have returns indistinguishable from 0.
    - Smaller acquirers have negative longer-run returns.
  - Not helpful re source of gains / losses or determinants of success.

Table 6

Three-Year Post-Merger Abnormal Returns for Acquiring Firms, 1961 to 1993

Portfolio Composition	Equal-Weight	Value-Weight
Full Sample	-5.0% ***	-1.4%
Financed with Stock	-9.0% ***	-4.3%
Financed without Stock	-1.4%	3.6%
Growth Firms	-6.5%	-7.2%
Value Firms	-2.9%	1.1%

Source: Mitchell and Stafford (2000)

Note: Statistical significance at the 1% and 5% levels are denoted by *** and **, respectively.

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Accounting-based Performance Studies

- Mixed results on changes in performance, divestitures, or productivity from mergers.
  - Andrade, Mitchell, and Stafford (2001) (authors positive) / [results mixed]
  - Healy, Palepu, and Ruback (1990) (authors positive) [results mixed]
  - Maksimovic and Phillips (2001) (authors neutral / positive)
  - Kaplan and Weisbach (1992) (authors neutral)
  - McGuckin and Nguyen (1995) (authors neutral)
  - Schoar (2002) (author neutral / negative)
  - Ravenscraft and Scherer (1987) (authors negative)
- Bottom-line: No clear results.
  - Puzzle relative to event study results.

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Clinical studies:

- Kaplan, Mitchell and Wruck (2000). For individual acquisition:
  - Calculate annual cash flows.
  - Calculate value at divestiture.
  - Compare disc. value of post-merger cash flows to pre-merger value.
  - No general results.

Determinants of gains and losses

- Larger sample, statistical: Most relevant paper is Houston, James and Ryngaert (2001).
  - Look at 41 large bank mergers. Acquirer estimates cost savings and revenue increases at acquisition announcement.
  - Combined returns related to projected cost savings.
    - $1 of cost savings NPV yields $0.58 of stock value.
  - Combined returns negatively (but not significantly) related to projected revenue increases.
- Related versus unrelated mergers.
  - Diversified firms tend to trade at discount. Reason not yet well-established. Could be selection bias.
  - Plant productivity declines in unrelated, but is neutral / increases in related mergers. (Schoar (2002)).
- Limited evidence of market power in other papers.
  - Related transactions typically fare better than unrelated, although not uniformly.

Micro determinants of success

- Large sample papers not relevant.
- Clinical studies. Kaplan (2000).
  - Mergers driven by technological / regulatory change.
  - Deep understanding of target firm's business.
    - Presumably correlated with related versus diversifying.
  - Organization design and structures appropriate to the business.
  - Appropriate compensation system and incentives.
  - Consistent with results in Bower (2001) and consulting studies.

For deals that succeed, where does the money go?

- All deals:
  - Benefit to consumer if lower costs translate into lower prices.
  - Increased productivity reflected in higher GDP / capita.
  - Extra money may stay within company to be reinvested or be paid out as dividends / share repurchases.
- Cash deals:
  - Extra money initially goes to shareholders of target.
    - Capital reallocated.
  - Extra cash flow of combined company goes to pay off debt.

Synthesis / Conclusion

- Do mergers create value on average? Yes.
  - Rely on announcement returns as critical evidence:
    - Mergers using stock are value neutral.
      - With negative information effect of using stock, difficult to know the true effect of mergers.
    - Mergers using cash are value increasing.
  - Accounting-based studies less reliable:
    - Noise.
    - Even more problematic measuring performance relative to expectations.
  - Mergers associated with technological and regulatory change.
    - Mitchell and Mulherin (1996).
- Who gains? Who loses?
  - Target shareholders gain.
  - Acquirer shareholders neutral.

Synthesis / Conclusion - 2

- How should one evaluate merger success?
  - Discounted present value of the changes in cash flows from the merger.
  - Ex ante:
    - announcement period returns.
    - "true" expected changes in cash flows (if possible).
  - Ex post:
    - measure the actual changes in cash flows (if possible).
- What drives merger success?
  - Cost cutting / economies of scale rather than top line growth.
  - Deep understanding of target firm's business.
  - Organization design and structures appropriate to the business.
  - Appropriate compensation system and incentives.

Mergers: A Prescriptive Perspective

Professor Pankaj Ghemawat

Harvard Business School

December 9, 2002

Outline

- Why do managers' assessments of overall success of mergers and their financial success differ?
- What do managers mean by merger success?
- How, strategically, should one think about success/failure?
- What are bases of value creation (not just cost reduction, market power)

Measures of Success

- Stock Price Performance
- Accounting Measures of Profitability
- Others
  - Exploiting overvalued stock ("strong currency")
  - Maintaining/improving market share rank
  - Implementing strategy
  - Achieving a strategic transformation

A Strategic Scorecard

+ FORESTALLING RISKS
+ GENERATING KNOWLEDGE/ INNOVATION

CEMEX: Value-Addition through Cross-Border Mergers

LEVERS	CEMEX
Accelerating Growth	• Overtook Votorantim as major player
Boosting Margins -**C**ost Advantage	• Absolute reductions in operating costs through PMI • Scale economies (IT, etc.) • Capital cost reduction through bottomfishing
-**D**ifferentiation/ Willingness-to-Pay	• Diversion of imports away from key markets (acquis. of terrminals/most extensive intl. trading network) • Brand-building for the self-construction segment
-**E**nhancing Industry Attractiveness	• Deliberate emphasis on market restructuring • The benefits of multimarket contact
Forestalling Risks	• Reduced risk of competitive attack • Reduced sensitivity to Mexico risk
Generating Knowledge/ Innovation	• Learning from Valenciana acquisition in Spain (IT)

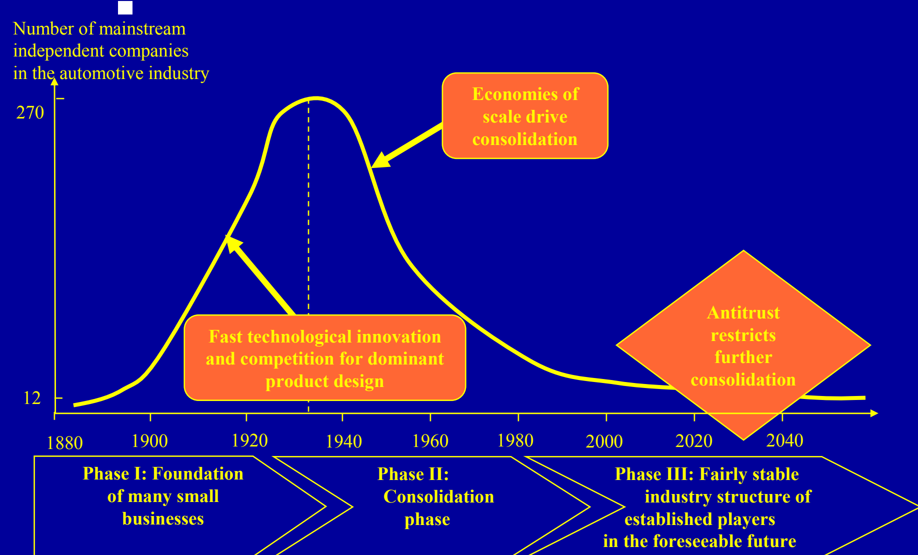
Limits to Value Addition through Merger

Levers Of Value Addition	Limitations
Accelerating Growth	◆Usually not achieved ◆Often a margin-volume positioning tradeoff
Cost efficiencies	◆Cost savings often exaggerated ("the rubber baseline") ◆Costs of takeover premia often left out of the analysis ◆Diseconomies of scale/scope/complexity
Differentiation/willingness-to-pay	◆Limited effectiveness of bundling nonoverlapping products (as opposed to complements) ◆Heterogeneity in customer preferences ◆Adjustment costs (customer, employee attrition)

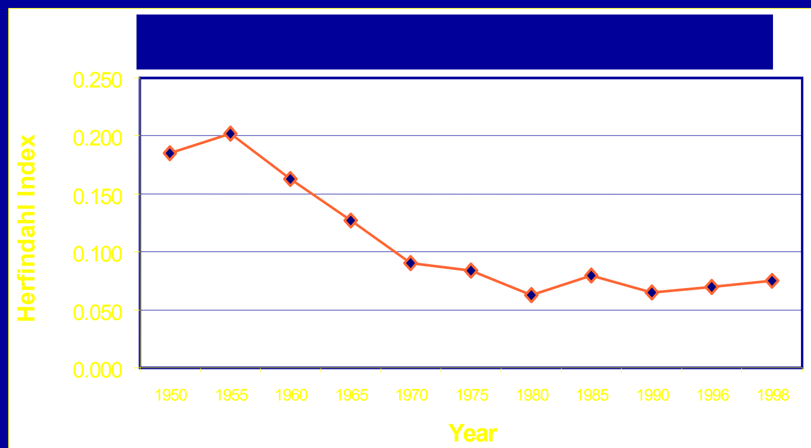
Limits To Value Addition through Merger

Levers Of Value Addition	Limitations
Enhancing Industry Attractiveness	◆Free-rider problems ◆Regulatory/non-market restraints
Forestalling Risks	◆Irreversibility of mergers ◆Unusual characteristics of cement market (product markets primarily regional/national, key competitors global--and relatively concentrated)
Generating Knowledge/ Innovation	◆Specific knowledge ◆Complexity/reuse costs ◆Internalization/coordination may reduce variety below requisite levels

Number of Competitors in Automobiles



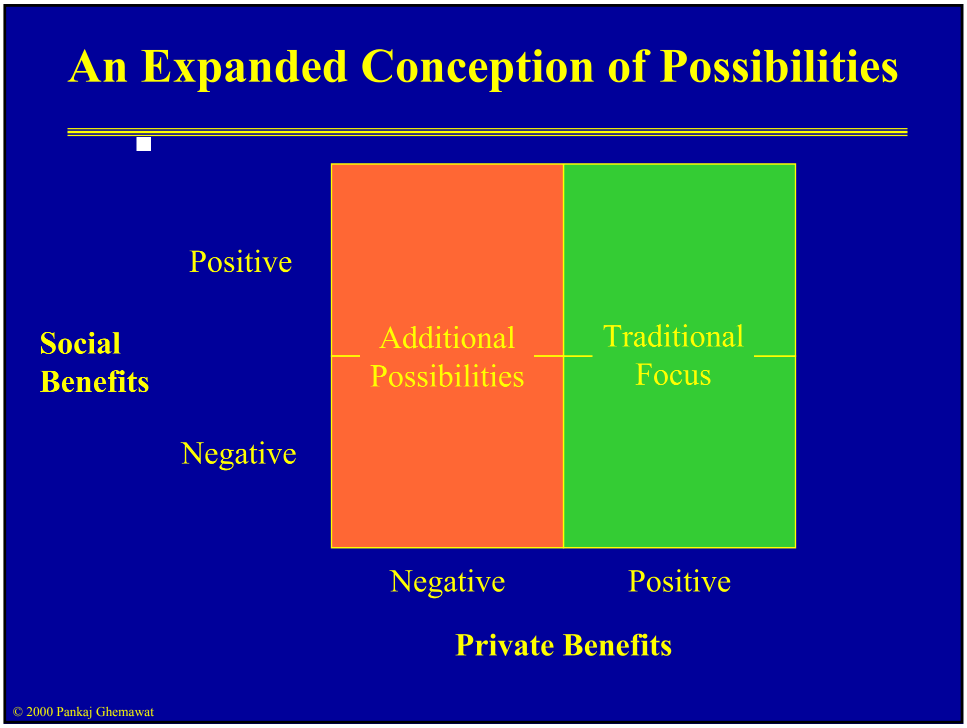
Global Market Concentration in Automobiles



Source: Ghemawat and Ghadar (2000)

Recommendations

- Recognition of enormous variation in outcomes
- Deeper understanding of industry dynamics and competitive strategy as opposed to a transactional approach
- Broader analysis of benefits and costs
- Recognition that practice can be improved greatly


An Expanded Conception of Possibilities
Positive
Social
Benefits
Negative
Additional
Possibilities
Traditional
Focus
Negative
Positive
Private Benefits
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FTC Bureau of Economics Roundtable

Understanding Mergers: Strategy & Planning, Implementation, and Outcomes

McKinsey presentation
December 9, 2002

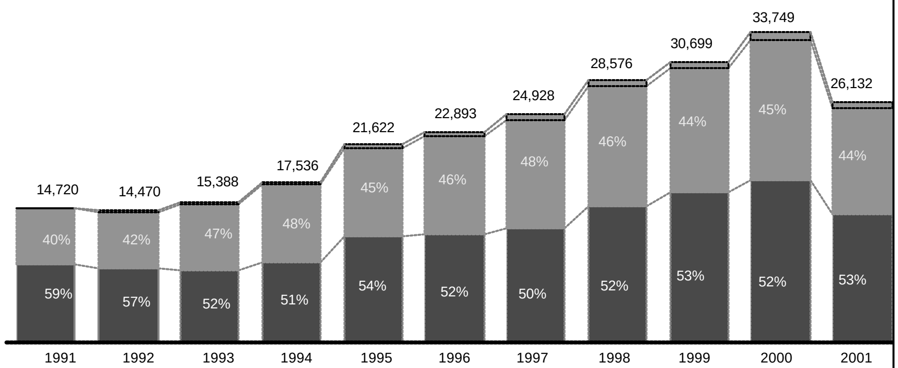
McKinsey&Company

Agenda

- Recent research on the effectiveness of mergers
- Defining the value of success in mergers
- Examples of successful mergers

M&A remains a key strategic option with deal volumes still at 1997-98 levels

Breakdown by size of total worldwide number of deals announced 1991–2001
US$ Billion



	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total deal value* US$ B	342	354	449	558	936	1,096	1,607	2,477	3,263	3,383	1,681

* Includes only deals with disclosed value
Source: Thompson Financial Securities Data

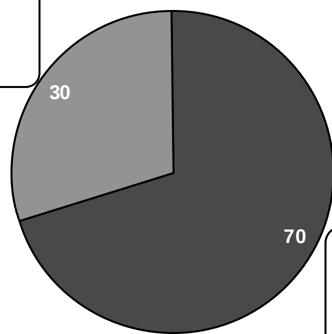
Research shows that in most cases mergers fail to deliver against their expectations, whatever the rationale

Study	Per cent failed*	Study	Per cent failed*
McKinsey (2000)	70	AT Kearney (1998)	58
KPMG (2001)	70	Mercer (1996)	57
KPMG (1999)	83	Coopers & Lybrand (1996)	66

* Definitions of failure range from no net growth to inferior stock performance relative to industry
Source: The Art of M&A Integration; industry literature

Why are there so few winners?

Poor deal
- Unrealistic synergies
- Price too high
- Competitor reactions



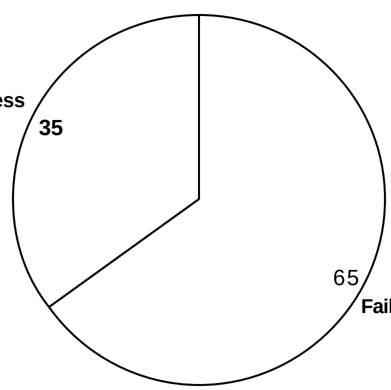
Good deal poorly implemented
- Poor integration management
- Failure to address cultural differences
- Customer losses
- Poor communication
- Poor tracking

Source: Interviews; McKinsey Corporate Finance Practice

McKINSEY & COMPANY 2000

Percentage of deals that fail to meet success criteria*

100% = 47 companies involved in a major deals between 1997-99



Key findings

The study found that failures were due to significant dilution of performance ethic, poor implementation, loss of key people. **Characteristics of successful mergers are strength of performance ethic, quick implementation, retention of key people, targets achieved, positive market indicators.**

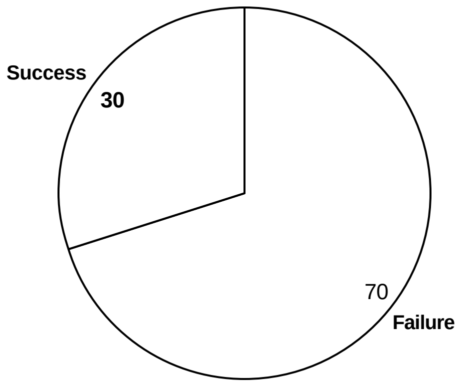
* Criteria for success: change in performance ethic profile and improvement in a combination of market indicators (share price, analyst opinion, revenue growth)

Source: Improving Merger Success by addressing Organizational Issues – Bekier, Dollenberg, Fox and Heede

KPMG 2001

Percentage of deals that failed to increase shareholder value*

100% = 118 companies involved in a major deal between 1997-99



Key findings

The study found that **successful deals used a robust and well-managed process**, priorities were allocated to the activities to be carried out, clear decisions were made about how and by whom the activities should be handled.

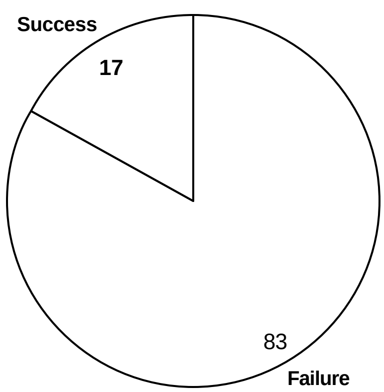
* Measured against a change in equity price pre-deal and again approximately 1 year after

Source: KPMG World Class Transactions– Insights into Creating Shareholder Value

KPMG 1999

Percentage of deals that failed to increase shareholder value*

100% = 107 companies involved in a major deal between 1996-98



Key findings

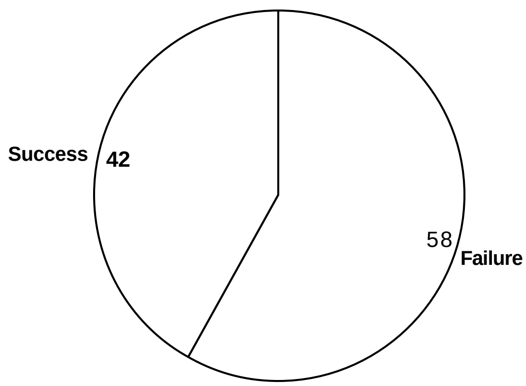
The study found that **successful deals engaged in a combination of the following key best practices**: synergy evaluation, integration project planning, due diligence, selecting the management team, resolving cultural issues, communications. Further, the study found that **chance of success increased for companies which undertook a combination of these practices early in the deal.**

* Measured against a change in equity price pre-deal and again approximately 1 year after

Source: KPMG Unlocking Shareholder Value

AT Kearney 2000

Percentage of companies showing an increase in shareholder value and profitability over a 3-year period post merger



Key findings

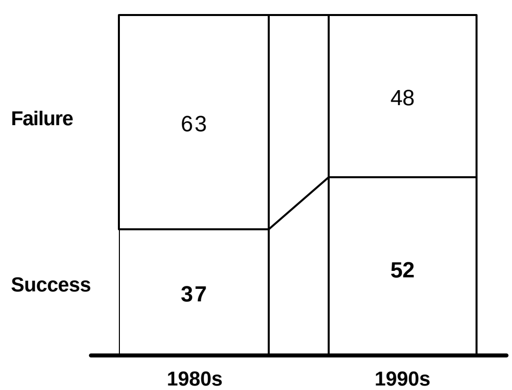
The study found that **58% of all mergers fail to reach the goals they set out to achieve – to increase stock prices and profitability.** Issues include failure to put corporate vision first, failure to move quickly enough in establishing leadership team, overemphasis on cost cutting vs. growth, failure to overcome corporate cultural differences, failure to communicate, and failure to manage risk.

Source: ***Seven Sins Can Snag Company Marriages***, Bangkok Post, 5/12/2000

Mercer Management Consulting 1997-98

Percentage of deals that achieve above-industry shareholder returns over a 3-year period

100% = 215 transactions valued at $500 million or more



Key findings

The mergers of the 1990s are substantially outperforming those of the 1980s. The improvement is not related to strategy or price but rather to **improved post merger management.**

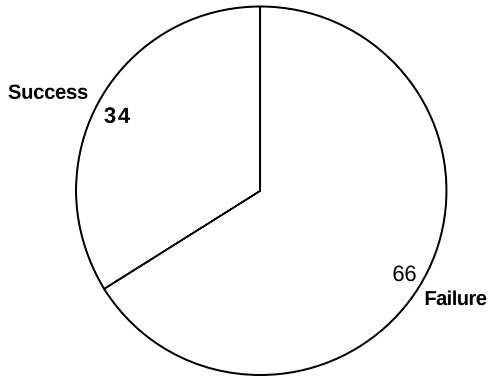
1) A compelling, ambitious vision, understood and shared by shareholders and management alike
2) A pragmatic approach to the alignment of all the pieces with the vision – organization structures, processes, systems and culture
3) A plan for a fast and focused transition.

Source: The Art of M&A Integration; Making mergers work for profitable growth, Mercer Management Consulting

Coopers & Lybrand 1996

Percentage of deals that are financially unsuccessful

100% = 124 transactions from 1993-1996



Key findings

The study found that 66% were financially unsuccessful.

By a substantial margin, surveyed companies reported that a rapid transition ("more quickly than their normal pace of work") had a more favorable effect on gross margin, profitability cash flow, productivity, and speed to market.

Quick transition companies also reported less difficulty with operating philosophy, management practices and information systems compatibility issues.

By almost nine to one, companies believed they should have moved the transition more quickly.

Source: The Art of M&A Integration, Speed makes the Difference:, Coopers and Lybrand 1997

True success is determined by the acquirers ability to achieve their strategic intent

	Sources of value				
Strategic rationale	**Cost synergies**	**Revenue synergies**	**Management improvement**	**Operational improvement**	**Examples**
Economies of scale	X		X	X	RBS/Natwest
Economies of scope		X	X	X	Vodafone/Mannesmann
Vertical integration	X			X	Time Warner/AOL
Diversification		X			Viacom
Market power	X	X	X	X	Daimler/Chrysler
Access to R&D	X	X			Cisco, Orange

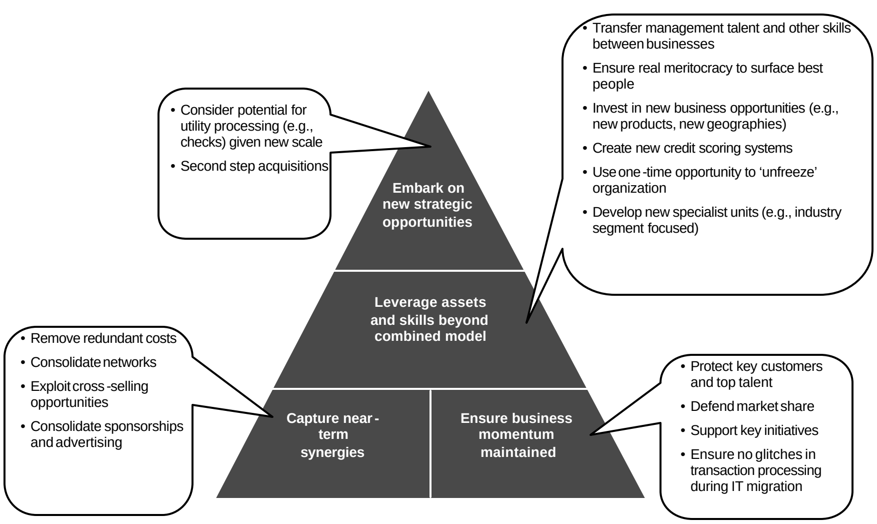
Determining if consumers benefit in mergers

	Sources of value			
Strategic rationale	**Cost synergies**	**Revenue synergies**	**Management improvement**	**Operational improvement**
Economies of scale	X		X	X
Economies of scope		X	X	X
Vertical integration	X			X
Diversification		X		
Market power	X	X	X	X
Access to R&D	X	X		

Value can benefit 3 parties

- **Increase shareholder worth**
- **Re-invest in company**
- **Benefit customers**
  - **Price reductions**
  - **Efficiencies**
  - **New opportunities**

The key value drivers must be understood



In summary, merger success is assured by focusing on value creation and on people issues rather than integration

1. Set high top-down merger goals that include both financial and non-financial aspirations
2. Recognize current business momentum has greater value than integration synergies and act swiftly to protect it
3. Ensure rigorous synergy identification through stretching top down financial targets and requiring bottom up confirmation
4. Capitalize on the unique unfreezing opportunity to achieve a superior new company
5. Move swiftly, front end load decision making and pursue 70% solutions that are 100% implementable
6. Conduct explicit handover from integration activities to business as usual with emphasis on building commitment to capture synergies
7. Appoint new managers as early as possible striving for excellence, even at the expense of perceived equity between merger partners
8. Identify the cultural challenges up front, based on differences between the two organizations and explicitly design a process to address them
9. Populate integration effort with top performers and managers with line experience
10. Communicate often and early, focusing equally on the process of integration and the content of key decisions made

Success stories

The merger	The deal	KSFs
BP – Amoco (also ARCO and Burmah Castrol 1998-2000)	This series of multibillion dollar transactions between 1998-2000 created a single, global company with a market cap of $200 billion. Chief executive Sir John Browne explained the vision behind the acquisitions, "In different ways, each of the steps we took helped us to fill a strategic gap that we had identified in the mid-1990s. These steps took us into natural gas and into the Far East, where we were traditionally weak, and into some of the best retail markets in the world. Our goal is to be a global player–we want giant fields that we can develop at low cost."	BP moved quickly to capture near term synergies and create common values and processes. They were able to cut costs by 20 percent of the combined BP-Amoco cost base. Within 100 days of closing the Amoco deal, BP had filled all the top management jobs and completed most of the cuts –including some 10,000 layoffs. During that period, BP-Amoco's stock price rose by nearly 11%. Browne also consistently and visibly led the change, facilitating open communications to all stakeholders and acting as a cheerleader for the merger. He imposed BP's structure and management style on the new company, an approach that ultimately resulted in the resignation of some senior figures at Amoco. However, the ultimate result was BP achieved the projected $2 billion in cost savings within the first year, a full 12 months ahead of schedule. BP, which reported a 19% increase in second quarter 1999 pre-exceptional profits to $1.36bn, presents a definitive counterpoint to the enduring notion that M&A activity destroys shareholder value.

Source: Lit search ("The Leadership Testing Ground", Journal of Business Strategy, Mar. 2002; "BP-Amoco's Result a Tribute to M&A Success", The Financial News, Aug. 1999)

Success stories

The merger	The deal	KSFs
Unilever – Bestfoods (2000)	This $24 billion cross-border deal aimed to create the preeminent global food and consumer goods company. The complementary nature of their geographic coverage and combined product portfolio together with Bestfoods' strong foodservice operations, enables the combined company to further raise their growth ambition.	The Unilever – BF team: • Moved quickly in the design and staffing of the organization – Announced October 2 the same day shareholder approval granted – "All Star Team approach using clear selection criteria • Aggressively acted on regulatory issues – Strategy to speed approval through divestments • Focused on top line growth – Leveraging Unilever brand in Latin America on BestFoods strength – Leveraging BestFoods brands in Asia on Unilever's strength – Cross channeling Unilever's Foods products through BestFoods channels – Focus on Go-To-Market operations in integration

A managerial perspective on M&A

Joseph L. Bower
Harvard Business School
FTC Roundtable on M&A
December 9, 2002

A Managerial Perspective on M&A

M&A is a make or buy decision

Three types of managerial perspective:

- The variations in what the managements are trying to accomplish
- The process over time
- The process of implementation

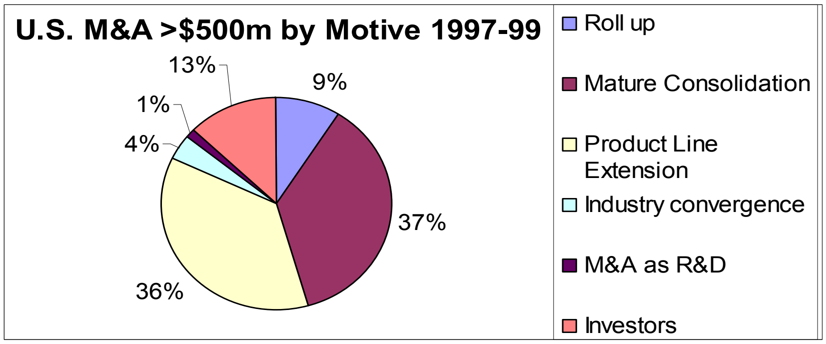
7 Different Strategic Objectives:

- **Reduce overcapacity, eg Chemical Bank merges with Chase (mega-mergers)**
  - Acquire or merge with competitors to take capacity off line and rationalize other activity
  - Use larger market share to strengthen pricing
- **Roll up a fragmented industry, eg. BancOne in the 1980's**
  - Expand geographically in an industry with local delivery – often a service
- **Product or market extension, Quaker buys Snapple**
  - Extend product line, or enter new country markets

7 Objectives, cont.

- **Use M&A as R&D, eg Microsoft buys Vermeer**
  - Acquisitions used instead of R&D to build position quickly
- **Build a new industry, eg Viacom buys Paramount**
  - A bet that there are strategic benefits to be gained from integration across industries
- **An Investor Buy-out**
  - A bet that value can be created with new, private, leveraged ownership
- **and Blue fish**

Leaving out bluefish



What difference does it make?

- ***Companies can be thought of as consisting of resources, processes, and values***
  - Resources are the assets – tangible and intangible
  - Processes are the way companies convert assets into goods and services
  - Values are the way employees think about what they do and why. They shape priorities and decision making
- ***It is relatively easy to assess and rationalize assets***
- ***It is very hard to assess processes or change them***
- ***It can be even harder to see the depth with which values are held. It may be impossible to change them.***

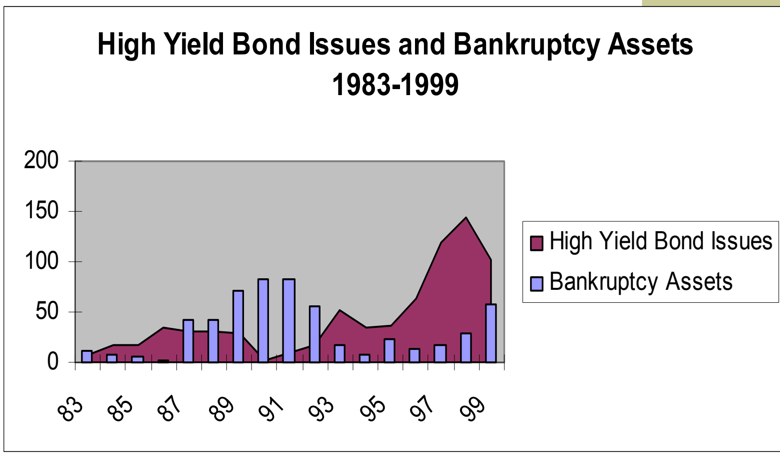
What difference does it make?

M&A is a business process. Managements need to learn how to do it well.

- **Targeting** – assessing resources, processes and values
- **Doing the deal:**
  - **Negotiating** – getting the price right
  - **Closing** – getting to yes
- **Integrating** – rationalizing resources, imposing (or modifying) processes and values

Implementation: The wrong price

- If the price was too high, there is no way of succeeding against a strict financial test (An Anglo perspective?)
- Attempts to make such deals succeed often destroys the acquired company
- And sometimes the acquirer.



Research on Implementation:Two dimensions of success

Level of completion of human integration		Low (task integration)	High (task integration)
	High	Mixed Success: satisfied employees, but no operational synergies achieved	Successful acquisition
	Low	Failed acquisition	Mixed success: operational synergies achieved at expense of employees

Level of completion of task integration

The basic finding

- A longitudinal study (5 years +) nine big deals
- The substance of human integration and task integration involve two different trajectories
- But they are deeply interdependent so that failure in one can block or defer success in the other.
- Failure at task integration has its source in failed human integration
- Value creation requires both

The Panel Discussion

- Proceed following the process of a deal
  - Targeting
  - Doing the deal
  - Implementation
  - Lessons
  - The Cosmic Question

Panelists

- Peter Brodsky – Partner, Hicks-Muse
- Bill Earnest, GM Corp Planning & Strategic Transitions, Conoco-Phillips
- Juan Pedro Hernandez, VP/Treasurer P&G
- Robert Ingraham, COO GlaxoSmithKline
- Michael Jones, Business Development Leader – GE Medical Systems
- John Mayfield, Group Controller, Construction Products and Finishing Systems Group, Illinois Tool Works
- Dan Scheinman, Chief Strategy Officer - Cisco

FTC Merger Outcomes Roundtable - Merger Integration Best Practices

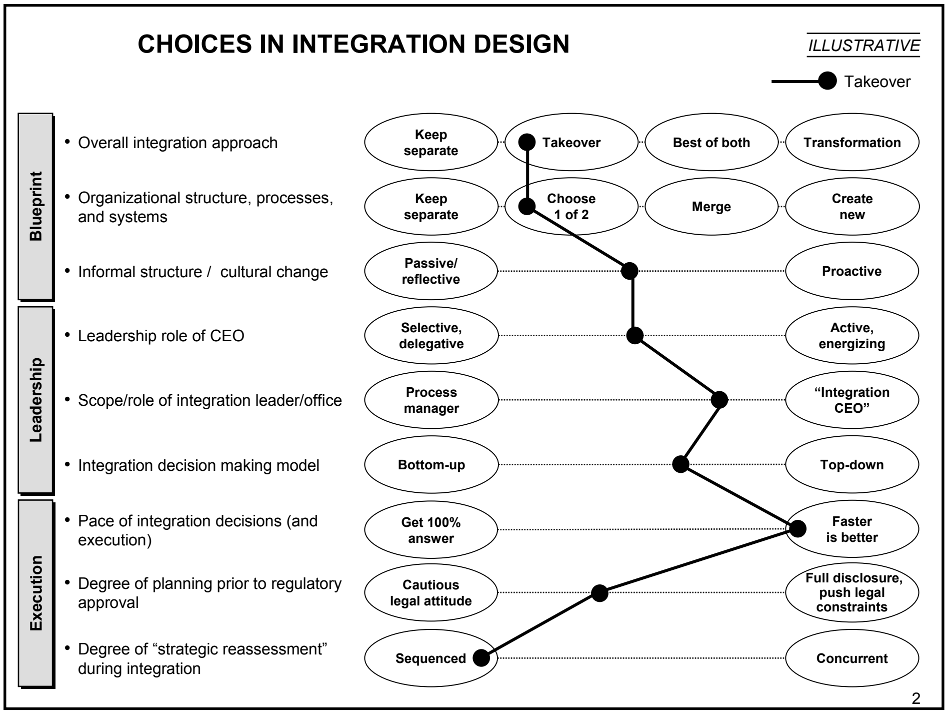
William E. Earnest
ConocoPhillips

MERGER INTEGRATION – SUCCESS FACTORS

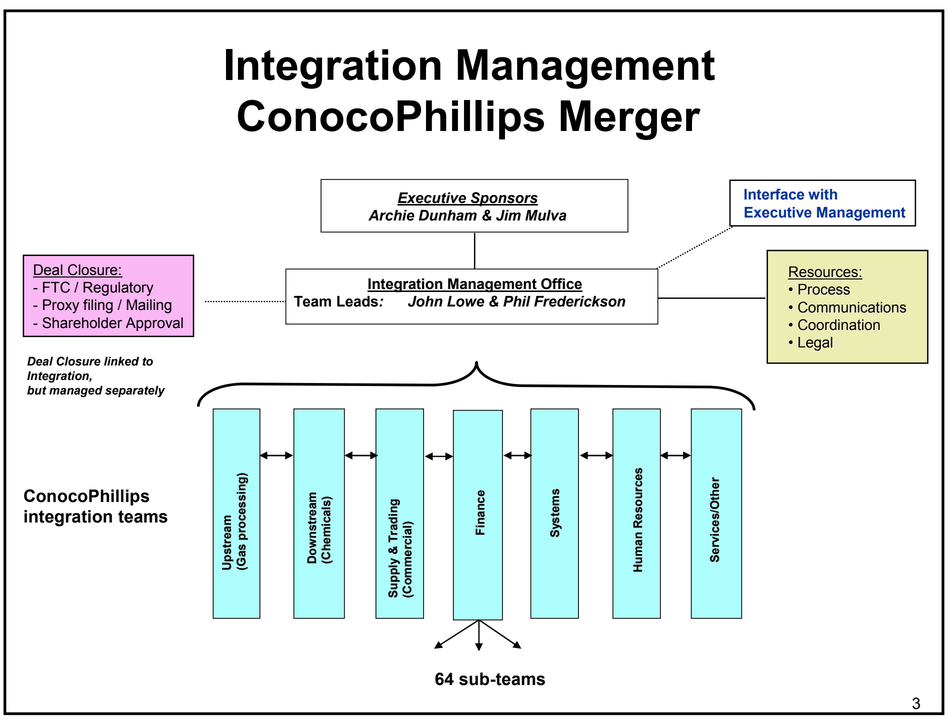
Set high aspirations	• Set high merger aspirations top down that include both financial and nonfinancial targets
Protect current business	• Recognize current business momentum has greater value than integration synergies and act swiftly to protect it
Establish separate integration organization	• Establish a merger management leader/organization and an integration management team to manage the merger
Establish strong integration process	• Move swiftly, front-end load decision making and pursue 70% solutions that are 100% implementable, empower integration leaders
Focus on value creation	• Focus on value creation and business objectives – not only on integration
Address cultural challenges	• Identify the cultural challenges based on differences between the two organizations upfront and explicitly design a process to address them focused on core business processes
Establish strong people selection process	• Appoint new managers as early as possible, striving for excellence, even at the expense of perceived equity between merger partners
Have focused communications	• Communicate often and early, focusing equally on the process of integration and the content of key decisions made

Source: McKinsey Co.

1



CHOICES IN INTEGRATION DESIGN
ILLUSTRATIVE
Takeover
Blueprint
Leadership
Execution
• Overall integration approach
• Organizational structure, processes, and systems
• Informal structure / cultural change
• Leadership role of CEO
• Scope/role of integration leader/office
• Integration decision making model
• Pace of integration decisions (and execution)
• Degree of planning prior to regulatory approval
• Degree of "strategic reassessment" during integration
Keep separate
Takeover
Best of both
Transformation
Keep separate
Choose 1 of 2
Merge
Create new
Passive/ reflective
Proactive
Selective, delegative
Active, energizing
Process manager
"Integration CEO"
Bottom-up
Top-down
Get 100% answer
Faster is better
Cautious legal attitude
Full disclosure, push legal constraints
Sequenced
Concurrent
2



Integration Management
ConocoPhillips Merger
Executive Sponsors
Archie Dunham & Jim Mulva
Interface with Executive Management
Deal Closure:
- FTC / Regulatory
- Proxy filing / Mailing
- Shareholder Approval
Integration Management Office
Team Leads: John Lowe & Phil Frederickson
Resources:
• Process
• Communications
• Coordination
• Legal
Deal Closure linked to Integration, but managed separately
ConocoPhillips integration teams
Upstream (Gas processing)
Downstream (Chemicals)
Supply & Trading (Commercial)
Finance
Systems
Human Resources
Services/Other
64 sub-teams
3

Three Phases of Merger Integration

9 mos. before close	6 mos. before close	Closing	Completed

Architecture design	Implementation planning	Implementation and tracking
• Integration process design • Subteam scoping and launch • Information sharing / comparisons • Stretch synergy targets and synergy categories	• Day 1 readiness preparation • Implementation plans and coordination • Organizational structure, staffing and business process design • Portfolio and strategic issues • Synergy initiative/action plans • Handoff to new management team	• Synergy and key issues tracking • Accountability thru Operating Plans • Portfolio and strategic issues • Transition to day-to-day operational teams

4

FTC Bureau of Economics Roundtable

December 9, 2002

Juan P. Hernandez
Vice President and Treasurer,
The Procter & Gamble Company

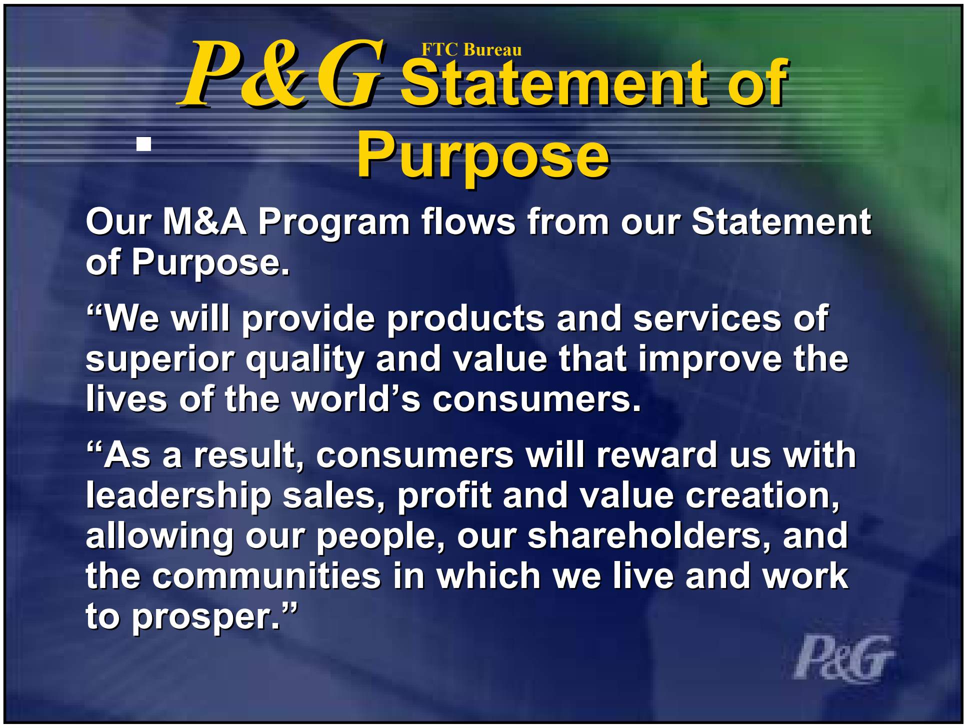
P&G

FTC Bureau

Agenda

- M&A Planning Process
- Approaches to Value Creation
- Q&A's

P&G



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P&G Statement of Purpose
Our M&A Program flows from our Statement of Purpose.
"We will provide products and services of superior quality and value that improve the lives of the world's consumers.
"As a result, consumers will reward us with leadership sales, profit and value creation, allowing our people, our shareholders, and the communities in which we live and work to prosper."
P&G

FTC Bureau
M&A Program
Planning
Fish In The Right Pond
P&G

FTC Bureau

Value Creation Through M&A

Planning

M&A Process Steps

1. Integration with Corporate Strategy Process
2. Target Selection & Prioritization
   -- Clearly Defined Objectives
   -- Reality Check on "Fit" Elements
3. Initial Valuation
   -- Internal Analysis
   -- Walk Away price
4. Due Diligence
5. Refined Valuation
6. Negotiation – Transition – Integration into P&G

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Value Creation Through M&A

Planning

Strategic Planning

- Operating units develop business strategy and set long and medium term goals.
- Business unit M&A program flows from the business where-to-play/how-to-compete choices.
- Screening priority setting at the business unit level.
- Business Unit strategy and M&A Program reviewed and prioritized at the Corporate/ CEO level.

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Value Creation Through M&A

Planning

Target Selection

- Fit with P&G's Core Competencies:
  - -- Branding
  - -- Innovation
  - -- Scale/Efficiencies
- Fit with P&G's Growth Strategy:
  - -- Faster Growing
  - -- Higher Margin
  - -- More Asset Efficient Businesses

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Value Creation Through M&A

Planning

Internal Analysis/Valuation

- Current business model and its sustainability.
- Asset's performance and future potential if merged in our portfolio.
- Identification of "value creators" where/how/when value is created.
- Assessment of asset availability.
- Pre-determined walk away price.
- Deal type and structure.

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Value Creation Through M&A
Planning

Due Diligence

- Right team and clear objectives. Team is a combination of business owners and subject matter experts.
- Leader of the team should be the ultimate business owner if/when transaction is completed.
- Assign responsibilities to team members on checklist specific items.
- Validate internal analysis (growth, synergies), valuation major risks and price.
- Identify key transition issues.
- Fine-tune thinking on structure.

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Value Creation Through M&A
Planning

Transition & Integration

- Critical part of the planning process.
- Follow the business plan in the acquisition recommendation.
- Systems compatibility are normally an issue. Plan ahead transition needs and what needs to be done. Assign responsibilities.
- Don’t wait until closing to start integration.
- Assign people to the transition and to the acquired business who worked the acquisition process, including due diligence.

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Value Creation Through M&A
Sources of Value Creation

- Strategic Fit
- Core Competencies: Branding
  Innovation
  Scale/Efficiencies

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Value Creation Through M&A
Sources of Value Creation

- Customers stock our products (right place, visibility, price, etc.)
- We communicate the unique product benefits to consumers (compelling advertising).
- Consumers <u>choose</u> our brands – <u>use</u> our brands – and find them a terrific value.
- Do these with right cost & capital structure …

<u>Shareholder Value Creation</u>

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Value Creation Through M&A

- ### Sources of Value Creation

- RVI:
  - Global Beauty Care Infrastructure
  - Access to Skin and Conditioning Technology
  - Great Equities: Olay, Pantene
  - Synergies: Surfactant Technology from Detergents

- Consumers:
  - Real Science to Personal Care
  - Great Value to Consumers

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Value Creation Through M&A

- ### Sources of Value Creation

- Iams:
  - Terrific Equity
  - Access New Specialty Channels
  - Pet Care Technology
  - Synergies at Technology End (Tartar/Pet Tooth Care)
  - Mass Distribution Channels
  - Longer and Healthier Life of Pets

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Value Creation Through M&A

Sources of Value Creation

- Spinbrush
  - Battery Operated Brush
  - Low Cost Technology
  - Under Crest Equity
  - Great Value to Consumers:

    A Better Product, Improved End Benefits at Very Affordable Costs.

Q&A's

GE Medical Systems

Acquisition Integration and Implementation

Michael Jones

December 2002

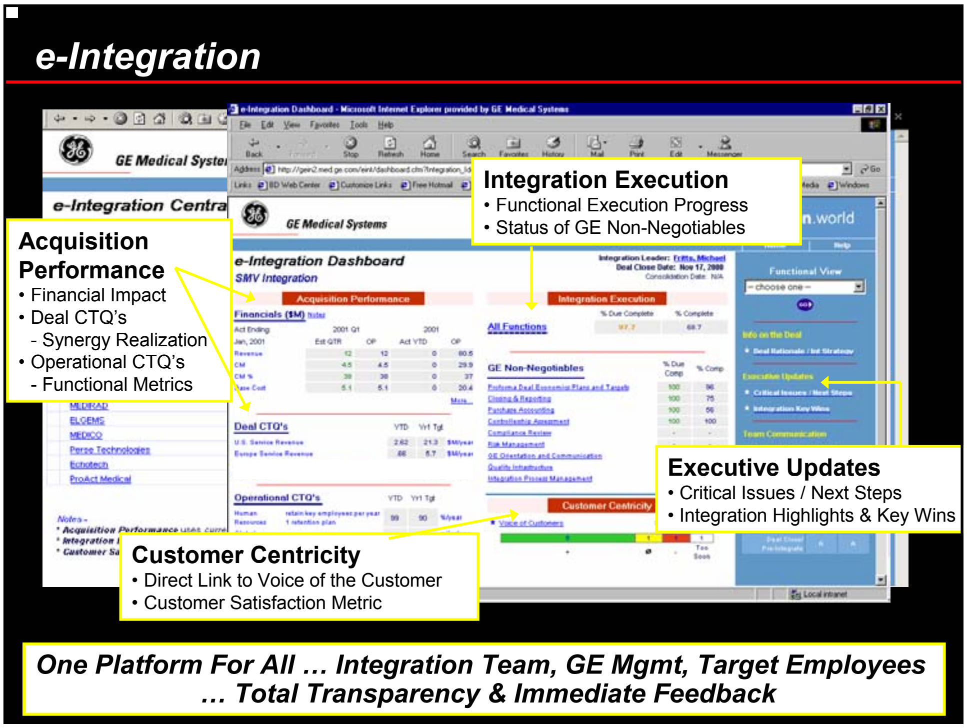
Key Elements of GE Integration Approach

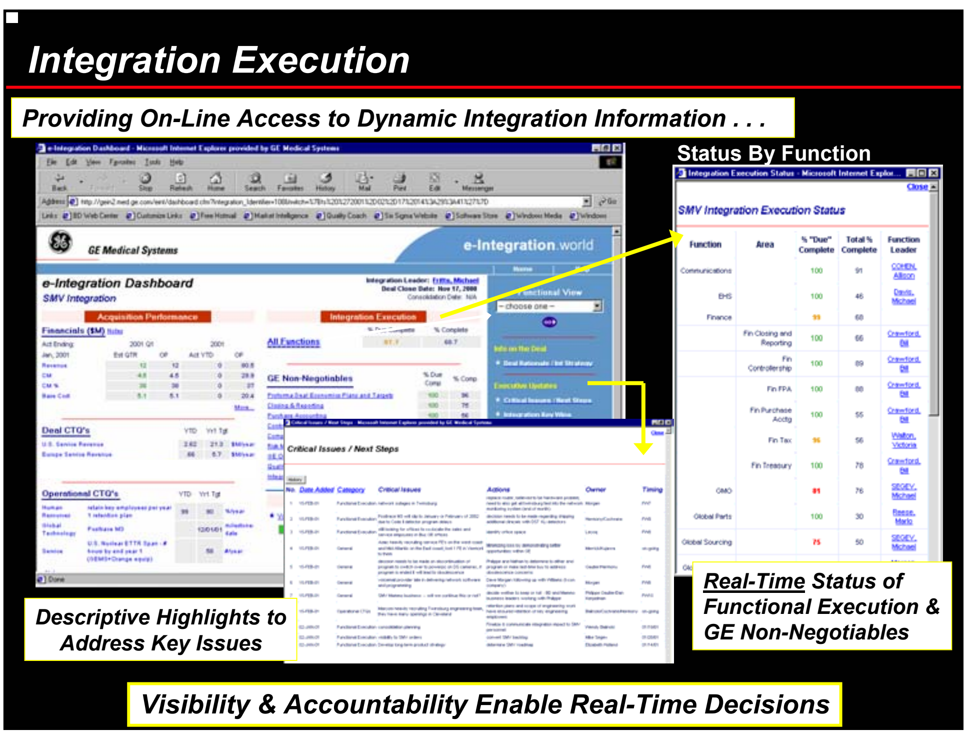
Process
- ✓ Ensure Seamless Operational Hand-Off … Starts with Due Diligence
- ✓ Balance Independence and Integration Speed
- ✓ Adopt Best Practices from Acquired Companies
- ✓ Broad Business and Functional Engagement

Leadership
- ✓ Commercial Sensitivity … First Priority … Always On the Screen
- ✓ Set Clear Measurements and Closely Monitor
- ✓ Business Leaders Ultimately Own Integrations

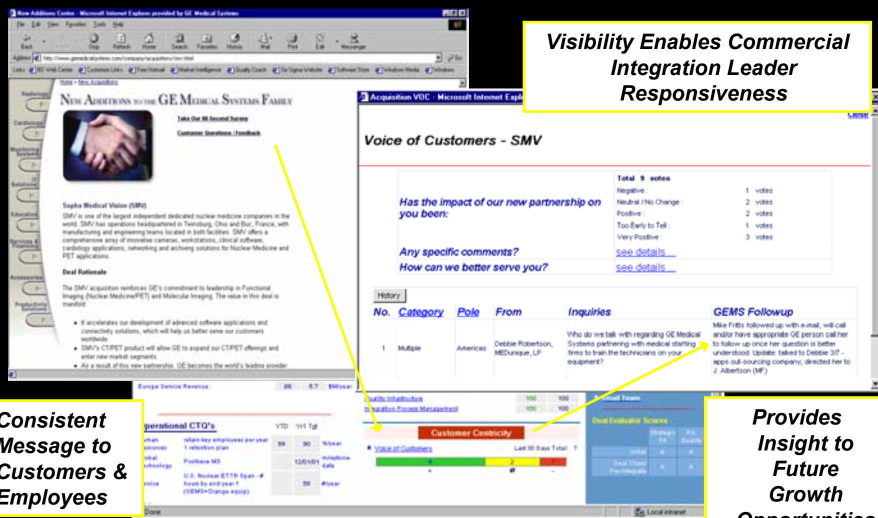
People
- ✓ Right Incentives… Get Key Players to Give GE a Chance
- ✓ Focus On Commercial and Key Talent Retention
- ✓ Integration Managers … Integral Part of Team from Beginning
- ✓ "A" Players on Both Teams … GE and Acquisition

e-Integration Tool Brings All Together … Clear Objectives, Goals and Track


e-Integration
Integration Execution
• Functional Execution Progress
• Status of GE Non-Negotiables
Acquisition Performance
• Financial Impact
• Deal CTQ's
- Synergy Realization
• Operational CTQ's
- Functional Metrics
Executive Updates
• Critical Issues / Next Steps
• Integration Highlights & Key Wins
Customer Centricity
• Direct Link to Voice of the Customer
• Customer Satisfaction Metric
One Platform For All … Integration Team, GE Mgmt, Target Employees … Total Transparency & Immediate Feedback


Integration Execution
Providing On-Line Access to Dynamic Integration Information . . .
Status By Function
Descriptive Highlights to Address Key Issues
Real-Time Status of Functional Execution & GE Non-Negotiables
Visibility & Accountability Enable Real-Time Decisions

Integration – Customer Voice



Visibility Enables Commercial Integration Leader Responsiveness

Consistent Message to Customers & Employees

Provides Insight to Future Growth Opportunities

Capturing Voice of the Customer to Measure Acquisition Impact

How We Look At Acquisitions

- ✓ Provide Our Healthcare Customers With Comprehensive Offering of Diagnostic Devices, Information Technologies and Related Services
- ✓ Helping Enable Better Outcomes At A Lower Cost
- ✓ Help Business Execute on Strategy Faster
  - *Expand Product and Services Offerings*
  - *Increase Our Overall Growth Rate*

#1

Improve and Expand Core Businesses … Product, Technology and Geographic Gaps … Improve Competitiveness

#2

Create New and Complementary Platforms for Future Growth

Help Business Meet Strategic and Financial Objectives

Importance of Fixed Cost Savings in Antitrust Efficiency Analyses

December 10, 2002

David Painter
Paul Anderson
David Weiskopf
LECG, LLC

Overview

- Merger Guidelines acknowledge the importance of fixed costs savings
- Fixed cost savings can provide direct price-related consumer benefits
- Fixed cost savings can contribute to important non-price consumer benefits
- Importance of fixed cost savings should be assessed on a case-by-case basis

Merger Guidelines

- Identify efficiency-related consumer benefits
  - Lower prices
  - Increased output
  - Improved product quality
  - Enhanced customer service
  - Introduction of new products
- Fixed cost savings contribute to all these consumer benefits

Price-Related Consumer Benefits

- Fixed costs can directly impact pricing decisions
  - Studies conclude that many corporations make pricing decisions based on <u>total</u> cost
    - Govindarajan and Anthony (1983)
    - Shim and Sudit (1995)

Price-Related Consumer Benefits

- Govindarajan and Anthony
  - 1983 Survey of Fortune 1000 industrial companies
    - 501 respondents
    - 41 percent based prices on total cost
    - Additional 41 percent based prices on total production costs or total production costs plus other variable costs
    - Only 17 percent used variable cost pricing

Price-Related Consumer Benefits

- Govindarajan and Anthony (continued)
  - Concluded that “in the real world most large companies use full costs rather than variable costs”
  - Concluded that the results of their survey “unequivocally destroy… the myth that full costs, and especially allocated costs, are irrelevant as a basis for pricing decisions…”

Price-Related Consumer Benefits

- Shim and Sudit
  - 1995 survey of 600 large industrial companies
    - 141 respondents
    - 36 percent based prices on total cost
    - Additional 34 percent based prices on total production costs
    - Only 12 percent based prices on variable costs
  - Consistent with findings of Govindarajan and Anthony

Price-Related Consumer Benefits

- Cost-based contracts and contracts allowing for cost audits
- Many bid situations (e.g., construction trade)
- Pricing decisions tied to gross profit thresholds
- Knowledgeable power buyers who force lower prices

Price-Related Consumer Benefits

- May provide management the latitude to undertake price cutting
  - Firm management is under continuous pressure to maximize short-term earnings
  - Fixed and variable costs have equal footing in reported profits
  - Fixed costs savings may provide the cushion to undertake price cutting that produces “short-term” earnings consequences but offers long-term growth prospects

Price-Related Consumer Benefits

- Managers responsible for setting prices may be accountable for attaining a target level of profitability that includes fixed and allocated costs
  - Managers may not have control over or knowledge of the breakdown between fixed and variable costs
  - Product and brand managers often operate as profit centers and price off total costs
  - Studies of firm pricing often cite lack of time, resources and information needed by managers to determine optimal pricing
- Transfer pricing situations
  - Lower fixed costs may affect transfer price for inter-company goods and services

Typical Brand Manager P&L Statement

	Year 1	Year 2	Year 3
Sales	$70,000	$72,000	$75,000
Raw Materials	21,000	21,600	22,500
Other Variable Mfg Costs	9,800	10,080	10,500
Fixed Mfg Costs	15,500	15,750	16,000
Gross Profit	23,700	24,570	26,000
Marketing Expense	4,200	4,350	4,500
Research & Development	1,200	1,250	1,300
Corp Administration	2,000	2,100	2,200
Divisional Administration	750	825	900
Property Taxes	375	375	375
Operating Profit	17,650	15,670	16,725
Capital Expenditures	10,500	5,750	7,500
Working Capital	2,500	3,250	4,000
Net Cash Flow	$4,650	$6,670	$5,225

Price-Related Consumer Benefits

- May enable companies to sustain or extend the duration of below-cost price competition or to intensify below-cost pricing competition
  - May enable firms engaged in below-cost price competition to continue investments in R&D, new product development & other consumer-oriented services
  - May limit the extent to which paring of least profitable products or customers is undertaken by firms engaged in below-cost price competition
  - Commentators note that firms that face aggressive pricing often adjust by reducing other competitive activities

Price-Related Consumer Benefits

- May delay or reduce the risk of market exit by firms engaged in extended below-cost pricing
  - The result of many "price wars" is relegation of losers to niche markets or exit from the market

- Incremental investments made possible by fixed cost savings may themselves result in lower variable costs which lead to lower prices
  - There can be many such investments, including "make / buy" decisions
    - Fixed cost savings may justify moving outsourcing in-house
    - Outsourcing of production generally gives rise to a variable cost, whereas internal production has both fixed and variable components
    - Reduction of variable cost may lead to lower prices

Non-Price Consumer Benefits

- Do fixed cost savings benefit shareholders exclusively?
  - Perception that fixed cost savings only benefit shareholders is erroneous
  - Rationale behind most mergers is not to distribute fixed cost savings to shareholders, but rather to invest in business
  - Reinvestment in business increases firm value and leads to consumer benefits

Non-Price Consumer Benefits

- Increasing share of earnings retained and invested productively in the business
  - Studies show that dividend rates have declined
    - Average dividend yields have fallen from 5-6% in the mid-1970's to approx. 1.25% in 2001
  - Studies show that percentage of companies paying dividends has declined dramatically
    - From 66.5% in 1978 to 20.8% in 1999

Non-Price Consumer Benefits

- Studies indicate that the propensity to pay dividends declined between 1978 and 1998 for firms with high investment outlays
  - Dividend ratios inversely related to expected investment outlays

Non-Price Consumer Benefits

- Reduced leverage
  - Fixed cost savings contribute cash that can be used to reduce leverage
    - High debt levels limit investment
    - Studies show lower growth rates and higher prices for highly-leveraged companies

Non-Price Consumer Benefits

- SEC filings typically point out limitations imposed by high leverage
- Increased vulnerability to adverse economic and industry conditions
- Limited ability to fund future working capital, capital expenditures, research and development costs and other general corporate requirements
- Limited flexibility to plan for, or react to, changes in the business and the industry
- Increased interest expense that might have to be paid because some borrowings are at variable rates of interest
- Limited ability to borrow additional funds, particularly in light of financial and other restrictive covenants of existing indebtedness

Non-Price Consumer Benefits

- Lower average cost of capital
  - Improved credit ratings
    - Credit ratings driven by forecasts of cash flow and related ability to meet financial commitments and adequately fund the business
    - Improved credit ratings result in lower-cost capital
  - Antitrust scholars acknowledge the importance of capital-savings efficiencies
    - Large companies enjoy significantly lower borrowing costs
    - Cost of capital disadvantage leads to competitive disadvantages

Non-Price Consumer Benefits

- Internal source of readily accessible funds
  - Internal capital is primary source of funding for business operations
  - External debt and equity sources generally have associated transaction costs and often-long lead times
  - Without adequate profit and cash flow, external capital more costly to attract

Non-Price Consumer Benefits

- New product development
  - Fixed costs generally taken into account in decisions regarding new product development
    - Investment decision premised on total costs over the life expectancy of the product
    - From brand or product manager's standpoint, costs include ongoing fixed costs and allocated costs
    - Fixed cost savings may enhance investment decision by reducing fixed and allocated costs associated with decision
  - Product life cycles are becoming shorter and new product development crucial to success
    - Studies show that the development of new products and services is becoming the primary source of sustainable competitive advantage

Non-Price Consumer Benefits

- Examples of industries where new product development is of major importance
  - Automobiles
  - Biotechnology
  - Consumer and industrial electronics
  - Computer software
  - Pharmaceuticals
  - Food and other consumer goods
  - Firms within these and similar industries invest proportionately larger sums into R&D

Non-Price Consumer Benefits

- Improved success rate for new products
  - Savings can be used to fund investments in employee training and information technology
  - Savings can contribute to new product efforts by subsidizing failure rates
    - Studies show that many R&D projects never result in commercial product and between 33 percent and 60 percent of all new products that reach market fail to generate an economic return

Non-Price Consumer Benefits

- Bring new products to market quicker
  - Studies conclude that speed to market is critical for business success
  - Fixed cost savings can contribute to intensified capital investment aimed towards shortening new product development cycles and introducing new products more quickly into the marketplace

Non-Price Consumer Benefits

- Other potential consumer benefits from fixed cost savings include
  - Provide funding for increased advertising, product promotion and customer services
- In sum, fixed cost savings provide funds for internal growth opportunities, asset replacement, and ongoing investment in the business
  - Non-price consumer benefits from fixed cost savings “multiply” by diffusion to competing firms

Credit Should Be Accorded On a Case-By-Case Basis

- When should fixed cost savings count?
  - Judge the potential impact of fixed cost savings on prices within the market
  - Judge weight to be given to non-price consumer benefits by assessing the value of such benefits within the relevant market

Credit Should Be Accorded On a Case-By-Case Basis

– Accord more credit in markets where competitors have a more efficient cost structure
– Assess the effect of fixed cost savings to the merged firm's cost of capital
– Assess merged entity's growth intentions
– Determine merged firm's historical use of excess cash flow

Credit Should Be Accorded On a Case-By-Case Basis

- Responsibility for demonstrating consumer benefits rests primarily with the merging parties
  – E.g., AmeriSource Bergen
    - Lower cost of capital
    - Accelerated repayment of debt
    - Empirical studies showing lower growth rates and higher prices of highly-leveraged companies
    - Evidence of higher business failure at pre-merger credit ratings
    - Evidence that Bergen declined to bid or service certain customers and pared customer accounts due to capital constraints
  – Notwithstanding, antitrust authorities should undertake inquiry into potential consumer benefits from fixed cost savings

Sources of Information Relevant to an Assessment of Fixed Cost Savings

- Business unit P&Ls, budgets and forecasts and financial targets to determine extent to which managers are accountable for covering fixed and allocated costs and what benefits may be derived from fixed cost savings
- Capital authorization requests, investment proposals and pro forma business unit P&L's to determine the relevance of fixed costs in investment decisions and the potential of fixed cost reductions to enhance future investment proposals
- Historical financial statements to assess the company's debt position and the likely impact of fixed cost savings on the merged firm's cost of capital and internal hurdle rates
- Pricing models to gain an understanding of company's pricing methodology and extent to which reductions in fixed costs might impact pricing decisions
- Business and marketing plans to determine the extent to which managers and sales and marketing personnel are accountable for full costs
- Cost allocation methodologies to determine the basis for cost assignments to specific products and business units and potential impact on future investment proposals

Summary

- Fixed cost savings can provide direct price-related consumer benefits
- Fixed cost savings can provide or contribute to important non-price consumer benefits
- Determination of the importance of fixed cost savings should be made on a case-by-case basis
- Primary responsibility for demonstrating consumer benefits from fixed cost savings rests on the merging parties

Efficiency Claims Experience

- Merger Guidelines
  -- Merger Specificity
  -- Verifiability
  -- Cognizable
- What We Would Like
- What We See
- How To Provide

Merger Guidelines

"*Cognizable efficiencies* are merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service." Horizontal Merger Guidelines p. 31

Merger Guidelines

Merger Specific – "*…*efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anti-competitive effects." Horizontal Merger Guidelines p. 30

Merger Guidelines

"*…*efficiencies*...*,which enable the merging firms to reduce the marginal cost of production, are more likely to be [cognizable]." Horizontal Merger Guidelines p. 32

Merger Guidelines

"The Agency also will consider the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market."
Horizontal Merger Guidelines p. 32

Merger Guidelines

"*…*the merging firms must substantiate efficiency claims so that the Agency can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific."
Horizontal Merger Guidelines p 31

Federal Trade Commission
Understanding Mergers Roundtable
December 10, 2002

Pre-Consummation Information Exchange and Integration Planning

M. Howard Morse
Drinker Biddle & Reath
Washington, D.C.

Critical Legal Distinctions

1. Gun Jumping v. Information Exchange
2. Hart-Scott-Rodino Act v. Sherman Act / FTC Act Limitations

See generally, H. Morse, *Mergers and Acquisitions: Antitrust Limitations on Conduct Before Closing*, 57 Business Lawyer 1463 (2002)

Hart-Scott-Rodino Act

Premerger notification

- allows government to investigate before consummation
- avoids "unscrambling the eggs"

The Statute:

"No person shall acquire, directly or indirectly, any voting securities or assets of any other person, unless both persons (or in the case of a tender offer the acquiring person) file notification ... and the waiting period has expired ...

Neither the statute nor HSR rules define the term "acquire"

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HSR Rules / Beneficial Ownership

The Rules:

"acquiring person" = person who will "hold" voting securities or assets

"hold" = "beneficial ownership"

"Statement of Basis and Purpose":

"the existence of beneficial ownership is to be determined in the context of particular cases with reference to the person or persons that enjoy the indicia of beneficial ownership," which include

- right to obtain any increase in value
- risk of loss,
- right to vote
- investment discretion

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Beneficial Ownership / Operational Control

DOJ radio speeches

- "local marketing agreements" and "time brokerage agreements" "may prematurely transfer beneficial ownership"
- outside the context of an acquisition would not violate HSR

U.S. v. Titan Wheel International, Inc. (1996)

- agreement transferred "possession and operational control" of tire plant with the effect of "transferring beneficial ownership"

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U.S. v. Input/Output (1999)

integrated personnel and operations + held out company as integrated to the public

- reorganization effective immediately
- personnel moved offices, new e-mail addresses, business cards
- phones answered under new name
- personnel traveled to resolve dispute for other company
- consulted on other possible transactions

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U.S. v. Computer Associates Int'l, Inc. (2002)

Computer Associates "exercised unlawful control"

- installing employees to review contracts
- restricting discounts without approval
- restricting contract terms, fixed price contracts, services
- collecting + disseminating competitively sensitive information
- making day-to-day management decisions

- merging parties must remain "separate and independent economic entities"; acquiring person may not exercise "operational or management control"
- "customary provisions" restricting actions "reasonable and necessary" to protect value of transaction do not violate HSR

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Fitting a Square Peg in a Round Hole?

"Signing the contract transfers some indicia of beneficial ownership. By itself, that transfer is entirely lawful.

But the transfer of additional indicia of ownership during the waiting period

– such as assuming control through management contracts, integrating operations, joint decision making or transferring confidential information for purposes other than due diligence inquiries –

are inconsistent with the purposes of the HSR Act and will constitute a violation."

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Sherman Act / FTC Act

Sherman Act § 1:

"every contract, combination ... or conspiracy in restraint of trade" is illegal

FTC Act § 5:

prohibits "unfair methods of competition"

Naked price fixing, market division, customer allocation
= per se illegal

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The Agencies' Position

DOJ:

"the pendency of a proposed merger does not excuse the parties of their obligations to compete independently"

FTC:

"between the time two competitors agree to merge and when they consummate their transaction, they are separate economic actors who are bound by the competition laws"

But see International Travel Arrangers v. NWA, Inc. (1993)

rejects view "only the formal consummation of a merger precludes application of section 1 of the the Sherman Act to an alleged conspiracy between the merging companies"

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Government Enforcement

Torrington Co. (FTC 1991)

FTC § 5 violation to tell customer to purchase from merging party and refuse to quote to "speed up" the consolidation, per se illegal customer allocation

Commonwealth Land Title Ins. Co. (FTC 1998)

FTC § 5 violation to enter agreement setting prices, terms and conditions for services to be jointly provided "pending formation" of joint venture

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U.S. v. Computer Associates Int'l, Inc. **(2002)**

Computer Associates' "conduct of business" covenants

- prohibiting discounts, fixed price contracts, specific services, requiring standard contract

"extraordinary and not reasonably ancillary to any legitimate goal"

Consent order allows

- agreements to operate in the "ordinary course" consistent with past practice
- restrictions on conduct that would cause a "material adverse change"
- reasonable and customary due diligence
- joint conduct lawful in the absence of the transaction

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Premerger Information Exchange

Antitrust concerns:

1. Sham negotiations to collude
2. Predatory conduct by one firm to obtain information
3. Legitimate merger discussions may lead to coordinated interaction

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Supreme Court precedents (*Container Corp., U.S. Gypsum*) apply rule of reason to information exchanges considering:

- structure of industry
- nature of information exchanged

Legitimate business justifications:

- due diligence to determine and confirm value
- planning efficient integration

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Precautions and Safeguards

- restrict distribution and use
  - planning, non-operational staff, outside advisors
  - for use in evaluating transaction, planning integration, destroy or return
- aggregate customer specific, product specific data
- delay exchange of most sensitive data

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Recent Enforcement Action

Insilco Corp. (FTC 1998)

- non-aggregated, customer-specific information, current and future pricing plans, formulas
- "transfer of such competitively-sensitive information in such highly concentrated markets violates Section 5"
- but analysis asserts exchange would "likely harm competition in any market"

Computer Associates

- information exchange among elements of control alleged

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Can Mere Exchange of Information Violate HSR?

"While parties have argued that their intent was merely to plan integration rather than to implement it, we do not think this distinction meets the requirements of the Act ...

When to-be-acquired firms release information that goes beyond due diligence ... they ... are jumping the starting gun that is supposed to be triggered by the expiration of the waiting period ...

we consider the release of information violates the HSR Act ... unless the acquired firm can show it would have provided such information to a firm other than the acquiring firm."

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Gun Jumping

- HSR - Preserving the integrity of the regulatory process
  - may not implement the transaction until the waiting period has expired
  - absence of competitive concerns is irrelevant
- Preclosing activities between the parties when competitive issues exist
  - exchange of information in connection with the merger
  - covenants and provisions in the agreement of sale
  - preparation for start-up (closing) and integration

Business Needs

- Once announced, the deal should go through
  - usually this is even more important to the seller than to the buyer
- Value must be maintained and captured
- Start up must be smooth (effective)

Due Diligence and Integration

- The process of due diligence (value confirmation) and integration (value capture) is one continuous process
- Due diligence
  - confirms value
  - identifies what needs to be done for successful start up and integration
- Due diligence continues until closing but emphasis shifts from value confirmation to value capture
- Buyers need for information continues until closing

Exchange of Information

- Traditional rule of reason analysis
- Practitioners are comfortable and experienced in dealing with these issues
- Further guidance not needed
- Must recognize that need for information continues until closing

Covenants and Provisions in the Agreement of Sale

- Seller needs certainty that deal will go through
- Important to regulatory agencies that approved deals close
- "Ordinary course of business" covenant is not enough
- Conditions of closing are not a substitute
- Lack of specific covenants may cause less competitive vigor
- In evaluating covenants Gov't should consider the underlying business reality
- Covenants are typically arms length and carefully negotiated

Preparation for Start Up

- Activities prior to closing to facilitate an effective start up should be allowed unless they raise anti-competitive issues.
- Typical case -- information systems
- The business may never recover from a bad start up

Legitimate Pre-Closing Needs

- Due diligence
  - Good information is vital for deal selection and valuation
  - Distinguishing “necessary” vs. “unnecessary” information is elusive – more is usually better
  - But keeping competitively sensitive information out of competing personnel’s hands can readily be done with some fairly simple steps
  - Proper legal focus here is Section 1 – not 7A
  - Section 1 analysis should usually require rule of reason approach, given presence of legitimate rationales

- 2 -

Legitimate Pre-Closing Needs

- Integration Planning
  - Integration success or failure and ability to capture planned efficiencies can turn on fast post-closing integration of acquired business
  - Distinction between planning and implementation is important and is usually manageable in practice, with good guidance
  - Difficult questions often relate to information flow – buyer needs thorough understanding of target business, and may in some areas require involvement of buyer’s business people who understand the issues
  - Business imperatives must be tempered by legitimate 7A concerns – and by concerns about agency distraction from substantive deal review/clearance

- 3 -

Legitimate Pre-Closing Needs

- Ordinary Course Conduct
  - Buyer (and seller) have legitimate interest in fixing deal terms and preserving target's value pending closing
  - Sellers and their employees may have incentives (unrelated to competition on the merits) to deviate from the ordinary course and undermine value of the deal
  - Appropriate contractual restrictions on such non-ordinary-course activities should not be condemned simply because they relate to competitive activities – need to examine the facts and justifications
  - Question: What if the discounting in Computer Associates had clearly been outside the seller's ordinary course?

- 4 -

Current Guidance

- From the Agencies
  - Several cases/consents, many reasonable on their face
  - Agency "gloss" has been more aggressive than the consents
  - Some tendency to blur Section 1 and 7A analyses
  - Potential for overly regulatory approach - is burden on the parties to justify any deviations from "no-deal" status quo? Or on the agencies to show the elements of a specific violation?

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Merging Parties'
Pre-Closing Conduct

Mark Whitener
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FTC Merger Outcomes Roundtable
December 10, 2002

Overview

- Current business environment makes it especially important that acquisitions be well-planned and well-executed
- Business needs for thorough due diligence and rapid deal integration are legitimate, and should inform the antitrust analysis of pre-closing activities
- Planning for rapid post-closing integration is <u>not</u> about "closing early" but is about ensuring that the integration succeeds at all
- Well-counseled companies can operate in the current legal environment – but some efficient conduct may be impeded at the margin by overly-restrictive guidance
- The agencies can help by sticking to the fundamentals of the (<u>distinct</u>) Sherman Act Section 1 and HSR Act Section 7A analyses
- Practitioners can help by giving practical guidance based on those fundamentals and by avoiding cookbook solutions

- 1 -

Current Guidance

- <u>From Practitioners</u>
  - Unavoidable focus on agencies' consents, speeches in giving guidance
  - Clients' desire for simple do's and don'ts can lead to rigid advice
  - More fact-intensive case-by-case guidance is more useful, but costly and time-consuming
  - Antitrust counsel will appropriately focus on the big picture – the need to clear the deal – but this can result in an overly restrictive approach in order to avoid a gun-jumping sideshow

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Going Forward

- No crisis here – some complexity and need for judgment calls is probably inevitable
- Not a call for "more guidance" – but for adherence to a defined legal framework
- Agencies and practitioners should focus on fundamentals of distinct Section 1/Section 7A analyses:
  - Is there a <u>per se</u> Section 1 violation? Rare, given usual presence of justifications
  - Is there a rule of reason violation for improper information exchange? Real competitive analysis needed
  - Is there a transfer of <u>beneficial ownership</u> – giving rise to a 7A violation? Focus on HSR Act Statement of Basis and Purpose

- 7 -