THE ACQUISITION PROCESS

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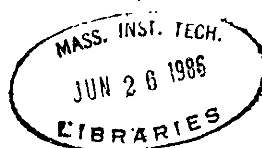

Archives

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by

DENNIS B. SULLIVAN III

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for the Degree of Master of Science in Management of
the Massachusetts Institute of Technology

ABSTRACT

The thesis examines the various functional roles involved in the acquisition process in an attempt to identify aspects of each, which may contribute to a successful acquisition.

The objectives of this thesis are as follows: (1) to survey the literature on important aspects for successful mergers and acquisitions; (2) to identify the merger and acquisition policies and those important aspects thereof which contribute to the success; (3) to identify search and valuation techniques; and (4) to obtain insight from corporate practitioners involved in merger and acquisition activity.

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TABLE OF CONTENTS

	Page
ABSTRACT	2
ACKNOWLEDGMENT	3
TABLE OF CONTENTS	4
LIST OF EXHIBITS	6
CHAPTER 1. Introduction	7
1. History of Merger and Acquisition Activity	7
2. Reasons for Diversification through Mergers and Acquisitions	13
3. Literature Review	17
CHAPTER 2. The Acquisition Process Described	30
1. Develop and Implement a Plan	30
2. Identify and Evaluate Acquisition Candidates	30
3. Acquisition Review	30
4. Valuation	35
5. Rethink Strategic Objectives, Fit of the Candidate and Consider Likely Alternative Scenarios	37
CHAPTER 3. Regulation of Mergers and Acquisitions	39
1. Financial Accounting and Reporting Implications	39
2. Tax Aspects of Corporate Acquisitions	43
3. SEC Regulation	50
4. State Corporate Law	53
5. Antitrust Regulation	54
CHAPTER 4. Research and Methodology	
1. Introduction	57
2. The Sample	57
3. Research Methodology	57
CHAPTER 5. The Acquisition Process	
1. Introduction	79
2. Company 1	79
Diversification Strategy	79
The Acquisition Process	80

TABLE OF CONTENTS
(continued)

Page

3. Company 2 82
   Diversification Strategy 82
   The Acquisition Process 83

4. Company 3 85
   Diversification Strategy 85
   The Acquisition Process 88

5. Company 4 89
   Diversification Strategy 89
   The Acquisition Process 90

6. Company 5 96
   Diversification Strategy 96
   The Acquisition Process 96

7. Company 6 98
   Diversification Strategy 98
   The Acquisition Process 99

8. Company 7 100
   Diversification Strategy 100
   The Acquisition Process 101

CHAPTER 6. Summary and Conclusions

1. Communication and the Diversification Strategy 107
2. The Acquisition Process 110
3. Organizational Fit 112
4. Regulatory Matters and the Acquisition Process 113
5. Pre-Acquisition Search 114
6. Valuation 115
7. Role of the CEO 117
8. Negotiation 117
9. Integration 119
10. Comparisons and Contrasts 120
11. Suggestions for Further Study 122

BIBLIOGRAPHY 124

APPENDIX 127

LIST OF EXHIBITS

		Page
Exhibit 1-1	Number of Manufacturing and Mining Firms Acquired, 1895-1978	8
Exhibit 1-2	Abnormal Stock Price Increases from Successful Takeovers	10
Exhibit 1-3	The 10 Biggest Mergers of 1985	12
Exhibit 1-4	Potential Benefits of Diversification	18
Exhibit 1-5	Strategic Fits Between a Target and a Bidder Business	24
Exhibit 1-6	Acquisition Screening System	25-26
Exhibit 3-1	APB No. 16 Criteria for Pooling of Interests	40-41
Exhibit 3-2	Comparison of Tax Characteristics of Acquisition Methods	51
Exhibit 4-1	The Acquisition Process Questionnaire	59-76
Exhibit 4-2	Companies Receiving the Questionnaire	77
Exhibit 5-1	Acquisition Guidelines for Company 4	91-94
Exhibit 5-2	Acquisition Criteria for Company 7	102-103
Appendix	Summary of Responses to Selected Questions	127-129

CHAPTER 1

Introduction

The purpose of this thesis is to examine the various functional roles involved in the acquisition process in an attempt to identify aspects of each, which may contribute to a successful acquisition. The focus of the research was to inquire as to how companies search for, value, evaluate, negotiate with and integrate acquisition candidates. The conclusion identifies and compares those common aspects of the acquisition process which can influence its ultimate success.

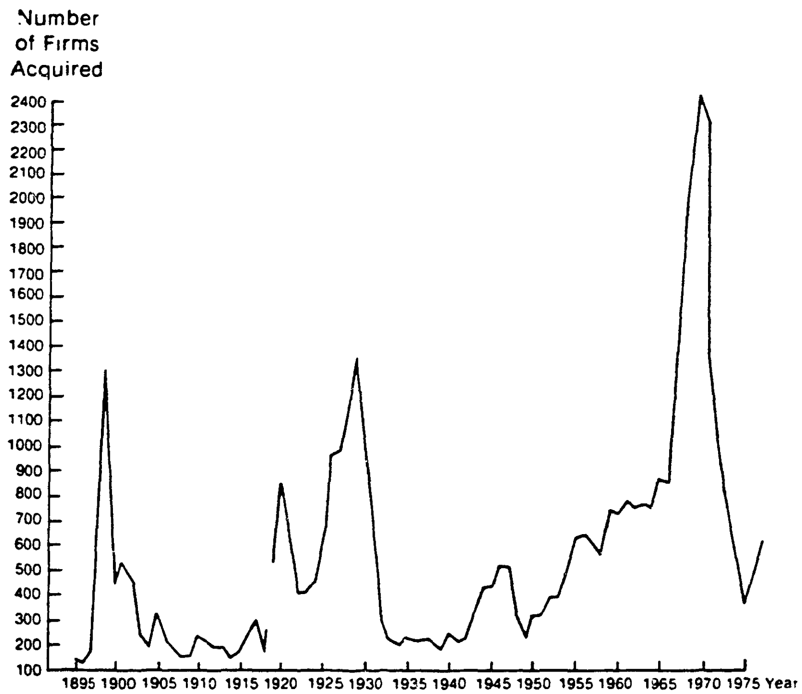
The study is presented in the form of a research report which draws upon company interviews and responses to the Questionnaire shown as Exhibit 4-1. Among the conclusions is that the diversification strategy should be communicated, in writing, to those both inside and outside the company in a position to identify acquisition candidates. Also, it is essential to involve operating managers in the acquisition process, as they may be in the best position to identify potential acquisition candidates and because they are in a better position to assess the organization fit of the candidate. The companies contacted indicated that benefits of merger and acquisitions include quick entry to a market, technology or capability with greater management control over the outcome. These conclusions and more are elaborated upon in Chapter 6.

1. History of Merger and Acquisition Activity

Legislative and public concern about mergers is a function of the volume of mergers. This volume has varied considerably over the period since 1895 as shown in Exhibit 1-1.[1] The first wave of mergers between 1895 and 1902 is associated with horizontal mergers of a large number of firms in numerous industries which formed trusts. Today's industrial

EXHIBIT 1-1

Number of Manufacturing and Mining Firms Acquired, 1895-1978



Sources: F. M. Scherer, *Industrial Market Structure and Economic Performance* (Chicago: Rand McNally, 1970), p. 104; Bureau of Economics, FTC, *Current Trends in Merger Activity, 1971*, May 1972; and Bureau of Economics, FTC, *Statistical Report on Mergers and Acquisitions*, December 1978.

giants, U. S. Steel, General Electric, United Fruit, American Can, American Tobacco, U. S. Rubber, and DuPont, originated during this period. The second wave of merger activity occurred in the late 1920's. This period included the formation of public utility holding companies, as well as smaller vertical acquisitions in the manufacturing sector.

The late 1960's wave, which peaked in 1968, was characterized by conglomerate mergers, combinations of diverse enterprises. Most of the acquirers during this period were small to medium sized companies, adding businesses outside their own industry. For conglomerates, the merger wave ended in 1970 with the collapse of the stock market. For other companies, it ended in the 1973 recession.

The current merger wave, which began in the late 1970's, prompted a July, 1983 report of the SEC Advisory Committee on tender offers that contained 50 recommendations for new regulations.

Michael Jensen has examined the various criticisms of corporate takeover and merger activity.[2] He argues that the popular view (or concern) underlying the proposals is wrong, because it ignores the fundamental economic function that takeover and merger activities serve. These activities provide an arena whereby alternative management teams are able to compete for the right to control - that is, manage the corporate resources. This benefits shareholders, since management is subject not only to the normal internal control mechanisms of their organization, but also to the scrutiny of the external market for control.

That these activities benefit shareholders has been supported by the evidence of a dozen studies. See Exhibit 1-2 summarizing the results of the studies, which indicate that target company shareholders gain on average 30% from tender offers and 20% from mergers.[3] The shareholders of

EXHIBIT 1-2

Abnormal Stock Price Increases from

Successful Takeovers*

	Target Companies	Bidding Companies
Tender Offers	30%	4%
Mergers	20%	0%
Proxy Contests	8%	N.A.+

*Adjusted to eliminate the effects of marketwide price changes.

+Not applicable

SOURCE: Jensen, Michael C. "Takeovers: Folklore and Science" Harvard Business Review, November-December, 1984, pp.112.

bidding companies, on the other hand, earn only about 4% from tender offers and nothing from mergers. If this is the case, then what is the motivation underlying the current wave of merger and acquisition activity and how can the process be improved to increase the benefit to shareholders of bidding and acquiring companies?

The current merger wave developed into a tidal wave of takeovers, mergers and buyouts in 1985. During 1985 General Electric, itself a product of the 1895-1902 wave, bought RCA for more than $6 billion. More recently, General Electric has decided on a greater presence in the financial services marketplace, having announced plans to acquire the investment banking and financial services firm of Kidder Peabody and Co. In the food industry, R. J. Reynolds acquired Nabisco, and Phillip Morris acquired General Foods. Beatrice, in a defensive maneuver, is going private in a management led leveraged buyout. In entertainment, ABC was acquired by Capital Cities Communications. Allied Corporation and the Signal Companies were also among the participants in the estimated 3000 mergers that took place in 1985. See Exhibit 1-3 for the ten biggest mergers of 1985.

According to Martin Sikora, editor of the publication "Mergers and Acquisitions", just as many deals for just as many dollars were done in 1984 as in 1985. What was unique about 1985 was the "breadth and depth of the deals". In 1985, there were a record 36 deals, valued at $1 billion or more, compared to 18 such transactions in 1984 according to W. T. Grimm, a merger research firm.

What is driving this activity, according to Alan Zakon, Chairman of the Boston Consulting Group, is companies are buying other companies because they can. With cash flows high and financing being readily

EXHIBIT 1-3

THE 10 BIGGEST MERGERS OF 1985

In Billions of Dollars

Deal	Value
General Electric-RCA	$6.28*
Beatrice-Kohlberg Kravis	$6.2*
Royal Dutch Shell-Shell Oil	$5.67
Phillip Morris-General Foods	$5.63
General Motors-Hughes Aircraft	$5.0*
R. J. Reynolds-Nabisco	$4.9
Allied-Signal	$4.85
U. S. Steel-Texas Oil & Gas	$4.0
Baxter Travenol-American Hospital Supply	$3.63
Nestle-Carnation	$2.89

*Deal pending but not formally completed.

SOURCE: Mergers & Acquisitions.

available at comparatively low rates, takeovers are within reach of many companies.

The torrid pace of the 1985 mega-merger activity may be cooling off. Some factors contributing to the slowdown mega-merger volume appear to be the all time high of the stock market, above the 1800 level. This has made many companies too costly for the acquirer.

In addition, uncertainty over proposed tax changes, together with rule changes already adopted by the Internal Revenue Service and the Federal Reserve Board, have helped curb takeover activities. The Feds' recently adopted rule sets a limit at 50% on high yield, high risk, "junk bond" financing that can be sold to finance certain hostile takeovers. Proposed tax law changes would increase the portion of an acquisitions purchase price that is subject to tax. In addition, a proposed IRS rule limits the amount of depreciable assets to their fair market value. Any premium over fair market value would be a non-recoverable capital expenditure.

2. Reasons for Diversification through Merger and Acquisitions

This next section considers the reasons why mergers occur. Among the reasons mentioned have been: (1) creation of shareholder value; (2) diversification of risk; (3) potential for speculative gain; (4) entrepreneurial value creation; (5) increased market power; and (6) tax related motives.

2.1 Creation of Shareholder Value

The economic firm has as its sole objective, the maximization of shareholder values. This is equivalent to increasing the net present value of the firm. The firm must balance the transaction costs and the extra costs associated with running a multi-business enterprise against the sources of value or increased cash flow available through diversification.

The so called "synergistic" effect or "2 + 2 = 5" effect asserts that the entities combined through diversification activities may be worth more than the sum of the parts.[4] Whether this is true, has not been confirmed by research. The attainment of economies of scale may provide the synergistic effect. Economies of scale in production, distribution, marketing, administration and finance are sources for achieving real economies of scale.

In addition, complementary activities in the firm's production and distribution process may generate real economies. This assertion is suggested in a study by Rumelt in which he concludes that:

> .....the dominant-constrained and related-constrained groups are unquestionably the best overall performers, and both strategies are based upon the concept of controlled diversity. Neither totally dependent upon a single business, nor true multi-industry firms, these companies have strategies of entering only those businesses that build on, draw strength from, and enlarge some central strength or competence. While such firms frequently develop new products and enter new businesses they are loath to invest in areas that are unfamiliar to management.

This statement refers to the superior performance attained by firms that diversify in fields whose production, distribution or marketing activities are related. See the discussion on strategies for creating economic value.[5]

2.2 Diversification of Risk

The diversified portfolio of activities will reduce overall risk, will make the company less vulnerable to a downturn in one business sector, and will bring added flexibility.[6]

The stability obtained has a benefit to the management team, but benefits derived by stockholders are less than clear, as they can obtain the same benefits of diversification through a mutual fund. Thus, while

there are possibilities for value creation through risk diversification, the success of such strategies is unproven. Risk diversification may lead to a portfolio of unrelated businesses built through acquisitions. Stockholders who do not hold a diversified portfolio, may benefit from such diversification while other stockholders may not benefit.

2.3 Potential for Speculative Gain

One incentive to unrelated diversification may have been the possibility of producing capital gains.[7] When a conglomerate acquired a firm with a lower price earnings ratio than its own, the market often evaluated the combined earnings of the two firms at the higher price earning ratio of the conglomerate, rather than applying a weighted average to the two. This provided an instantaneous capital gain. However, rather than creating value for its shareholders, a firm that grows using such a strategy is using its shareholders' ignorance of the true value of acquisition candidates to make investments which might not be in the shareholder's best long term interests. Needless to say, if such a strategy results in a significant gain at divestment, the acquisition was not contrary to shareholder interests.

2.4 Entrepreneurial Value Creation

The net present value of a firm increases whenever an event occurs or action is taken that increases the firms discounted future cash flows. Therefore, as a firm moves to invest in an attractive high yield project, or to acquire undervalued assets, its value can increase immediately.

2.5 Increased Market Power

Firms may attempt to gain a strategic advantage in the market place through size and diversity. Blocking access to materials or markets has the potential to reduce the number of competitors and the level of

competition in an industry. Furthermore, signalling a strong commitment to dominate and defend all markets in which a firm competes should also reduce the potential competition that it faces.

2.6 Tax Related Motivations

Other economic motives include changes in the capital structure of a poorly levered firm which may produce extra revenue from the additional tax shield of interest payments. In addition, corporations with expiring net operating loss carryforwards or investment tax credits may wish to acquire profitable companies, thereby utilizing the carryforwards and obtaining, in effect, tax free income from operations. See the recent paper by Auerbach and Reishus supporting this conclusion.[8]

2.7 Summary of Merger Benefits

The trends and extent of diversification confirm there are strong forces driving it. Prior to the 1960's, much of the diversification involved activities related to the firm's core businesses. During the 1960's unrelated diversification came on the scene with the emergence of the conglomerates. Although the conglomerate form has received considerable attention, the related form of diversification has always played a major role in the long term trend among diversified firms. The importance of related diversification has been emphasized by a number of cross sectional empirical studies.[9]

Relatedness is determined by the managers, who perceive them in a certain way. Diversification is said to be related if it:[10]

a. inolves businesses serving similar markets and/or

b. using similar distribution systems

c. involves businesses using similar production technologies

d. involves businesses using similar science based research

e. involves businesses operating at different points of the same value added chain.

See Exhibit 1-4 for a description of the major benefits available from the two forms of diversification. This thesis will consider both types of diversification through acquisition.

3. Literature Review

How the acquisition process works, or should work, is a topic which has been discussed by a number of writers. This section will review some of the recent literature on the various roles and functions involved in the acquisition process.

In an early work by Mace and Montgomery[11] , 275 executives were interviewed in an effort to provide a broad introduction to the area of mergers and acquisitions. Among their conclusions, they indicate that an indepth review of the acquired company's management is an essential step in the acquisition process. They conclude that the acquisition process is not a mechanical, sequential performance of essential steps. Rather, the elements of acquistion are profoundly affected by what is said by representatives of the acquirer and the acquired during business discussions.

In a more recent paper[12] Jemison and Sitkin discuss the notion of Strategic Fit and Organization Fit. Strategic fit addresses the factors which will affect the future combined financial performance. Organizational fit, on the other hand, encompasses the issues identified by Mace and Montgomery dealing with post-acquisition integration.

Rigorous financial analysis and modeling should result in sound acquisition decisions concerning issues of strategic fit according to Jemison and Sitkin. However, given different planning and control systems, organizational cultures and management styles, there may still be

EXHIBIT 1-4

Potential Benefits of Diversification

	Related Business Diversification	Unrelated Business Diversification
Product-market orientation	Diversification into product markets with similar marketing and distribution characteristics, or similar production technologies, or similar science-based research activities.	Diversification into product markets with key success variables unrelated to the key success variables of the acquirer's principal business.
Transferable resources with greatest potential for creating value	Operating and/or functional skills; excess capacity in distribution system, production facilities, or research operations.	General management skills; surplus financial resources.
Nature of potential benefits	Increased productivity of corporate resources through operating efficiencies, improved competitive position occuring from increased size of business, and reduction in long-run average costs can lead to a reduction in the variability of a company's income stream and/or a larger income stream than that available from simple portfolio diversification.	More efficient cash management and allocation of investment capital, reduced cost of debit capital, and growth in profits through cross-subsidization can lead to a larger income stream than that available from simple portfolio diversification. Reduction of systematic (market-related) risk is unlikely.
Relative ease of achieving potential benefits	Relatively difficult because of organizational problems associated with integrating formerly self-sufficient companies into the acquiring company.	Relatively easy to achieve capital efficiencies and benefits of cross-subsidization.

Source: Salter, M. S., Weinhold, W. A., Diversification Through Acquisition, Strategies for Creating Economic Value, p. 145.

difficulties in combining the two companies successfully. Several studies and articles have focused on these issues.

Drucker points out the need for a "tempermental" fit between companies as a criteria for a successful acquisition.[13] In an article focusing on acquisitions and mergers of insurance agencies, the author asserts that the critical factor is research and planning. Reasons given for merger failures include personality differences, egos, and an unclear picture of the merging companies.[14]

The management of the human side of acquisitions including motives, attitudes of management and other human resource issues, have been written on extensively.[15] [16] [17] According to Hayes[18] , management appraisal of the selling company is the key to overall success. He also indicated the importance of post-acquisition management autonomy, management style, acquisition announcement, timing and negotiating strategy as important to the success of the acquisition.

The acquisition process has been described as a sequential process[19] as follows: preliminary market research, development of criteria for acceptance of candidates, identification of candidates, initial contact with prime candidate, detailed information collection, financial and market analysis, negotiation of agreement in principle, confirmation studies and closure. The author notes that, as the investigation of a target company progresses, corporate development subjects the company's prospects to closer and closer scrutiny. Analysts examine in more detail every aspect of the company's finances, operations, products.

Dory prepared detailed case studies of the acquisition scanning process in six companies that had made successful acquisitions.[20] Three company variables, according to Dory, explain differences in scanning

processes and success of acquisitions: organizational policies, the management's experience with sucessful acquistions, and the leadership style of the chief executive officer.

In firms with successful acquistion scanning processes, organizational policies facilitated participation of managers in scanning and decision making. Policies that involved more managers in scanning and encouraged those managers to have broad contacts resulted in the greatest success. He also concludes that a somewhat democratic leadership style resulted in a relatively efficient scanning process because available information was quickly gathered when alternatives were identified; additional scanning was applied only to the more promising alternatives.

Other articles and publications are available by practitioners in the merger and acquisition field. These works, in general, provide guidelines and checklists to assist a manager in completing a successful merger or acquisition.[21] [22] In addition to providing a step by step approach which may or may not be applicable under any specific set of circumstances, the works deal with legal issues in merger and acquisition transactions. They also draw upon case studies and examples to illustrate the strategic issues to be considered in the process, as well as to illustrate the negotiating and personality factors integral to the process. These publications provide the manager with an understanding of the performance of other acquisitions, which may be of assistance in evaluating the risks and rewards of contemplated merger and acquisition activity.

The chairman of ARA Services, Inc., a services management company, who has participated in over 300 acquisitions, emphasizes the importance of building a good relationship between buyers and sellers involved in the acquisition process.[23] Most acquisitions by ARA are an addition to

existing services. Coordinated by the corporate development committee, the ARA approach is to evaluate the potential of an industry, then select the best company in that industry by evaluating such factors as growth, performance and management. According to the article, management must mesh with ARA management because ARA retains over 80% of its acquired management.

According to two commentators on merger and acquisition activity in the financial services industry, the fit between the acquirer's expansion strategy and the activity, technology and skill base of the acquiree is crucial.[24] The acquisition process itself should involve a systematic approach with the first step a strategic analysis of the acquirer's current business. Thereafter, a statement of overall strategy and a set of acquisition criteria should be developed on which to base the screening process to determine the fit of potential acquisition candidates.

The general conclusion of several economists who have studied the results of mergers and acquisitions, is that unrelated diversification does not lead to higher corporate returns.[25] Reid conducted an empirical study of the relative success of acquiring and non-acquiring firms in the period from 1950-1959. He found that the highest percentage of very successful firms were not involved with acquisitions.[26] Weston and Mansingkha's work notes, however, that diversification out of industries with low profitability may enable firms to improve profitability from inferior to average levels.

Research by Rumelt focused on the performance of companies following various diversification strategies.[27] His work showed that single-business companies outperformed the average in terms of capital productivity, but underperformed it in terms of corporate growth. Unrelated business

companies during the same period under study, 1950-1970, showed significantly higher corporate growth rates, but also showed lower rates of capital productivity.

In a subsequent study, Rumelt adjusted for industry effects on profitability and found that increasing diversification leads to decreasing relative profitability.[28] According to Rumelt "given an industry, those specializing in it will tend to be more profitable than those for which it is a sideline". From Rumelt's two studies, one can see the dilemna companies face is that sticking close to traditional businesses can condemn a company to average performance. However, wide ranging diversification places the productivity of capital at risk.

Given this research, Salter and Weinhold suggest that carefully prepared diversification objectives and acquisition guidelines, along with a sound acquisition screening process can increase the probability of selecting a merger partner that will create real economic value for the diversifying company's shareholders.[29] They point out that as one moves from related diversification toward unrelated diversification, the nature of potential benefits changes. Operating "synergies" related to integrating functional activities fade into benefits stemming from general management efficiencies. Eventually, when the totally unrelated diversifying acquisition is made, only financial benefits can be achieved.[30] According to the framework developed by Shelton, a pure related-complementary fit is vertical integration, while a pure related-supplementary fit is horizontal integration.[31] The related-supplementary target business provides the bidder primarily with access to new customers and markets, rather than with new assets or products. Related-complementary target businesses provide the bidder with new products,

assets or skills for product markets currently served by the bidder, rather than with access to new markets. See Exhibit 1-5, from the Shelton paper, for an illustration of strategic manner in which an acquired target business can change the product-market opportunities of a bidder business.

Salter and Weinhold suggest a screening grid, reproduced at Exhibit 1-6, which focuses on measures that summarize the key factors contributing to the value creation potential of acquisitions. These measures are divided into three broad groups dealing with risk characteristics, return characteristics, and integration potential.

The benefit of acquisition screening systems is that they tend to reinforce a broad understanding among managers of the company's diversification objectives and guidelines. In addition, working with a formal screening system develops a common language relevant to the diversification objective. This system and a mututal understanding of company needs all ensure that key decision makers follow similar logics when acquisition opportunities appear. Therefore, by carefully preparing divesification objectives and acquisition guidelines, along with a sound screening process, an acquirer can increase the probability of selecting a merger partner that will create real economic value for the diversifying company's shareholders.

Whether policies and guidelines, formal or otherwise, are in place and whether acquistion screening systems are utilized will be a part of my study of the acquisition process employed by the sample companies. The answers to these questions and others are being sought in an attempt to identify those aspects which tend to make the acquisition process successful. Chapter 4 describes the methodology for the study of the acquisition process.

EXHIBIT 1-5

Strategic Fits Between a Target
and a Bidder Business

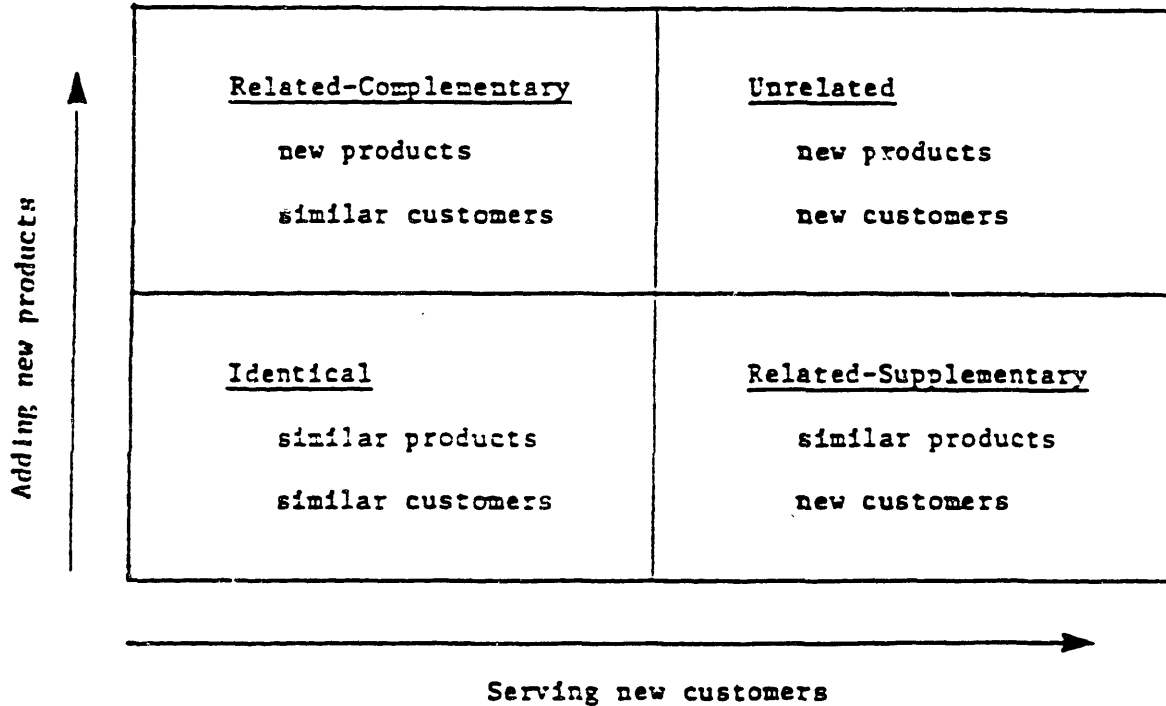


Illustration of possible ways that an acquired target business can change the product-market opportunities of a bidder business.

EXHIBIT 1-6

Acquisition Screening System

	Scoring Range	Industry A (Company A)	Industry B (Company B)	Industry N (Company N)
I *Risk Characteristics*				
A. *Capital Market Measures*				
1. Financial risk				
2. Systematic (market-related) risk				
3. Unsystematic (business-specific) risk				
B *Microeconomic Measures*				
4. Vulnerability to exogenous changes in supply and demand				
5. Ease of market entry and exit				
6 Potential of excess productive capacity				
7. Gross margin stability				
8. Strength of competitive position				
C *Political and Legal Measures*				
9. Degree of government intervention				
10. Societal liabilities				
11. Antitrust risk				
Subtotal, Risk Characteristics				
II. *Return Characteristics*				
A *Nature of the Investment*				
1. Size of the investment				
2. Period of the investment				
3 Liquidity of the investment				
4. Noncapitalized strategic investments				

EXHIBIT 1-6

(continued)

	Scoring Range	Industry A (Company A)	Industry B (Company B)	Industry N (Company N)
B. *Nature of the Return*				
5. Size of the return				
6. Period of the return				
7. Return due to unique company characteristics				
Subtotal, Return Characteristics				
III. *Integration Potential*				
1. Supplementary skills/resources				
2. Complementary skills/resources				
3. Financial fit/ risk-pooling benefits				
4. Availability of general management skills				
5. Organizational Compatibility				
Subtotal, Integration Potential				
Grand Total				

FOOTNOTES
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FOOTNOTES
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CHAPTER 2.

The Acquisition Process Described

The purpose of this chapter is to provide an introduction to the various steps to be untertaken by members of management or their designates during the Acquisition Process.

1. Develop and Implement a Plan

Top management should establish acquisition objectives and develop guidelines for their implementation. Strategic considerations such as horizontal acquisition of new businesses in growing industries must be approved by the Board of Directors. Strategic guidelines for complementary acquisitions should also be established. These guidelines should integrate the acquisition process with the business and corporate strategic planning process.

2. Identify and Evaluate Acquisition Candidates

Once the strategic guidelines have been set, a search for candidates may be undertaken. Industry searches can be focused by SIC code number. After a list of potential candidates has been developed, it should be narrowed down to those companies which should be studied in more detail.

3. Acquisition Review

1. Develop an understanding of the major business factors in the industry in which the company operates.

   i. Identify the major companies, market share, and distinctive features and ways of doing business (production, marketing, etc.) of the company and major competitors.

   ii. Determine what the important technological aspects of

the industry are and if there have been any significant recent developments, and how these would influence the business of the company.

iii. Evaluate the significance of government regulation and and regulatory requirements, including any new or proposed regulatory requirements which may not have yet affected the company's reported results.

iv. Determine how difficult it is for a new competitor to enter the industry, and to what degree competitors or suppliers might try to integrate their operations forward or backward.

2. Analyze the major materials and productive resources used in producing the company's product, the status of relationships with major vendors and suppliers.

3. Review listings of major customers, and ascertain the amount and types of business done with each company.

In-Depth Organizational Review Checklist

(This is an extensive checklist which, given time constraints and other "negotiating" factors, probably will not be completed in all acquisitions.)

1. Obtain the history and background of the company from the time it was founded to the present.

2. Obtain details of the current capital structure of the company including any contingently issuable shares from conversions or stock options.

3. Review organization charts, procedures manuals, and information on key management personnel, including compensation, age, position and background. Review management compensation for

several preceding years.

4. Obtain and review a list of all current contacts. Note all important aspects, including transferability clauses in the event of change of ownership of the acquisition candidate.

Ensure that the following kinds of contracts have been specifically requested and reviewed.

a. Employment contracts
b. Stockholders agreements
c. Sales and purchase agreements
d. Union agreements
e. Pension and other employee benefit plans and agreements
f. Leases
g. Loan and banking agreements

5. Identify all related parties and analyze the details of all inter-company transactions, including dealings with unconsolidated related parties.
6. Review procedures for preventing illegal acts or payments.
7. Obtain and review credit agency reports on the acquisition candidate.
8. Read minutes of meetings of board of directors and committees for several years, articles of incorporation, corporate bylaws, and all other legal instruments related to the corporate activities of the acquisition candidate.
9. Obtain geographical information on location of markets, facilities, and employees.
10. Obtain a listing of all employee benefit plans. Review

pension fund financial statements, the status of pension funding in relation to prior service and vested benefits, and compliance with ERISA and IRS requirements.

11. Obtain copies of all insurance policies, and analyze major coverage and exposures, including any self-insurance practices, and details of major insurance claims in the last few years.

12. Obtain an understanding of the company's research and development activities - including an analysis of funds and resources committed and results of past research and development activities.

13. Review the company's major assets and operational facilities, and estimate their remaining useful lives and productive capacity in relation to capacity utilized in recent years.

Additional Information

1. Ascertain the following:
    a. The reason the company is for sale.
    b. If any previous proposed transactions have been terminated by the prospective buyers and why.
    c. If any cosmetic actions have been taken by the seller to make the acquisition candidate look more attractive than it really is.

2. Determine the desired tax structures and accounting method (purchase or pooling of interests) to be used, and determine if the terms of the transaction are consistent with the desired effects.

3. Ascertain whether any filings with the SEC or other

regulatory authorities that are required as a result of the acquisitions

4. Ascertain and consider the role of intermediaries and other professionals in the transaction, and inquire as to the amounts of fees payable to each.

5. Consider whether any potential antitrust considerations could exist and if any pretransaction filings or approvals are necessary.

Financial

1. Develop an understanding of significant industry and company accounting practices and policies.

2. Review financial statements and annual reports for several preceding fiscal years, and the most recent interim financial data available.

3. Review income statements, balance sheet and cash flow forecasts for current and future years, including product line and business segment breakdowns.

4. Determine carrying values of major facilities owned, and identify any assets pledged as collateral or as to which liens exist.

5. Review copies of recent years' tax returns and information on status of tax examinations for open years, and copies of recent reports on tax examinations.

6. Ascertain details of pending or threatened litigation.

7. If possible, review auditors' work papers and letters of recommendation.

8. Review current backlog information by product line and

business segment, and comparative backlog data for prior periods.

9. Review the detailed accounting records to the extent deemed appropriate in the circumstances, comparing such to trial balances used in preparing the financial statements. Be alert for adjusting entries made in consolidation for judgmental adjustments to the financial statements.

4. Valuation

After obtaining the information, a value can be determined for the acquisition candidate. Naturally, a valuation could be determined without all of the information called for in the previous subsections. However, it would not be as complete and therefore less precise.

In some situations, the value may be determined by a premium over the market value for the stock. In these circumstances, it becomes essential to determine the underlying value of the earning power of the company. In other cases, a discounted cash flow model will be the appropriate means to determine the offering price for the company.

Since valuation is an essential step in the acquisition process, it is crucial that all the major players and their competent advisors review the valuation. It is critical in order to avoid overpaying for the acquisition candidate.

When evaluating acquisition candidates, the comparison approach involves allocating capital among the acquitions that are available. For a portfolio approach to value based planning consult Hax and Majluf.[1] Because the investment lacks liquidity, a long-term horizon is required. With a long-term approach, several methods of valuation should also be considered: liquidation value, book value, public-market value, public-

market value of related firms, previous acquisition value of related firms, present value of expected cash flow.

The discount rate can be determined based on the capital asset pricing model. In this approach, the cost of equity capital is determined by reference to the risk free rate of interest, plus the equity risk premium.[2]

The equity risk premium is determined by multiplying the Beta of the company by the stock market rate of return in excess of the risk free rate of interest. The individual Beta of the company is derived by regressing individual security rate of return data against the return on a stock market index like the S & P 500. For further description consult "Principles of Corporate Finance" by Brealey and Myers.

Controversy exists over instability in calculated Beta values over time. Also the capital asset pricing model from which the Beta is derived is only a one-period rate of return model, whereas corporate acquisitions are capital-budgeti decisions requiring a multi-period analysis. In general, the appropriate risk/return parameters for the multi-period analysis cannot be easily derived from historic one-period data using the CAPM, unless one makes a host of the other assumptions.

In theory, if no better alternative is available, and the present value of the cash flow is greater than the cost to acquire, then the acquisition investment should be undertaken regardless of the immediate impact on reported earnings. The capital market will not be fooled by short-term accounting effects and will figure out the incremental wealth of the firm resulting from the acquisition.[3] However, since it is difficult for management to rely entirely on the long run as opposed to the short run financial impact, management should also examine proforma financial

statements to assess the potential impact of alternative acquisition approaches.[4]

At times, it may not be possible to make accurate projections of cash flows, or to estimate the market value by capitalizing future earnings at the appropriate discount rate. In this case, valuation can be done based on historical earning power and capitalization rates for comparable publicly traded companies. There are a number of crucial assumptions that must be made in these analyses. Therefore, considerable professional judgement with review and a consensus of those involved is a suggested approach.

5. Rethink Strategic Objectives, Fit of the Candidate and Consider Likely Alternative Scenarios

After preliminary information is developed and valuations compiled, management should continue to evaluate questions of organizational and strategic fit. Such criteria should be applied to the range of available acquisition candidates. It may also be advisable to develop base case and alternative planning scenarios.

The alternative scenario analysis will deal with questions of future products, future management and professional needs, the role of government and its impact on business, financing requirements, and future technologies. Comparison of the answers to these and similar questions for the company and potential acquisition candidates and likely industries will provide a basis for evaluating the prospects for investment decisions.

FOOTNOTES
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CHAPTER 3

Regulation of Mergers and Acquisitions

Introduction

This section will discuss the major Tax, SEC, Accounting, State Corporate Law and Antitrust implications of mergers and acquisition.

1. Financial Accounting and Reporting Implications

There are two basic methods of accounting for a business combination: pooling of interests and purchase method. The difference between the two is that a pooling is viewed as a combination of two previously separate stockholder groups into a single enterprise, whereas in a purchase, one company is regarded as having bought a bundle of assets subject to existing liabilities.

1.1 Pooling: If a business combination meets all of the conditions specified in Accounting Principles Board Statement No. 16. (APB 16)[1] then the combination must be treated as a pooling of interests. The results of operations for financial statement purposes are reported as though the companies had been combined as of the beginning of the period, and prior period results are restated on a combined basis.

In the 1960's merger wave, prior to adoption of APB 16, pooling of interests were frequently applied to purchase situations to create instant earnings. This was curtailed by APB 16, which set forth twelve criteria which, if met, mandate pooling of interest accounting for business combinations. See Exhibit 3-1 for the criteria.

The underlying concept, however, is that in a pooling of interests there is an amalgamation of two or more ongoing businesses with a sharing of risks by each stockholder group. The substance of the transaction must

EXHIBIT 3-1

APB. No. 16 CRITERIA FOR POOLING OF INTERESTS

1. Each of the combining companies is autonomous and has not been a subsidiary or division of another corporation within two years before the plan of combination is initiated.
2. Each of the combining companies is independent of the other combining companies.
3. The combination is effected in a single transaction or is completed in accordance with a specific plan within one year after the plan is initiated.
4. A corporation offers and issues only common stock with rights identical to those of its existing common stock in exchange for at least 90% of the voting stock interest of another company at the date the plan of combination is consummated.
5. None of the combining companies changes the equity interest of the voting common stock in contemplation of effecting the combination either within two years before the plan of combination is initiated or between the dates of the combination is initiated and consummated; changes may include distributions to stockholders and additional issuances, exchanges, and retirements of securities.
6. Each of the combining companies reacquires shares of voting common stock only for purposes other than business combinations, and no company reacquires more than a normal number of shares between the dates the plan of combination is initiated and consummated.

EXHIBIT 3-1

(continued)

7. The ratio of the interest of an individual common stockholder to those of other common stockholders in a combining company remains the same as a result of the exchange of stock to effect the combination.
8. The voting rights to which the common stock ownership interests in the resulting combined corporation are entitled are exercisable by the stockholders; the stockholders are neither deprived of nor restricted in exercising those rights for a period.
9. The combination is resolved at the date the plan is consummated and no provisions of the plan relating to the issue of securities or other consideration are pending.
10. The combined corporation does not agree directly or indirectly to retire or reacquire all or part of the common stock issued to effect the combination.
11. The combined corporation does not enter into other financial arrangements for the benefit of the former stockholders of a combining company, such as a guaranty of loans.
12. The combined corporation does not intend or plan to dispose of a significant part of the assets of the combining companies within two years after the combination other than disposals in the ordinary course of business of the formerly separate companies and to eliminate duplicate facilities or excess capacity.

take precedence over the form which usually entails an exchange of common for common stock of the acquired company.

1.2 **Purchase Method:** If a business combination does not meet all the conditions (12 enumerated) then it must be treated as a purchase. Under the purchase method, the acquiring company allocates the cost of the acquired company to the specific assets acquired and liabilities assumed. Any excess of the cost of the acquired company over the amount assigned to the net assets acquired, should be recorded on the financial statements as goodwill. Goodwill is amortized over its useful life not to exceed 40 years. (See APB No. 17 for the treatment of goodwill.)[2]

It should be emphasized that amortization of a portion of the purchase price over a 40 year period may be advantageous for maintaining growth in earnings per share. However, for tax purposes, goodwill is not deductible. This issue should be resolved in advance of structuring the acquisition.

1.3 **Earnings Per Share, Effect of Accounting Alternatives:** The purchase or pooling method may have significantly different impacts on earnings per share and stock market values. Because of these differences, projections of future book earnings under both alternatives are necessary before any financing decision is made.

Where the reported book value of the net assets of the selling company and their fair market value approximate the purchase price, no goodwill will be created. In this situation, subsequent differences in financial statements are minimal.

Usually purchase price will exceed book value, requiring a revaluation of assets and liabilities, which will result in a non-tax deductible charge to income. For an illustrative example and further

discussion see Arthur Anderson, "Accounting and Tax Considerations for Business Combinations"[3]

2. Tax Aspects of Corporate Acquisitions

This section is intended to provide an outline of the tax factors to be considered in determining the optimal structure of an acquisition. The acquisition of a corporation can be accomplished as: (1) a taxable acquisition or (2) a nontaxable acquisition. In a taxable acquisition, the shareholders of the target corporation may sell their stock or cause the corporation to sell its assets. The tax is imposed because cash is received in the transaction. The tax would be imposed on the gain resulting from either method. In a nontaxable acquisition, the shareholders of the target corporation may either exchange their stock or cause their corporation to exchange its assets for stock of the acquiring corporation. No tax is imposed since the transaction is merely a change in the form of the investment with no cash being received. The tax basis of the old stock carried over as the tax basis for the new shares received in the exchange.

The analysis that follows is intended to highlight the major tax issues which should impact the business decisions. The significantly different tax costs associated with various deal structures must be considered in valuing the proposed transaction. For example, the amount and timing of tax shield will be directly affected by such matters as purchase price allocation and appraisals.

The tax aspects, therefore, could significantly impact projected ROI for valuation purposes.

2.1 Taxable Acquisitions: There are two types of taxable acquisitions:

1. Cash purchases of target company's assets. (The purchase price equals cash plus liabilities assumed.)
2. Cash purchase of target company's stock.

i. **Asset Purchase**

The purchase of assets for cash is advantageous for an acquirer. Subsequent tax deductions for depreciation and amortization will reflect the full purchase price of the acquired assets. The overall purchase price will be established and could be allocated in the purchase agreement to the various underlying assets. This, however, may be difficult because of adverse party interests at the time of the transaction. In which case, an independent appraisal should be obtained which allocates the purchase price to inventory and machinery and equipment which have shorter depreciable lives for tax purposes. The IRS in any event, requires that assigned values should be made in accordance with their relative fair market value and the appraisal may support an "aggressive" allocation.

If, however, the parties do agree to an allocation of the purchase price in the purchase agreement, it will usually be respected by the IRS. It will not be as crucial to justify the fair market value of the assets as when there is no such allocation.

If intangible assets are acquired, every effort should be made to establish that they have an ascertainable value separate and distinct from that of goodwill, and that they have a limited useful life. The appraisal can also establish a value and useful life for intangibles. If both are not established, the Internal Revenue Service will disallow deductions

related to the purchase of these intangible assets. Allocating an inordinately high value of an acquisition price to intangible assets instead of tangible assets should be avoided.

One significant advantage to an asset purchase is that the acquired is not liable for any tax deficiencies for "open years" which can be assessed by the IRS. Furthermore, an asset purchase will avoid problems associated with undisclosed liabilities when a corporation is acquired intact.

When a company is acquired via purchase of assets, none of the target company's tax attributes are acquired. This is not the case with other methods of acquisition. If a selling company has net operating loss and investment tax credit carry forwards, an alternative acquisition strategy should be pursued.

The seller's interests in a sale are different than those of the acquirer. Sale of assets for example, may be disadvantageous for the seller. The sale of assets is taxable to the seller, with a tax being paid on the difference between sales price and the adjusted basis (cost less depreciation) of the assets. Depreciation and investment tax credit recapture are also incurred by the seller in a sale of assets. Furthermore, to the extent the selling price is allocated to the inventory of the seller, ordinary income will be taxed to the seller. The well-advised seller will insist on a provision whereby the purchaser agrees to reimburse the seller for the tax liabilities in excess of those that would have been incurred in a stock sale.

ii. Stock Purchase

The acquirer purchases the stock of the target company which remains as a distinct legal taxable entity. Maintaining legal existence may offer

the advantage of facilitating license, franchise and contract transfers. However, it has the disadvantage of subjecting the acquirer to liability for unrecorded liabilities and tax liabilities for all open tax years on which the IRS may make an assessment. It is advisable to insist on an indemnification in the purchase and sale agreement to protect the acquirer. Another possibility is to hold back "escrow stock" or a portion of the purchase price in an escrow account until you are certain there are no remaining unexpected liabilities.

In a stock purchase, the underlying assets may have a lower book value than purchase price. In order to prevent reduced depreciation deductions to the acquiring corporation, Section 338 of the Internal Revenue Code provides an election to treat the stock purchase as an acquisition of assets for tax purposes. This will enable the acquirer to take full depreciation deductions.

However, electing to treat the purchase as an asset purchase will eliminate any favorable carryforwards which might otherwise have been available. In addition, investment tax credit recapture and depreciation recapture are triggered. In contrast to an asset purchase, the acquirer is responsible for the recapture tax liabilities. Therefore, should it be anticipated that an IRC Section 338 election will be made subsequent to acquisition, consideration should be given to a provision in the sales agreement for reimbursement of the recapture tax by the seller through adjustment or the purchase price. Alternatively, an election is possible pursuant to Section 338(b)(10) of the Internal Revenue Code whereby the seller becomes responsible for recapture taxes.

In a stock purchase, the purchaser assumes the tax position of the prior owners. The investment tax and net operating loss carryforwards will

be available to the acquiring entity, unless Section 338 is elected. Where significant tax carryforwards exist, a stock purchase is more favorable than an asset purchase.

The acquiring company also assumes any negative tax attributes of the target company. Any previously undisclosed tax liabilities that arise belong to the new owner. Therefore, in a stock acquisition, inquiry must be made into the status of ongoing and potential income tax audits, unpaid back taxes as well as current year estimated tax payments.

For the seller, a stock sale is often preferred to an asset sale. While the stock sale is also a taxable event, investment tax credit and depreciation recapture are avoided for the seller. For individual sellers, the gain to shareholders in a stock sale will be taxed at the lower 20% maximum long-term capital gain rates as compared to the 50% maximum ordinary tax rate. For corporations, the rates are 28% and 46% respectively. These rates may change according to the pending tax proposals.

2.2 Non-Taxable Acquisition

There are three basic types of tax-free acquisitions, referred to as type (A), (B), and (C) reorganizations. The basic patterns are:

1. Pursuant to state statutory law (a) the target corporation merges into the acquiring corporation, or (b) both corporations consolidate into a third corporation. This is known as an (A) Reorganization. IRC Sec. 368 (a)(1)(A).
2. The stockholders of the target corporation transfer their stock in the corporation to the acquiring corporation in exchange for the latter's voting stock or stock of its parent corporation. This is known as a (B) Reorganization. IRC Sec. 368 (a)(1)(B).

3. The target corporation conveys substantially all of its assets to the acquiring corporation in return for the latter's voting stock or stock of its parent. This is known as a (C) Reorganization. IRC Sec. 368 (a)(1)(C).

A (B) reorganization differs in form from an (A) or a (C) reorganization in three respects:

1. The exchange is solely for the stock, not the assets of the target corporation. (In an "A" or "C" reorganization, some cash may be given as consideration.)
2. The exchange is with the shareholders of the target corporation, and,
3. The target corporation continues in existence as a controlled subsidiary of the acquiring corporation following the exchange of stock; it retains its separate identity and various tax attributes.

The (B) reorganization has a number of advantages that are not always available in the other two reorganizations.

1. Shareholders approval is often not required.
2. Dissenting shareholders do not have appraisal rights.
3. The problem of a transfer of assets is avoided.
4. There is a substantial avoidance of the paperwork involved with establishing a new corporate entity.

For the acquiring corporation, the (B) reorganization, an exchange of stock for stock, has the advantage of conserving cash. However, in a stock exchange, the Section 338 election is not available to "step up" the basis of the assets. The acquirer assumes the target corporation's basis in the underlying assets and would forgo depreciation and amortization allowances that may be available through other forms of acquisition.

For the acquiring corporation, the "outside basis" or basis in the shares of the target corporation is the same as its basis in the shares transferred in the exchange. This has the advantage, however, of deferring a tax until such time as the shares in the target corporation are sold.

The tax attributes of the target company remain in existence after the exchange. Therefore, any investment tax credit or net operating loss carryforwards may be available to the newly combined entity. At the same time, however, the exposure to potential liability for open tax years remains as previously discussed.

From the sellers perspective, the stock for stock exchange is favorable. The exchange is a nontaxable event. At the same time, however, the seller receives no cash in the transaction. If the stock received is that of a publicly traded company, this presents no problem, as the stock can be immediately sold for cash.

2.3 Summary

From the viewpoint of tax savings and administrative ease, the asset purchase is generally the preferred acquisition method for most middle market transactions according to a survey conducted by the publication Mergers and Acquisitions.[4] If a purchase of stock is deemed advantageous, then a Section 338 election should be considered. The recapture liability should be addressed in the purchase agreement. If cash flow considerations dominate, then the stock for stock exchange should be considered.

There are many factors to be considered in planning an effective acquisition. Evaluating the economic impact of tax alternatives should be done at an early stage. Often the seller will be guided by tax considerations. Understanding the seller's position and evaluating the tax impacts of the various alternatives will enable the acquisition planner to design the most effective acquisition and negotiating approach.

Exhibit 3-2 presents a comparison of tax characteristics of acquisition methods.

3. SEC Regulation

Every business combination, whether effected through merger, transfer of stock, or sale of assets, necessarily requires consideration of the Federal securities laws.[5] In a stock for stock "B" reorganization, the acquirer must either (1) register its stock under the Securities Act of 1933, or (2) qualify the transaction as an exempt private offering or (3) qualify the transaction as an exempt intra-state offering or (4) qualify the transaction to fall within one of the other exemptions to registration under the 1933 Act.

If none of the exemptions are available, then a registration statement must be filed. Registration with the SEC will permit the target shareholders to resell their stock without restriction unless they become an "affiliate" of the acquirer pursuant to SEC Rule 144.

Present SEC Rule 146 in the context of a "B" reorganization requires that the acquirers stock be issued to no more than 35 persons, each of whom either alone or in conjunction with an independent "offeree representative" has such knowledge and experience in financial and business matters that he is capable of evaluating the risks and merits of prospective investment. Other small and private offering exemptions are SEC Rule 240 and Regulation D which represents an attempt by the SEC to coordinate existing exemptions from registration and reduce the regulatory burden on smaller issuers.

The intra-state offering exemption exempts offerings within the state, without registration if all parties are residents of the same state. State corporate and securities laws apply.

EXHIBIT 3-2

COMPARISON OF TAX CHARACTERISTICS
OF ACQUISITION METHODS

	Cash for Assets	Cash for Stock	Stock for Stock
1) Purchaser's tax basis in acquired assets for depreciation, amortization, and gain/loss	Fair market value	Historical basis	Historical basis
2) Purchaser's tax basis in acquired stock	N/A	Cost of acquiring stock	Sellers basis
3) Investment tax credit and depreciation recapture	Seller incurs tax	None, unless Sec. 338 "step-up" election is made in which case purchaser incurs tax	None
4) Tax attributes, i.e., ITC and net operating loss carryforward	Not available to purchaser	Available to purchaser unless Sec. 338 "step-up" election is made	Available to purchaser
5) Exposure to sellers tax liabilities and IRS audit	No	Yes	Yes
6) Taxability to seller	Taxable	Taxable	Non-taxable
7) Intangibles	Amount of purchase price allocated to intangibles can be amortized if certain requirements are met.	Only intangibles already on books can be amortized (if originally acquired by purchase) unless Sec. 338 "step-up" election is made	Only intangibles already on books can be amortized (if originally acquired by purchase)

In addition to filing registration statements, reporting companies are required to submit annual and quarterly reports. These forms 10-K and 10-Q respectively, constitute the ongoing disclosure process for public companies.

Supplements to the registration statements will report acquisition activity and Form 13-D is required to be filed by purchasers of 5 percent or more of the issued and outstanding common stock. Form 14-D1 is filed when a tender offer is made for a company.

Tender offers are regulated pursuant to Section 14(d) of the Securities Exchange Act of 1934. This section requires that the person or group making the tender offer file documents with the SEC disclosing the composition of the group, its financial sources and its plans with regard to the target company. The disclosure is the same as that required under Section 13(d) of the 1934 Act for a person, or group of persons, acquiring beneficial ownership of more than 5% of the stock of a public company.

Section 16(b) of the 1934 Act applies to purchases and sales of stock within six month periods by officers, directors and 10% shareholders of public companies. The section calls for repayment of gains on the purchase and sale of the company stock within a 6 month period by the indicated individuals. Its purpose is to automatically prevent those individuals with access to inside information, such as merger and acquisition plans, from benefiting from such information prior to public disclosure thereof.

There are substantial penalties for noncompliance with the federal securities. The laws do apply to merger and acquisition activity, therefore attention to their requirements is an essential element in the planning of any business combination.

4. State Corporate Law

In addition to federal securities laws, state corporate and securities laws will apply to mergers and acquisitions. For example, many states require that a merger or consolidation be approved by at least two thirds of the Board of Directors of a corporation which is incorporated in that state. Each state law is different. Delaware, for example, generally requires approval of a majority of the Board to approve a merger or consolidation.

Most states require a two thirds approval for a sale of all or substantially all of the assets of a corporation. Delaware and California require the approval of a majority for this purpose.

Many states have adopted law regulating tender offers. Generally, these takeover statues provide that:

1. Advance notice be given.
2. Information must be filed with the state regarding the tender offer.
3. State regulatory agencies may hold hearings to determine if the offer meets substantive standards.
4. There must be a minimum duration for the offer.

Dissenters rights, or appraisal rights are available in most states in the case of a merger, consolidation or sale of substantially all of the corporation's assets. The purpose is to compensate the minority shareholder in a fair manner pursuant to state laws. Delaware, however, denies appraisal rights upon a sale of assets, and also denies appraisal rights to shareholders of a corporation involved in a merger or consolidation, if the class of shares is listed on a national securities exchange.

5. Antitrust Regulation

The principal concern of antitrust policy is to maintain competitive industry and market structures. The FTC's pre-merger notification rules cover any type of transaction not specifically exempted. Antitrust Regulation is enforced by the Department of Justice and the Federal Trade Commission. These agencies have issued guidelines for assessing the legality of various mergers. Market share and number of firms in a market are key elements in these guidelines. Under the Reagan administration, antitrust enforcement has been curtailed drastically. An example of present enforcement policy is General Electric's permitted merger with RCA.

Current administration proposals would amend Section 7 of the Clayton Act making it more difficult for the DOJ to block mergers. The rationale put forth by the administration is that U.S. firms have lost their competitive edge and increased merger activity would enable firms to regain the lost advantage.

In addition to changes in administration, the long lead time between enforcement action and settlement of an antitrust cases create difficulties for interpreting policy. Industries and companies change as the enforcement policy itself is evolving. An example of an evolving administration policy was the U.S. government's decision to drop its suit against IBM, after 14 years.

Present legislation, however, requires pre-merger notification with the FTC and DOJ for all mergers and acquisitions in which one of the companies has sales or assets in excess of $100 million and the other company has sales or assets in excess of $10 million. Completion of an acquisition cannot occur until thirty days after the required filings.

While the administration is presently permissive in antitrust matters, companies must continue to monitor trends in enforcement.

FOOTNOTES
Chapter 3

[1] Financial Accounting Standards Board, Stamford, Conn., APB No. 16, 1970, Business Combinations.

[2] Ibid., APB No. 17, Intangible Assets.

[3] Arthur Anderson and Co. Accounting and Tax Consideration for Business Combinations in the United States. Chicago, Arthur Anderson and Co.

[4] Mergers and Acquisitions. The Journal of Corporate Venture, Washington, D.C., Mergers and Acquisitions, Inc., Nov.-Dec. 1985, p. 66.

[5] Levin, Jack S. Corporate Mergers and Acquisitions; Tax, SEC and Accounting Aspects, 1982 and 1984, Practicing Law Institute.

CHAPTER 4

Research and Methodology

1. Introduction

The objective of this thesis was to identify those aspects of the acquisition process which can influence its ultimate success. The approach employed was to contact companies which employ the acquisition method as a method for achieving corporate growth. This chapter describes how the companies were selected, the manner in which the information was collected and how the responses were evaluated.

2. The Sample

The sample was selected primarily from active acquirers in the Greater Boston area. Six out-of-state companies were also selected. The selection of Boston area companies was intended to contain travel time and expense in the event interviews were required. However, most of the information was eventually obtained via telephone or by correspondence.

Company contacts were obtained from the Dun and Bradstreet Million Dollar Directory or from academic and business associates. The companies are either known acquirers or were identified through the journal Mergers and Acquisitions.[1] Some of the Boston area companies had been identified in a prior study of mergers and acquisitions in technically based enterprises.[2]

3. Research Methodology

The study is presented in the form of a research report which draws upon the responses of company contacts, discussion with professional consultants, investment bankers, professional appraisers and, in certain instances, the author's background in selected areas.

The study is presented in the form of a research report which draws upon the responses of company contacts, discussion with professional consultants, investment bankers, professional appraisers and, in certain instances, the author's background in selected areas.

The questionnaire was designed to elicit responses to specific questions and also to provide the opportunity for general responses and subjective analysis. It was intended that open-ended questions would permit the respondent flexibility in indicating essential requirements for a successful acquisition. During preliminary telephone conversations, some of the company contacts also indicated a preference for specific questions. See Exhibit 4-1 for a copy of the questionnaire.

The types of companies to whom the questionnaire was sent and those responding to it are described at Exhibit 4-2.

In some instances, responses were obtained by interview or via telephone interview. In most cases, company information was obtained by reference to publicly available information such as annual reports, company history, Securities and Exchange filings, as well as the completed questionnaire.

The objective of the information gathering stage of this study was to obtain as much information as possible about the acquisition process. For example: how it was conducted, and what aspects thereof were considered crucial to the success of the acquisition. In addition, information about the company and its strategic objectives was also requested.

Responses to selected questions are summarized in the Appendix.

EXHIBIT 4-1

QUESTIONNAIRE

THE ACQUISITION PROCESS

QUESTIONNAIRE

COMPANY BACKGROUND

1. Date of incorporation ____.

2. Who are the company founders and initial investors? What is their present status?

NAME	FOUNDER/INVESTOR	PRESENT STATUS

3. What are the company's major lines of business or products?

4. Brief history of the company:

   How were the original products developed?

   How was the technology developed?

5. Does the company have an acquistion policy?

MERGER AND ACQUISITION POLICY

Origin of the Policy

1. Who suggested making acquisitions?

   Founder______________________________

   Board______________________________

   Others______________________________

2. Does the company have an acquisition policy?__________

   Discuss major changes in that policy in the last 3 - 5 years.

3. Has the company itself ever been approached by potential acquirers?_____

   If so, what were the potential benefits of such a combination.

4. Would the company participate in a turnaround situation?

THE ACQUISITION PROCESS

1. How would you describe the company acquisition process?

   Centralized ____________________

   Decentralized ____________________

   Comment:

2. Who performs various roles in the acquisition process? Please check as appropriate.

	Board of Directors	CEO	Other Top Mgmt.	Corp. Planning Staff	Legal	Finance	Outside Consul-tant	Other
Formulate Strategic Policy								
Search								
Evaluate								
Valuation								
Prepare Management Reports								
Coordinate Acquisition Effort								
Negotiate								
Manage Integration								
Post Acquisition Audit-evaluation								

3. What is the role of outside consultants (financial, marketing, audit expertise) during:

   Pre-acquisition phase ______________________________

   Negotiation phase ______________________________

   Thereafter ______________________________

4. What method is used to determine the value (price) of a potential merger acquisition?

   Return on Investment _____

   Industry Multiples _______

   Payback _______

   Other ________

   CAPM_________

   Please describe in detail your method of valuation.

5. When does the management/organizational integration process begin?

	Negotiation	Closing	Post Closing
Financial			
Tax			
Operational			

6. How much control does the acquired company's management usually retain in running the operations of the newly acquired company?

7. Does the company attempt to reach an understanding - agreement with the acquisition candidate's management during the negotiation phase as to their future role in:

   Staff selection ______________________________________

   Financing____

   Capital Expenditures__________________________________

   Customer Selection____________________________________

   Business Plans _______________________________________

   R and D Expenditures__________________________________

   Other____

8. What causes breakdown in negotiations?

9. Do you consider management philosophies and personalities more important than organizational characteristics to the success of the acquisition effort?

10. Is a group assigned responsibility for overseeing the transition and managing the integration effort?

11. Rank the following objectives high, medium or low in order of importance to the company's acquisition policy. Also list other objectives you consider important:

Market Expansion________________

Acquire New Products____________

Acquire New Technology__________

Improve Distribution____________

Diversification of Risk_________

Expand Production_______________

Improve Earning per Share________

Tax Benefits____________________

Investment______________________

Other___________________________

12. Does the company generally acquire stock or assets?

13. Have unrecorded liabilities such as subsequent lawsuits or unrecorded income tax claims been a significant factor in prior transactions?

14. What is the company's record with the Department of Justice and the FTC on antitrust matters? Is counsel involved at an early point in an acquisition effort?

15. How successful is the company's systematic approach in identifying acquisition candidates? How many people and which departments are involved in acquisition search?

16. In addition to industry and trade publications, SEC reports and investment services, what other sources are used to identify candidates? Have computerized data base been used?

17. What method does the company use to anticipate the investment community's assessment of acquisition or divestment activities? Furthermore, what is done to enhance the assessment by the financial community.

18. What are the important criteria that must be met by a potential candidate for subsequent valuation - acquisition consideration to continue?

19. In valuing the acquisition candidate, how extensively will you review:

_____a. Financial Statement Information such as other assets, liabilities, income.

_____b. Internal accounting and management control procedures.

_____c. Tax exposure.

_____d. Organization charts and company policies.

_____e. Organizational culture.

_____f. Community relations.

_____g. Major customers.

_____h. Advertising programs

_____i. Product life.

_____j. Product growth potential.

_____k. Salaries and contracts of upper management.

_____l. Labor relations.

_____m. Competitive position with respect to

- suppliers
- competitors
- customers

20. Does the acquisition - development professional compile a checklist or develop a matrix with which to evaluate and rank acquisition candidates?

21. What other techniques have you found useful in identifying critical success factors for acquisition candidates?

22. What else can a company do to improve the chances for success of its acquisition ventures?

MERGER AND ACQUISITION EVALUATION

1. Break down the company's mergers and acquisition into the following categories:

   A __________ Results good

   B __________ Results neutral

   C __________ Results unsatisfactory

   D __________ Acquisition subsequently sold or liquidated

2. Classify the first three mergers or acquisitions into the above categories. Is experience a good teacher?

   Merger/acquisition 1__________

   Merger/acquisition 2__________

   Merger/acquisition 3__________

3. What major pitfalls did you encounter in your merger and acquisition activity?

4. What is the biggest problem in the integration of the acquired company?

5. What are the advantages of mergers and acquisitions compared to the alternative strategies for attaining corporate objectives (alternatives such as internal growth, joint ventures, and licensing agreements)?

6. What are the disadvantages compared to these alternatives?

7. What single piece of advice would you give to a company that is about to embark on an acquisition and merger program?

MOST RECENT MERGER AND ACQUISITION CASE

1. Name of the acquired company:______________________________

2. Sales volume:______________________________

3. Profit:______________________________

4. Product line:______________________________

5. Who made the initial contact?______________________________

6. Which of the following reasons was important in the motivation for establishing contact? Cross out the items that are not critical and rank the remainder (1 = most important factor).

_____ Profit margin

_____ Market Expansion

_____ Executive group

_____ Management team

_____ New technology

_____ New product line

_____ Financial strength

_____ Marketing capability

_____ Production capability

_____ Customer base

_____ Other______________________________

7. What did you perceive as the reasons for selling? Cross out the items which are not critical and rank the remainder (1 = most significant factor).

_____ Reducing risk by diversification

_____ Survival maneuver

_____ Attractive offer

_____ Resolving corporate differences

_____ Other____

8. How does the post merger/acquisition performance compare with the projected results of operations.

Higher_______ Equal_______ Lower_______

9. What percentage of management continued after the merger/acquisition?

SECOND MOST RECENT

MERGER AND ACQUISITION CASE

1. Name of the acquired company:______________________________

2. Sales volume:______________________________

3. Profit:______________________________

4. Product line:______________________________

5. Who made the initial contact:______________________________

6. Which of the following reasons was importnat in the motivation for establishing contact? Cross out the items that are not critical and rank the remainder (1 = most important factor).

_____ Profit margin

_____ Market expansion

_____ Executive group

_____ Management team

_____ New technology

_____ Product line

_____ Financial strength

_____ Marketing capability

_____ Production capability

_____ Customer base

_____ Other ______________________________

7. What did you perceive as the reasons for selling? Cross out the items which are not critical and rank the remainder (1 = most significant factor).

_____ Reducing risk by diversification

_____ Survival maneuver

_____ Attractive offer

_____ Resolving corporate differences

_____ Other ____

8. How does the post merger/acquisition performance compare with the projected results of operations?

Higher_______ Equal_______ Lower_______

9. What percentage of management continued after the merger/acquisition?

THIRD MOST RECENT

MERGER AND ACQUISITION CASE

1. Name of the acquired company:____

2. Sales volume:____

3. Profit:____

4. Product line:____

5. Who made the initial contact?____

6. Which of the following reasons was important in the motivation for establishing contact? Cross out the items that are not critical and rank the remainder (1 = most important factor).

_____ Profit margin

_____ Market expansion

_____ Executive group

_____ Management team

_____ New technology

_____ New product line

_____ Financial strength

_____ Marketing capability

_____ Production capability

_____ Customer base

_____ Other________________________________

7. What did you perceive as the reasons for selling? Cross out the items which are not critical and rank the remainder (1 = most significant factor).

_____ Reducing risk by diversification

_____ Survival maneuver

_____ Attractive offer

_____ Resolving corporate differences

_____ Other ____

8. How does the post merger/acquisition performance compare with the projected results of operations?

Higher_______ Equal_______ Lower_______

9. What percentage of management continued after the merger/acquisition?

THE MOST RECENT NEGOTIATION WHICH FAILED

1. Name of the acquired company:______________________________

2. Sales volume:______________________________

3. Profit:______________________________

4. Product line:______________________________

5. Who made the initial contact?______________________________

6. Which of the following reasons was important in the motivation for establishing contact? Cross out the items that are not critical and rank the remainder (1 = most important factor).

_____ Profit margin

_____ Market expansion

_____ Executive group

_____ Management team

_____ New technology

_____ New product line

_____ Financial Strength

_____ Marketing capability

_____ Production capability

_____ Customer base

_____ Other ______________________________

7. What did you perceive as the reasons for selling? Cross out the items which are not critical and rank the remainder (1 = most significant factor).

_____ Reducing risk by diversification

_____ Survival maneuver

_____ Attractive offer

_____ Resolving corporate squabbles

_____ Other_______________________________________

8. Why did the negotiations fall through?

EXHIBIT 4-2

Description of Companies Receiving and Responding to Questionnaire

	Companies Receiving Questionnaire	Companies Responding
Diversified Manufacturer Primarily Electronic Products Sales >100 Mill.	3	2
Diversified Manufacturer Primarily Electronic Products Sales >1 Bill.	1	1
Electronic Products and Services Sales >125 Mill.	2	1
Natural Resources Production and Manufacturing Sales >1.4 Bill.	1	1
Diversified Manufacturer - Conglomerate Sales >12 Bill.	5	2

FOOTNOTES
Chapter 4

[1] Mergers and Acquisitions. The Journal of Corporate Venture. 1983-1985.

[2] Adaniya, George A. Mergers and Acquisitions in Technically Based Enterprises, Masters Thesis, Sloan School of Management, February, 1968.

CHAPTER 5

The Acquisition Process

1. Introduction

The results of discussions, as well as a review of other publicly available information and answers to the questionnaire, reprinted as Exhibit 4-1, are reported in Chapter 5. Included for each of the companies responding is a discussion of the diversification strategy and the acquisition process, as well as other comments and examples as appropriate.

2. Company 1

Diversification Strategy

Responding from Company 1 was the Vice President, Corporate. The company was founded in 1946, by a group of professors from MIT, specifically for the commercial manufacture of compact xray generators. Its original products were developed for the treatment of cancer. However, during the past 16 years, through internal product development in other areas and the acquisition of other businesses, the company has become a diversified manufacturer.[1] The company produces specialty wire and connectors, communications devices, plastic insulation products and medical plastic products, as well as instrumentation used in industry, utilities, construction and research.

Although the company does not have a written acquisition policy, it maintains an ongoing diversification strategy, redeploying assets into new business areas. In 1984, it sold and leased back its corporate headquarters, and in 1985 divested its Electronized chemical business. In January of 1986, the company acquired a plastics company and an instrument company with sales of 2 million and 8 million respectively.[2]

The Acquisition Process

The company ranks the objectives of its acquisition policy as high, medium or low as follows:

High: Market expansion, new products, diversification of risk and improved earnings per share.

Medium: Acquire new technology, improve distribution and investment.

Low: Tax benefits.

The acquisition process at Company 1 is centralized with the CEO and a few of his staff.[3] At times, including recent acquisitions, candidates may be identified by Division General Managers.

The CEO of Company 1 formulates diversification policy. Top management and investment bankers and brokers assist in searching for and identifying potential acquisition candidates. Valuation of the candidates is done by the CEO and other top management with evaluation and the necessary approvals from the Board of Directors.

The corporate planning staff is involved in keeping the process on track. The staff prepares management reports and coordinates the acquisition effort. After the acquisition, the corporate planning staff is involved managing the integration of the acquired company and evaluating the operations of the newly acquired company. The company attaches high importance to the acquisition activity and attempts to be as analytical and objective in the process as with other activities for the company.

The company reports good results of its 24 acquisitions. Only one was unsatisfactory and that 8 acquisitions were subsequently sold or liquidated for various reasons.

The initial criteria to be met by a potential candidate include good management, a large enough size to assure a critical mass, profitable or potentially profitable, sophisticated product and in an industry related to the rest of the company. Within the last few years, the company has focused on larger acquisitions than previously would have been considered, because it takes as much time to administer a smaller division and because existing management in larger organizations is usually more mature, stable and capable.

For valuation of the acquisition candidate the company considers the following extensively:

1. Financial Statement Information
2. Major Customers
3. Product Life
4. Product Growth Potential
5. Labor Relations
6. Competitive Position

Also, important to the evaluation are internal management and control systems, tax liability exposure, and salaries and contracts of the acquired company management. Of lower importance are organizational culture, community relations, and advertising programs.

In selection of candidates, the company has found it particularly important to limit consideration to businesses which would produce "synergism". Essentially, the company believes in sticking to what they know and do best. Once a company is acquired, it is important to motivate existing management so that their enthusiasm filters down through their organization.

Following the acquisition, the company encourages autonomy of existing management and it makes the resources of the parent company available. During the negotiating phase, the company tries to reach agreement with the candidate's management with respect to its future role in financing, capital expenditure approval, R & D expenditures and the development of business plans. The company scrupulously adheres to its promises which improves the likelihood of a successful acquisition.

The company has found it important and, at times difficult, to establish regular two-way communication with the newly acquired companies. This is particularly true for companies with very decentralized operations, which may tend to dilute corporate management effectiveness in trying to administer to a wide spread organization.

The benefits to mergers and acquisitions, which undoubtedly far surpass certain administrative difficulties, include quick entry to a market, technology or capability. Also, this approach permits management of the company greater control of the outcome than other arrangements such as through licensing or joint venture.

3. Company 2

Diversification Strategy

The Director of Business Analysis responded from Company 2. The company was founded in the late 1800's as a producer of Carbon Black and Natural Gas. Since that time, the company has expanded internationally to become the world's number one carbon black supplier.

During the late 1960's and early 70's, the company diversified into energy related businesses as well as specialty metals and specialty products.[4] In 1985, the company began a restructuring program involving the intended sale of its metals business (except tantalum) and the natural gas

transmission business in Texas. Tantalum is produced for use in manufacturing electrolytic capacitors and for nonelectronic applications such as chemical process equipment, various industrial, aerospace and medical applications. The company believes it is one of the world's leading producers of tantalum.[5]

The company's diversification plan in the specialty chemicals and materials segment combines established business with business development efforts in special materials for the electronics markets. The company is finding new uses for its traditional businesses, such as conductive blacks for the plastics industry. In addition, the company is adding new developmental businesses to the specialty materials division in a continued effort to provide a range of specialized products for the electronics market.[6]

According to the Form 10K on file with the SEC, the company's special materials program was restructured as three new business units designated as Ceramic Packaging, Crystalline Products and Crystals Units. The company has made acquisitions of related businesses and has entered into a joint venture and a partnership to further certain of these businesses. During the next fiscal year, the company intends to pursue other similar opportunities to further develop these business units.[7]

The diversifying program of 1969 and the 1970's was developed at the CEO and Board level in conjunction with a major consulting study according to the questionnaire returned. The present asset restructuring program necessitated by various economic, international and regulatory events, again formulated at the CEO and Board level.

The Acquisition Process

The acquisition process for Company 2 is highly centralized for acquisitions in excess of $50 million, but decentralized for smaller or

product line related acquisitions below that amount. The CEO, Group Management, Corporate Planning and Division Management are all involved in the search for acquisition candidates. Inputs from all these groups are pooled together in narrowing down the list of potential candidates.

According to the questionnaire returned, the Corporate planning group which also includes legal and financial specialists, along with division management, prepares valuations and management reports and assist other top management in coordinating the acquisition effort.

The CEO is closely involved in the decision making for the specialty materials acquisition program. Marketing and distribution capabilities, as well as financial projections are prepared and reviewed before the CEO becomes too involved in the evaluation of the research and findings for decision making purposes.

Consultants and investment bankers may introduce potential candidates, but generally are not involved in valuation and negotiating except in the case of a large acquisition. In identifying potential candidates, there exists a lack of available information on smaller companies. However, once identified, the potential candidate's product profiles, business plan, and financial statements become very important.

In valuing the candidates, Company 2 also considers extremely important the strategic implications such as candidate's major customers, product life, product growth potential (key), competitive position with respect to suppliers, competitors and customers, as well as potential tax exposure, labor relations and organization and company policies. Also important are existing management's contracts and salary requirements.

In valuing acquisition candidates, the development professional compiles the available information and uses a selected format to evaluate

and rank acquisition candidates. For valuation, the company considers industry multiples, as well as discounted cash flow models based on best and worst case scenarios to consider a range of possible outcomes. The company uses the capital asset pricing model to determine a corporate or industry appropriate rate of return for use in its models.

Prior negotiations may have broken off, due to too high a price being asked, lack of a perceived value or fit or conflicting personalities.

The respondent for Company 2 believes that company personalities or corporate culture deserve a harder look during the evaluation stage. The company has analyzed the best and worst acquisitions over the years in an attempt to identify success factors. Some of these have been indicated previously under the discussion of valuation. The major pitfalls of merger and acquisition activity found are culture anomalies, unforeseen industry changes and a lack of adequate cost controls at the company acquired.

In order to establish better control of the acquired company, the top financial person is usually replaced by a controller from Company 2. Middle management usually stays at the acquired company, but top management is replaced.

Considered essential to acquisitions, are knowing the industry (i.e. a good fit with the existing business) as well as knowing the people expected to continue with the acquired companies. The company considers the advantage of the diversification strategy as the opportunity to develop new products and markets which complement its existing nature products.

4. **Company 3**

Diversification Strategy

Company 3 is a conglomerate with operations in an areospace/technology sector, commercial products sector and a financial services sector.

The company began as a textile company which diversified into a number of unrelated consumer and industrial markets through approximately 100 small acquisitions.[8] Larger acquisitions include a helicopter company, machine companies, other manufacturing companies, a venture capital company and financial service companies. Recently, the company was itself the subject of takeover attempts which motivated it to merge with a large financial services and aerospace-defense company.

Company 3 is a large diverse and flexible conglomerate whose founder stated the principles for its diversification strategy in 1952 as follows:[9]

1. Eliminate the effect of business cycles by having many divisions in unrelated fields.
2. Lessen Justice Department and Federal Trade Commission monopoly problems by avoiding acquisitions in related businesses.
3. Eliminate single industry temptation to overexpand at the wrong time. Finance the growth of only those divisions which show the greatest return on capital at risk. Rather than overexpand any division, use surplus funds to buy another business.
4. Confine acquisitions to leading companies in relatively small industries. Never buy a small company in a $5 or $10 billion industry.

In 1952, when the company began on its diversification program, it had $40 million in tax loss carryforwards acquired in previous mergers. Because the tax loss carryforward expired in 5 years, the company began a crash program of acquisitions, acquiring 50 companies in seven years.[10]

The company and its strategies have changed over the years, but some of the principles which contributed to the successful growth of this conglomerate still apply today.

Much of the discussion herein reported was obtained from a presentation at the Sloan School of Management by a retired Group Vice President from Company 3. He was responsible for the Aerospace Group at Company 3.

Mr. A indicated that earlier acquisitions of companies were always based on incentive arrangements. Out of necessity, management of the operating business remained decentralized in their prior owners or management. The sellers were compensated with incentives based on sales growth over predetermined levels. This facilitated growth of the individual businesses, which was financed from surplus funds from the corporate level. This, he felt, was one of the main benefits of the conglomerate form that it could assist business development by funding the counter cyclical element in the various businesses. The conglomerate is a financial leveler, an antidote for the cyclical phenomenon in business.

Another benefit to the conglomerate form is the ease of installing management controls and information systems. These information systems facilitate management by objectives and the implementation of management incentive compensation systems. The division president's incentives were based on division profits in relation to the division net worth. Group officers, however, were compensated based on company-wide performance rather than that of the group to avoid partisan lobbying. The tradition of management by incentives goes back to the manner in which its founder assured the continued cooperation and commitment of those selling out to Company 3.

Regarding more recent acquisitions, Mr. A commented that it takes just as much time to buy small companies as it does to buy larger companies. Furthermore, smaller companies are less self sufficient, requiring greater management assistance from the acquiring company. In addition, he felt it more difficult to achieve significant growth in a small company.

Additional comments on acquisitions are that the more technical a business, the more important it is that the people know the product and the business. Although, in a few instances, Company 3 was able to turn a sick business around, he cautioned to "watch out for the bargains out there".

What makes for a successful conglomerate is knowing when to divest the weak companies and being able to identify the good companies to hold on to or "shed the losers and build the winners."

With regard to the recent merger between Company 3 and another large diversified company finalized in 1985, Mr. A argued that shareholders of both companies are better off. Both companies had too much cash and were the subject of takeover attempts.

Company 3 financed the merger with 1.4 billion in new debt, that was reduced to $700 million by December, 1985.[11] The debt will be further reduced by application of the proceeds of a divestment program of smaller, less profitable businesses by the Company.

The Acquisition Process

Discussion with the Director of Corporate Development for Company 3 confirms that the acquisition process is presently conducted in a decentralized manner, with coordination and review by the corporate office. For larger horizontal diversification, such as with the recent merger, the acquisition process would be conducted by the corporate office.

In evaluating potential acquisition candidates, he emphasized that an overriding issue is that the acquirer must pay what the market will bear. In evaluating the value, however, industry multiples are important as is the projected earnings per share pickup or dilution from an acquisition. He, however, emphasized the importance of projecting the candidates performance and its potential impact on combined earnings.

In response to a question on the important criteria that must be exhibited by a potential candidate, he emphasized that "people compatibility" is very important. The management must fit with the existing organization, since the intention is that they will remain and manage the newly acquired business.

5. **Company 4**

Diversification Strategy

The information from Company 4 was developed from company publications and from discussion with the Director of Strategic Planning for the company. Company 4 is a multidimensional, high technology company with operations around the world. Prior to 1971, Company 4 was primarily in the aerospace business.[12]

In 1971, the company implemented a diversification strategy to reduce dependence on the aerospace business and to grow through acquisition of market leaders in selected industries. Currently, the company's sales are balanced among four industries: building systems, aerospace, electronics and automotive. In addition, the company has diversified into international markets with 40% of sales international in 1985.

In order to foster its global strategy, the company developed an Atlantic Advisory Council in 1983 and a Pacific Advisory Council in 1985. Each was formed to assist in developing business opportunities in their

respective region. Also, in 1985 the company formed an International Business corporation to coordinate all overseas business activities.

The company maintains an active diversification strategy with a current focus on strategic repositioning of the corporation to strengthen the fit between operating units and the technology base. According to the Director of Strategic Planning, the company's acquisition process is decentralized, which is consistent with their decentralized approach to management. This is in contrast to the acquisition and management process at Company 2, where the acquiring company establishes immediate control of the acquired company and involves the CEO extensively in the acquisition decision.

The Acquisition Process

At Company 4, acquisition guidelines have been formulated by the CEO, top management and the corporate planning staff. They establish a framework for evaluating investment alternatives available to the corporation, which are consistent with the strategic, financial and marketing goals of the company. The guidelines are intended to be "rules of thumb" rather than rigid specifications. See Exhibit 5-1 for an example of the guidelines.

Acquisitions that strengthen current businesses are identified by operating management. The division or operating management, as well as the corporate planning staff, legal and finance professionals, will evaluate, value and put together acquisition reports on the potential candidate. Depending on the particular circumstances, the acquisition effort may be coordinated by the CEO or an investment banker or consultant or by operating management. The same applies to negotiating, although in larger acquisitions, investment bankers will be involved in the negotiating.

EXHIBIT 5-1

ACQUISITION GUIDELINES

PURPOSE AND SCOPE:
These guidelines establish a framework for evaluating investment alternatives available to the Corporation, which are consistent with the strategic, financial, and marketing goals of the Corporation and the operating units. They shall be applied to the acquisition of discrete business units, where Board of Directors approval is required. The terms, "guideline" and "framework", are intended to indicate "rules of thumb", not rigid specifications.

METHODOLOGY:
The intent of the guidelines is to ensure that the strategic dimensions receive as much scrutiny as the financial parameters in the decision making process. All acquisitions should be clearly related to a sound rationale that is stated in the business unit strategic plan and that has been accepted by senior Corporate management as essential to the successful implementation of the plan. The following issues are general considerations that should be addressed in providing background on proposed investments. Specific transaction valuation and deal structuring issues have not been addressed, but they deserve careful consideration as part of any acquisition proposal.

STRATEGIC CONSIDERATIONS
- o Is the proposed investment in an attractive industry?
  - Is the industry large (e.g., greater than $1B) and exhibiting real growth significantly in excess of forecasted GNP?
  - What is average industry profitability and how does this vary among key players? Does the average exceed Corporate goals?
  - Is the industry primarily components or systems oriented, and how is value added?
  - Is it geographically, politically, or otherwise limited?
- o What is the competitive structure of the industry and how does this influence potential entry options?
  - How concentrated or fragmented is the industry (e.g., what is the combined market share of the top five competitors) now? Is it likely to change? How?
  - Is competitive position influenced by scale (e.g., do larger competitors have lower costs to manufacture, distribute, and/or market)? Is this likely to change?
  - Does the proposed investment create significant access to new and/or expanded markets

- o What are the critical factors necessary to succeed in this business? (e.g., what impact does R&D or capital investment appear to have on profitability? Do successful companies have more aftermarket presence and how do they control this? Where is the leverage?)

  - How does the proposed acquisition compare with these critical factors?

  - How do these factors translate into a competitive advantage for the acquisition candidate?

- o Does investment in this business create measurable synergies (e.g., are there significant, incremental benefits to as a result of this investment)?

  - Does the investment augment existing barriers to entry or create new ones (e.g., does the investment create product scale or cost advantages)?

  - Does the investment increase non-product market leverage (e.g., improve SBU ability to sell aftermarket parts and services, improve distribution scale and efficiency, etc.)?

  - Does the investment add incremental sales volume and/or increase profitability through lower costs?

  - What is the role of the investment in supplementing current SBU strengths or reducing weaknesses?

  - How does the investment increase value added (e.g., does the investment allow the SBU to capture a greater portion of the profit in the raw material-to-customer chain)?

  - Does the business currently have sufficient quality and depth of management in place to assure the successful integration, operation and/or development of this business within If not, is the likely level of required management time and attention justified by the overall attractiveness of the proposed acquisition?

  - Is the labor force of the proposed acquisition organized? Does any current union arrangement create risks for either the business to be acquired or other parts of the Corporation?

<u>FINANCIAL CONSIDERATIONS</u>

- o Does the investment earn an adequate return on a <u>stand-alone basis</u>?

  - At what historical average compound annual growth rate have earnings increased for the industry, major competitors, and this firm? At what rate are earnings expected to grow in the future?

  - How do historical and projected ROS's, ROA's, and ROE's compare to Corporate goals?

- Does the proposed investment derive the bulk of its earnings from businesses in which it has a strong market position?
- How highly leveraged (debt/equity) is the proposed investment?
- What is the direction (e.g., increasing) and magnitude (e.g., highly positive) of its historical and projected cash flows?
- What is the estimated payback period?
- What premium is being paid? How will this be recovered?

o What revenue and net income synergies result by taking into account the proposed investment's impact on existing operating units?

- Does the proposed investment create revenue opportunities for other units?
- Does the proposed investment create measurable cost reduction and/or improved efficiencies (e.g., distribution, marketing) for other operating units?
- How do these synergistic benefits affect the projected payback period?

o Does the proposed investment dilute current or projected year(s) earnings?

- What is the earnings per share impact of the proposed acquisition?
- Does the proposed investment increase financial leverage or adversely impact the Corporation's financial position?

EXPECTED RESULTS

o In general, an attractive potential acquisition should be characterized as:

- Participating in a large industry that:
  - Exhibits a real compound annual earnings growth rate in excess of GNP
  - Operates in a business where technological strength is a key success factor
- Being an attractive stand alone company that:
  - Can consistently generate an ROA that contributes to our Corporate goals. [Corporate-wide, we want to achieve an ROA of 15%, consistent with our projected ROE goals of 17-18%. Returns must be net of costs associated with purchase of the business. Individual businesses, in some cases, should achieve higher ROA's (e.g., service or military markets); but, in isolated cases might also show a lower return if more than compensating benefits result elsewhere in the Corporation.]
  - Enjoys leading market position(s) and superior profitability in its core markets

- Contributing immediately to growth and profitability
  - Is non-dilutive as an investment
  - Is strengthened in specific ways by joining
  - Improves the competitiveness of existing businesses
  - Is a rational, "natural" fit for skills, style, etc.

In identifying candidates, the company considers market expansion and the acquisition of new products and technology as critical. In the case of strategic business unit diversification in the 1970's, diversification of risk from overreliance on the defense related aerospace business was a major objective. The industry must be large and exhibit growth in excess of forecasted GNP.

Company 4 looks for sufficient quality and depth of management in place to assure the successful integration, operation and/or development of the business. Company 4 must understand the business that the candidate is in, and management should share the same beliefs and ideologies, so that they can work successfully together.

This is consistent with Company 4's decentralized approach to operating its businesses. The company prefers friendly takeovers, so that management stays in place. The company tries to evaluate "what existing management wants out of life" in order to assess whether they are likely to continue running the business after the acquisition. The acquired companies are integrated through a "hands off" approach. They operate autonomously, retaining their own identity and report to one of the divisions.

Emphasizing some of the strategic considerations, listed at Exhibit 5-1 there must be a clear fit with the operating unit and it must be in an attractive (growing) industry. The candidate must have a strong return on sales and return on assets in addition to being competitive, that is exhibiting returns to scale greater than its competitors.

Characteristics that would stop a proposed acquisition are poor strategic fit, no comparative advantage or if the company is not well managed. Also, Company 4 will not pay a significant market to book premium that will dilute earnings. In addition to good products and markets and

familiarity with the business, quality of and continuity of existing management is key. They must also be compatible with company management.

6. Company 5

Diversification Strategy

Responding to the questionnaire from Company 5 was the manager of business planning. Company 5 was formed in the 1950's to provide technical products and services developed by its founders. Today, the company's major lines of business are electronic components, packaging materials, and fire protection and flow control products and services. The company diversified its business through related business acquisitions.

The Acquisition Process

The acquisition process is described as decentralized, with the CEO formulating strategic policy. The business planning department and other top management are responsible for identifying acquisition candidates. Potential candidates are located through input from the divisions, investment bankers and other finders. The V.P. of finance, other top management and the business planning staff evaluate potential acquisition candidates. The business planning group is involved in all phases search - valuation - management reports - coordinating the acquisition and negotiation aspects. The operating division will also be involved in coordinating the acquisition effort as well as managing the integration after the acquisition.

During the process, outside consultants may be retained if a market study is required. In addition, investment bankers have identified potential acquisition candidates in the past, however, most of the valuation and negotiating and deal coordination is handled by the business planning department at Company 5.

In determining what a potential acquisition candidate is worth, the company evaluated the discounted cash flow projections, as well as the candidates fit with existing operations. It also considers appropriate industry multiples in the valuation process.

The company considers improvement of distribution of existing products and services and improvement of earnings per share as important objectives. Acquiring new products and new technology and market expansion are of medium importance. Diversification of risk, expansion of and utilization of tax benefits, are of low importance to Company 5's acquisition program.

In summary, the company looks for a good fit with existing operations and for good profit potential. Profit potential is related to potential market expansion, product line expansion and production capabilities.

In order to evaluate the candidate, the company looks at the following in detail: financial statements, management information systems in place, potential tax exposure, major customers, product life, product growth potential, labor relations and competitive position with suppliers, competitors and customers. The company also evaluates organization charts and policies, organizational culture, community relations and salaries and contracts. Management style and personality is important if the company will continue to operate, but not if the candidate will be integrated into an existing organization.

Compiling information for evaluation is done on an "ad hoc" basis - there are no checklists or matrixes to be completed. However, it is important to do a thorough analysis in order to avoid overpaying and to improve the acquisition's chances for success.

The advantages to growth through merger and acquisitions, as opposed to internal R and D efforts, joint ventures or licensing, is that the company knows what it is getting, management is already in place, so they don't have to be developed or hired, and the acquisition method is faster than alternative means of corporate development.

On the other hand, the major disadvantage is that a mistake in the acquisition process is very costly. Thus, it is critically important to perform a complete analysis and evaluation to avoid mistakes. Also, it was suggested to allow plenty of time for each acquisition because they generally take 3 to 4 times as long to complete as initially expected.

7. Company 6

Diversification Strategy

The Director of Planning and Acquisitions agreed to respond to the questionnaire for Company 6. The company was founded in 1958 as an electronics company for the purpose of manufacturing products for the Defense Department. The original product line included some antenna and microwave facilities which continue to be manufactured today. The company's major lines of business today are electronic products and cable services - electronics consists of an aerospace products group and an electronics and instruments group. The increase in defense department electronic procurement funding has contributed to the growth of this area of business for Company 6. The cable services division constructs, owns and operates CATV systems. The company owns fourteen cable systems servicing seventy eight communities.

The company seeks to create long term value for customers, employees, shareholders and the communities in which they operate by focusing on strategic market areas within the electronic products and

telecommunications industry.[13] The company seeks business opportunities where it can utilize its understanding of technology and the marketplace.

The company has a program base that is well balanced between present programs in the production and delivery stages and future programs which will provide future growth and technological innovation. It maintains a balance between R and D for future programs and current production in order to achieve business stability without overreliance on certain programs.

In August of 1985, a new department was established at the corporate level to provide an additional focus on acquisition objectives.

The Acquisition Process

The CEO, top management and the corporate planning staff have developed the acquisition policy for Company 6. The process is described as 60% centralized and 40% decentralized, with the group vice presidents involved in the search for candidates. Consultants are not used in the acquisition process as the company believes its management is in a better position to evaluate compatible technology and the potential of various markets.

For Company 6, the CEO, and top management are involved in all stages of the acquisition effort. The corporate planning staff is actively involved in coordinating the acquisition activity as well. After the acquisition, top management and the finance and administration departments see to it that the company is integrated successfully.

As most acquisitions are of technically based enterprises and given that Company 6 is market driven, the company vigorously validates a candidate's market and profitability forecasts. The company also attempts to evaluate the impact of technology leverage into its existing businesses. In evaluating acquisition candidates, the company considers

market expansion and the acquisition of new technology as well as improved earnings per share to be very important.

In addition to financial statement information, major customers, and product growth and market potential, the company extensively evaluates labor relations, competitor and customer competitive positions, as well as organizational culture. The development staff does not use a formalized approach to ranking or evaluating acquisition candidates. The process, however, is comprehensive and yet flexible depending on the situation and parties involved.

The company has found that it is important for both parties in the acquisition to develop mutual understanding and trust. Otherwise, negotiations will tend to break down. The company has had good success from its acquisition efforts. This is attributed to a balanced involvement by the group V.P. and his staff who know the business in addition to the director of acquisition and the CEO who are in a better position to evaluate the overall strategic fit and organizational fit of a given acquisition candidate.

The advantages of acquisition are rapid potential growth with control of destiny, which may be lacking in a large internally funded R and D project. It is essential that the company understand the technology and the markets being acquired. Top management must get along so that egos don't set in the way of progress.

8. Company 7

Diversification Strategy

The Director of Business Development responded for Company 7, which is a diversified industrial company with two industry segments. Segment one is a world leader in specialized products, systems and services for

organizing, filing, accessing and protecting diversified information media. The industrial and aero products group provides engineered components and systems to control vibration and other dynamic forces. The company today is the result of a merger of the two predecessor companies of approximately the same size in 1960.

The company, which maintains an active related diversification strategy, completed three acquisitions in recent years. In addition, the company divested its lowest margin business unit which did not fit well with existing operations. This divestment will produce additional funds for acquisitions and capital additions.

The objectives of the acquisition program are to acquire new products and technology, and expand markets. To a lessor extent, objectives include diversification of risk and expansion of production and distribution. The utilization of tax benefits and making investments are not objectives of the acquisition program.

For diversification into new areas, the company would consider proprietary products and services sold to industrial users, businesses and governments. They will also consider businesses or products that are compatible with existing engineering, manufacturing and marketing capabilities. The acquisition criteria for businesses unrelated to existing operations include:

- Sales of $25 million or more
- History of profitable growth
- Management in place and willing to stay

The Acquisition Process

Company 7's acquisition criteria summary is reprinted as Exhibit 5-2.

EXHIBIT 5-2
Company 7

ACQUISITION CRITERIA SUMMARY

DEFINITION OF COMPANY 7

Company 7 is a diversified industrial company with two lines of business. Company 7 a wholly-owned subsidiary, specializes in products, systems and supplies for organizing, filing, accessing and protecting computer-related and other information media. The Industrial and Aero Products Group provides engineered products to control vibration and other dynamic forces and to improve the efficiency and productivity of industrial equipment.

OBJECTIVES

- To expand existing activities
- To enter new areas of growth, in related fields
- To improve return on investment
- To achieve above-average growth in earnings per share
- To utilize maximum potential resources of combined operations

FEE POLICY

- Company 7 honors reasonable fee schedules
- Fee arrangements that reflect the value of services rendered will be negotiated before any serious acquisition consideration

RESOURCES

- Company 7 has a strong balance sheet and is prepared to negotiate transactions for cash, common stock, preferred stock, or combinations thereof, as conditions warrant and recognizing the needs of the seller.

ACQUISITION PROFILE

General

- Market leader with potential for substantial growth
- Proprietary product lines and standard products sold to industry/business/governments
- Public or privately held, U.S. or foreign based
- Key management personnel willing to remain and continue to build the business

Financial

- For businesses related to present activities, sales $2-50 million
- For businesses not related to present activities, approximately $25 million or more
- For manufacturing businesses, we look for minimum pre-tax profits as a percent of sales to be 10 percent or more

Product Lines

- Industrial and aero products for the control of dynamic forces and motions and to improve the efficiency and productivity of industrial equipment
- Products for holding, positioning and locating parts during manufacture and for reducing industrial noise
- Component and accessory products for organizing, filing, accessing and protecting computer and other information media
- Systems, equipment and supplies for specialized record keeping
- Proprietary products or services directly related to, or logical extensions of, the above
- Companies having direct mail marketing capabilities for office and/or industrial products
- Electronic motor speed controls
- Industrial, microprocessor, heating, ventilating and air conditioning controls

It's acquisition policy has been formulated by the CEO and top management in conjunction with the corporate development staff.

The acquisition process is centralized with the corporate planning staff involved in and coordinating all aspects of the acquisition. Top management and the CEO are involved in evaluation of alternatives and negotiating the transactions. Divisional management is responsible for managing the integration with audit evaluation from the finance department.

During preliminary analysis, tax professionals will review the transaction for critical tax issues which may affect valuations and negotiations. Occasionally, a task force is established consisting of operating managers to develop a business plan which will be used in preparing valuations and management reports.

The company considers management philosophies and personalities, as well as corporate culture to be a major intangible. Company 7 has had deals fall through because of personality or culture conflicts. Therefore, it tries to get a handle on this "intangible" aspect of an organization early on in the process.

The other important criteria which must be met for subsequent discussions to continue include:

-Good business fit

-Potential growth

-Good margins

-Reasonable price

The business development director for Company 7 emphasized that the acquisition criteria must fit the overall corporate strategic objectives.

Moreover, acquisitions must support overall business or corporate goals. The proper communication of this message, both inside and to the investment community, is essential.

Most of the acquisition candidates are private companies that they have been following for a long time. Files are kept and updated periodically. For example, a recent 8 million dollar acquisition had similar talks with Company 7 10 years prior to the recent acquisition taking place. Other potential sources of acquisition candidates include brokers, investment bankers, on-line data bases and leads from the business units on competitors or complimentary product lines.

In valuing acquisition candidates, the critical areas of analysis are:

-Financial statements

-Major customers

-Product life

-Competitive position

It is important to have good relationships and shared goals with the candidate's management. Also, after the acquisition, they should not be overly burdened with administrative requirements. The success of the acquisition program is dependent on knowing what its objectives are and evaluating whether this candidate helps you get there.

FOOTNOTES
Chapter 5

[1] 1984 Company 1 Form 10K on file with the Securities and Exchange Commission.

[2] 1984 Company 1 Annual Report to Shareholders.

[3] 1986 Company News Release.

[4] Responses to questionnaire reprinted at Exhibit 3-1, completed by Vice President & Corporate at Company 1.

[5] 1985 Company 2 Annual Report to Shareholders.

[6] 1985 Company 2 Form 10K on file with the Securities and Exchange Commission.

[7] 1985 Company 2 Annual Report to Shareholders.

[8] 1985 Company 2 Form 10K.

[9] Company 3 Stock Research Report, Salomon Brothers, Inc. November 5, 1985.

[10] Harvard Business School Case Study.

[11] Ibid. p. 3.

[12] Salomon Brothers, Stock Research Report. Ibid.

[13] 1985 Company 4 Annual Report.

[14] 1985 Company 6 Annual Report.

CHAPTER 6

Summary

This chapter summarizes and compares the findings on diversification strategy and the acquisition process. Each company developed a unique diversification strategy and method of acquiring other companies. In this chapter, I focus on the common aspects of strategy or process which may significantly affect the success of an acquisition.

1. Communication and the Diversification Strategy

For most firms, related diversification is the key to a successful acquisition program. For conglomerates, the financial benefits of smoothing out the effects of business cycles and providing the necessary resources for developing companies are key. During the 1980's, the conglomerates studied have also been focusing diversification efforts related to existing group or divisional businesses.

While clearly focusing on related diversification as a strategy for successful acquisition, all but two of the companies surveyed did not utilize a framework or matrix approach to rank the potential acquisition's degree of relatedness to existing products and services. All of the companies, however, considered that the strategic implications such as the size of the industry, the position of the candidate and its potential for growth, as well as the competitive position of the candidate with respect to competitors, suppliers, customers, as well as access to markets and technology to be important elements for the identification of potential acquisition candidates.

Considered important by all of the participants was management familiarity with the industry and business (i.e. a good strategic fit).

Management must understand the business and technology of the acquisition candidate for an acquisition to be seriously considered.

Company 7 has developed general acquisition criteria, which are not only utilized internally, but also made available to potential candidates. By so doing, the acquisition objectives are communicated both internally and to other companies potentially interested in the benefits of an association with Company 7.

Company 4 has developed written guidelines to focus strategic acquisition considerations. These informal guidelines include:

1. The size of the industry and its growth potential.
2. Does the proposed investment create significant access to new and/or expanded markets?
3. What are the critical factors necessary to succeed in the business?
4. What impact does R and D or capital investment have on profitability?
5. Does the investment create product scale or cost advantages?

The remaining guidelines are reprinted as Exhibit 5-1.

Although the acquisition objectives are not strictly adhered to, but rather working guidelines, writing them down will foster a definition and communication of the strategic objectives of the acquisition program. In all cases, the CEO, with Board input and approval, formulate the acquisition policy. Since their approval is required ultimately, they too are the final arbiters of whether a given acquisition meets the diversification objective.

The advantage of a written acquisition policy is that all those involved in the search, or all those who may be in a position to identify

acquisition candidates, would be made aware of the important strategic considerations. For vertical-related acquisitions, opportunities may be identified at the operating business level. It is therefore important that the operating business manager be aware of the acquisition criteria, so that he may investigate and communicate the available opportunities to the appropriate level for immediate follow-up.

In addition to communicating acquisition criteria down from the CEO and the Board, it is important to encourage communication back up from the operating level. This two way communication is essential for acquisitions to be identified and acted on in a timely manner. One mechanism which may assist two way communication for related acquisitions would be the development and utilization of a framework for identifying and screening potential acquisition candidates. An example of an acquisition screening system developed by Salter and Weinhold is reprinted as Exhibit 1-6. Questions of financial and operating risks and rewards, as well as strategic and organization fit considerations can be evaluated and compared for potential acquisition candidates.

Also, the framework would serve as an integrator of those involved in the acquisition process. A common language would be developed by those involved in the identification process. The importance of this communication is supported by the following breakdown of who made the initial contact for 18 acquisitions at the various companies studied.

Group Vice President	5
Director of Acquisitions	1
Division Managers	2
Employees	1
Investment Banker or Broker	4
Acquisition Candidate	3
CEO	2

Developing a common language along with the framework will speed the process by which good candidates are identified for further evaluation. Such a framework will also minimize the chances that potentially successful acquisition candidates are overlooked. The screening framework will lead to communication between those involved and a more effective utilization of time in identifying potential candidates.

Summary

The diversification strategy will be formulated at the CEO and Board level. Absent major corporate restructuring, it should call for related diversification. The strategic objectives and considerations should be communicated in written form.

Writing down the policy and strategic considerations will focus the diversification strategy. It will also enhance two way communication by involving those operating managers in a position to identify potential acquisition candidates. The strategy and guidelines must be communicated to those managers in a position to identify potential acquisition candidates. Also, investment bankers and the potential candidates themselves must somehow be made aware of the acquisition criteria.

Similarly, a framework should be established to facilitate the accumulation and transfer of information to the CEO or corporate development department for timely consideration, so that the acquisition process can continue.

2. The Acquisition Process

The managers surveyed mentioned the following as advantages of the merger and acquisition process, as opposed to other methods for reshaping or developing corporate strategy.

1. Easier to buy new technology than to develop it. Thereby reducing risk and time frames leading to faster growth of the firm.
2. Quicker entry to new markets than is possible by gradually building a presence.
3. Provides a means to recruit good management with a good track record.
4. Rapid growth with control of destiny.

The CEO and Board of Directors for the companies studied have determined that the advantages of diversification through the merger and acquisition process outweigh the potential disadvantages. The potential disadvantages to be guarded against may include:

1. Risk of failure for a sizeable investment.
2. Longer term commitment, once the acquisition is completed.
3. Risk of not knowing what the company is buying.
4. Chance that good people will leave.

Because a failed acquisition can be very costly, both in terms of the dollars involved, as well as the psyche of both companies and their employees, it is critically important to perform a complete analysis and evaluation. In order to successfully implement the acquisition program, the objectives thereof must be understood. The company must then decide "Does this candidate help us get there?". In order to make this decision, one manager suggested being as analytical and objective as possible, that as much importance must be accorded acquisition endeavors as with other aspects of the company.

Including operating managers on the evaluation committee may improve the acquisition analysis. Operating managers are closer to the business being evaluated, and therefore are in a better position to evaluate or point out those competitive aspects of a business which will make the acquisition successful. Moreover, the acquired company will eventually be integrated within an existing business or division and therefore, it is important to introduce those managers who will be working together early in the acquisition process.

In this way, questions of organizational fit and corporate culture, which have been indicated as being very important, but often overlooked, can be addressed during the evaluation process. Organizational fit is crucial to the success of an acquisition. If obtaining good management of a well run business is one of the objectives of the acquisition program, then one company advises that you must determine what the candidate's management wants out of life in order to assess whether they will remain after the acquisition and whether they will be compatible with company management.

3. Organizational Fit

Some of the mangers contacted have mentioned that inability to successfully integrate or lack of organization fit are among the reasons that acquisitions do not succeed. Some indicated that issues of corporate culture or organization fit deserve more attention. Inadequate consideration has been attributed to the specialists involved, the time frame in which decisions must be made, the ambiguousness of issues of organization fit and the lack of analytical tools for their evaluation.[1]

After the acquisition has taken place, both organizations' people must work together. By involving the people who will be working together

early on in the acquisition process, an early assessment can be made as to how they will work together in the future.

Also, the acquisitions' administrative and rewards systems should be evaluated in order to assess how the employees are motivated and what type of corporate culture exists. By involving the managers, who will be working with the acquired management, not only can personalities and culture, assessed, but also integration can begin in the formative stages of the acquisition process which should lead to a smoother integration process.

Sequential Approach

For each of the companies studied, a sequential approach to the acquisition process was indicated. The sequence involves pre-acquisition search, valuation, evaluation, negotiation and closing, and integration. Each company has defined its own framework or approach to the process, however, it may not be strictly adhered to for each acquisition. However, through an extensive examination of the important issues at each stage of the process, the short term and long term results of the process will be improved.[2]

4. Regulatory Matters and the Acquisition Process

Repeatedly emphasized was the importance of a complete analysis of all of the major issues involved in order to prevent mistakes. For issues of a regulatory nature, as discussed in Chapter 3, input is required from the applicable specialist. The in house counsel, tax professionals and chief financial officer or their designate would become involved in the early stages of the acquisition.

The manner of the review would depend on the size of the company. For instance, the conglomerates studies have an executive acquisition

review committee in place. In other cases, the CEO may give advice based on an overview of the facts or outside counsel may be asked to render an opinion. The acquisition review committee is made aware of potential candidates being considered and their input is requested. Ideally, the accounting, tax, corporate law, SEC and antitrust matters will be addressed and their impact factored into the valuation analysis and negotiating process. In some instances, a few of these concerns will not be addressed until after the fact. Hopefully, there are no surprises. However, all major issues that affect the outcome and future of the transaction should be addressed by the responsible specialist prior to closing the transactions.

5. **Pre-Acquisition Search**

The use of outside professionals varied greatly. In most instances, investment bankers or brokers were used to search for and identify potential acquisition candidates. The role of investment bankers, except in the larger transactions where advice in structuring and negotiating was required, was limited. Consulting firms were indicated to be useful for a discrete study of individual firms or for a more comprehensive industry analysis or for developing a diversification strategy. For firms considering acquisition of a new product or technology, consultants are used to evaluate the size of the market, as well as to evaluate expansion opportunities. For technically based companies, the acquisition of technology and the professionals who developed or manage the technology are critical to the acquisition.

For all of the companies studied, the corporate development staff or top management identifies and follows potential acquisition candidates. Operating management, as previously indicated, are often in the best

position to identify likely candidates and also to assess their potential value.

Available sources of information for public companies include commercial publications such as Moody's, Value Line and the S and P reports, as well as SEC filings. Data bases such as Compustat, NEXIS and Dialogue are also available to search for acquisition candidates and to evaluate existing candidates. The advantage of the data bases is that a search can be focused by SIC code or product, or other category and then a list generated from all of the public companies reported in the particular data base.

One of the problems indicated by some of the managers is that little information is readily available on privately held companies. Credit reports are available, but one manager indicated these are not detailed enough. Therefore, once a private company is identified, the acquiring company must obtain financial statements and other data for further evaluation.

6. Valuation

Without exception, growth or expansion is a major objective of the diversification strategy at the companies studied. The companies' listed market expansion, acquisition of new products, and new technology as high priorities for the acquisition process. Company 4 indicated that the acquisition of new products and new technology was critical to its acquisition program. Increasing earnings per share was also mentioned as an objective. Most companies would agree that this is a long term objective for the acquisition program, however, for publicly held companies, it is important that the acquisition not dilute earnings per share in the short run.

In order to anticipate the investment community's perception to possible strategies, some companies may contact security analysts to test reaction to a hypothetical situation. Other companies may rely on their own judgment as to how various strategies will be perceived by the investment community.

All of the companies contacted utilize financial models to value the acquisition candidates. The model provides a means to value the potential market expansion, new products or technology available through acquisition based on various assumptions. Most often indicated was a discounted cash flow model. The companies also analyzed best and worst case scenarios in order to determine a range of appropriate offers.

The companies used a number of approaches in valuing a potential acquisition. In determining a purchase price, the projected return on investment was compared to a company or industry wide appropriate rate of return. Also considered in developing an offer price were industry multiples and prices paid for similar companies in the past. For acquisitions where a new technology or product was important, an attempt is made to validate a market forecast.

All of the companies indicated that a number of approaches are used to value acquisition candidates. The Director of Business Development for Company 7 summarized the multi-method approach as follows. "We review price to book value, price to sales ratios, what the price/earnings multiples have been on similar transactions, perform a discounted cash flow analysis to see if the IRR exceeds the company's hurdlerate, review the effect of a given purchase price on earnings per share, return on sales and return on equity for the parent company, as well as consider potential financial or operating synergies."

7. The Role of the CEO

The CEO and the Board of Directors formulate diversification strategy and approve acquisitions to be made. For the larger companies studied, the acquisition process is decentralized at the divisional level for medium size acquisition, generally below a $50 million purchase price. At the larger companies, the CEO is actively involved in large acquisitions and also would be available for review and input on other acquisitions. For Company 2, the CEO is strongly committed to and involved with the specialty materials acquisition program. This commitment is indicative of the importance of the program to the long term strategy for Company 2.

According to a recent study, the CEO, even if not directly involved in every facet of the process, must support acquisitions in order that they be made in a timely and effective manner.[3] The key to successful acquisitions is the company's ability to make decisions on time, rather than the exact methodology of searching for, negotiating with and executing deals. The desire and commitment of the CEO to make acquisitions, according to the study, have a direct impact on the success of the acquisition program. If the CEO is not a full time member of the acquisition team, he maintained a close contact with the head of that team and was involved in all critical decisions.

8. Negotiation

In the larger transactions, 50 million or above, investment bankers may be involved in the negotiation process. Otherwise, negotiation is handled in house by the CEO, CFO or Divisional Vice President depending on the size of the company and the situation.

The Key to successful negotiation is sound acquisition analysis and the preparation of a sound negotiating strategy. But, even the soundest

strategy can falter in the midst of negotiations. One manager cautioned not to become overloaded in the process of the acquisition. He also cautioned to expect it to take 3-4 times longer than originally anticipated. Upper management at either the acquiring company or the target company may have distinctive interests that tend to increase momentum to finish things up. Other professionals, such as investment bankers, who are compensated on a fee basis, may wish to conclude the transaction in a timely manner. This is because the fee arrangement does not depend on their time expended. These motivations to finalize negotiations quickly can prevent managers from considering other alternatives, and objectively analyzing the issues of organization fit and strategic fit. It is important to allow sufficient time for analysis of all the issues which determine whether acquisition objectives are being met and will ultimately affect the success of the acquisition.

Most of the reasons given for breakdown in negotiations involve price or differing opinions on value. If the price is too high, an adequate return is not possible, or an adverse impact on the acquirer's earnings per share will occur. Other reasons given for breakdowns in negotiations are:

Personality conflicts

Management incompatibility

Inability to develop trust during negotiations

Antitrust concerns were not generally a problem for the companies studied. Although, where there is a potential problem, counsel would render an opinion thereon at an early stage.

9. Integration

The integration process can begin during preliminary analysis and continue through negotiation and closing. Trust must be developed on both sides and management and organizations should be compatible. Once the decision is made that a candidate will be acquired, integration efforts should begin.

After the acquisition, one company establishes a person responsible for overseeing the installation of administration and control systems. Another company may install its own financial person at the newly acquired company. This is consistent with that company's approach to integration, which is to establish complete control over the acquired company. Interestingly, this company is not technically based and therefore autonomy of management and its employees may not be as crucial as for those companies developing new ideas and products.

For all of the technically based companies, and for the larger companies, the acquisition of good management is one of the primary acquisition objectives. These companies prefer to let existing management run their companies in a decentralized manner. Administration and reporting systems may be altered, but large administrative burdens should be minimized, so that managers can concentrate on running their companies.

The companies utilizing this approach generally reach agreement with existing management as to their future role in staff selection, financing, budgeting, customer selection, business plans and R and D expenditures.

One company indicated that the acquired company's management will retain substantially the same control in running operations except that tax, as well as cash and insurance management will be transferred to the corporate office. Such an approach will minimize disturbances to the

employees and operations of the newly acquired company and let them concentrate on what they do best.

10. Comparisons and Contrasts

This chapter focuses the individual company's approach to the acquisition process. The Appendix provides a condensed comparative response format to selected questions from Exhibit 4-1.

Of all the respondents, only Company 1 did not have a written acquisition policy or guidelines. This could be due in part to the relative size of the company and that the acquisition process is highly centralized with the CEO.

Company 7 indicates 60% of its acquisitions were good, while Company 1 indicates 54% of its acquisitions as good. The rate of acquisitions indicated as subsequently sold or liquidated for Company 1 is 33%. Company 7, which has 20% higher sales volume and is in different industries, has written acquisition criteria and an acquisition process that is centralized within corporate development. Company 7 indicates only 15% of acquisitions as having been sold or liquidated.

While these results alone are not conclusive, they support the importance of written acquisition guidelines to the success of the acquisition process. The CEO's were not involved in all stages of the acquisition process for most companies. Consequently, it is also important that an organized, timely communication process be available to deliver all relevant acquisition information to the decision makers, ususally the CEO, for use in evaluating and negotiating. The CEO's time is limited and timing is critical to the acquisition process. Therefore, timely, accurate communication of key facts and recommendations is essential.

The size of the companies will affect who leads the acquisition process. For example, a division general manager or operating company president may lead an acquisition effort for Company 4, whereas the CEO would lead and negotiate the acquisition for Company 7. Company 4's division or operating company may be as large as Company 7 in its entirety.

All of the companies contacted were involved with technology and electronic products to some degree. Each recognized the importance of human resources to the development and operation of technology based industry. For this reason, most of the companies integrated operations slowly in order to avoid engineering departures.Furthermore, retention of good management to run a company's decentralized operations was also indicated as important.

One company replaced top management and top financial people. This company has not historically been an acquirer of technically based companies although it is moving in this direction. The other, more experienced technical acquirers suggested letting acquired companies run their own show, doing what they do best, with a minimum of administrative burden. One company transferred taxes and insurance to the corporate office, but otherwise did not alter administrative systems initially.

While all of the companies acknowledged the importance of a good organizational fit, issues of strategic fit were preeminent. As indicated at the appendix, the companies without exception ranked market expansion, the acquisition of new products and new technology as well as the improvement of earnings per share as among the higher objectives for acquisitions. If there was no strategic fit, then acquisition consideration was not warranted.

11. Suggestions for Further Study.

Potential areas for further study include:

The issue of organization fit could be examined from a historic perspective, by examining the experiences of acquired company management, employees and their organizations. If management were willing, the financial performance of the acquired company could be studied for both before and after the acquisition.

It would also be informative to perform a comparison of the actual results of acquired companies to their projected results developed during initial screening and valuation activities. This would highlight the occurrences which were not planned for, so that if significant, they could be incorporated into future acquisition planning and valuation.

One suggestion for a topic is a study of why negotiations fail and why acquisitions do not work out across a larger sample of companies. The knowledge gained through such an approach would lead to improved merger and acquisition negotiation strategies.

An interesting topic would be a study of acquisition guidelines, their relation to corporate strategy and their changes as corporations evolve. Study of the communication and implementation of those objectives is a suggested part of this approach.

Another area for future study is what happens when a division is sold. Does it go as a leveraged buyout to management or to some outside investor group or another company? How is the subsidiary or division divested when it no longer fits in with the overall corporate objectives? How do potential investors or acquirers find out about these opportunities?

FOOTNOTES
Chapter 6

[1] Jemison, D.B. and Sitkin, S.B., "Acquisitions: The Process Can be a Problem" Harvard Business Review, March-April, 1986 p. 108.

[2] Marlow, T. H. and Barbarosh, M. H., "Role of the CEO in Acquisitions" pub. ty National Association of Accountants and the Society of Management Accountants of Canada, April, 1986, p.7

[3] Ibid. p. 8.

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APPENDIX

SUMMARY OF RESPONSES TO QUESTION INDICATED

EXHIBIT 4-1
QUESTIONNAIRE

Page	Question	Question Description	Company 1	Company 2	Company 3	Company 4	Company 5	Company 6	Company 7
60	5	Written Acquisition Guidelines	N	Y	Y	Y	Y	Y	Y
62	1	Decentralized or Centralized Acquisition Process	C (CEO)	Both, depends on size	Both, size	Both, size	D	Both	C (Corp. Development)
62	2	Role of the CEO	Formulate Policy Search Evaluate Value Negotiate	Formulate Policy Search Post Acquisition Evaluation	Formulate Policy Search	Formulate Policy Search	Formulate Policy	Formulate Policy Evaluate Value Post Acquisition Evaluation	Formulate Policy Negotiate
62	3	Role of Outside Consultants	Search Audit	Limited, except in large acquisitions	+	Market Study Negotiate	Market Study	None	Identify
64	8	Causes of Negotiation Breakdown	Value Price	Value Price	Value	+	Lack of Communication Attorney Interference	Lack of Trust	Personality Conflict Price
65	18	Initial Criteria to be met for further consideration	Good Management Size Profitable Related Industry	Risk, Reward, Financial Strategic Value	Good Management Size Profitable Industry	Good Management Profitable Growth Industry Related Business	Good Strategic Fit Management Cash Flow	Profitable "Niche" Market Growing Market	Business Fit Growth Profitable Good Price
66	20	Matrix-Checklist to Rank Candidates	N	Y	+	N	N	N	Y
67	1	Results of Company Acquisitions							
		Good	54%	50%	+	+	66%	47%	60%
		Neutral	9%	10%			34%	13%	20%
		Unsatisfactory	4%	> 40%				33%	5%
		Acquisition subsequently	33%					7%	15%

+ - No information available

APPENDIX
SUMMARY OF RESPONSES TO QUESTION INDICATED
(Continued)

EXHIBIT 4-1
QUESTIONNAIRE

Page	Question	Question Description	Board of Directors	CEO	Other Top Management	Corporate Planning Staff	Legal	Financial	Outside Consultant	Division Management
62	2	Who performs the various roles in the acquisition process?	(Number of companies indicating a role as follows:)							
		Formulate Strategic Policy	3	7	3	2			1	2
		Search		4	3	5				2
		Evaluate	1	3	4	5	1	2	1	3
		Valuation		2	3	5	1	1	1	1
		Prepare Management Reports			1	6	1	1	1	1
		Coordinate Acquisition Effort			3	6		1	1	2
		Negotiate		2	3	2	1	1		2
		Manage Integration			3	1	1	3		1
		Post Acquisition Audit Evaluation		2	2	3		5		1

EXHIBIT 4-1
QUESTIONNAIRE

Page	Question	Question Description	Respondents - 7 Total Utilizing		
63	4	Valuation Method			
		ROI	6		
		Industry Multiples	6		
		Payback	2		
		CAPM	2		
		Discounted Cash Flow - IRR	7		
			Number of Respondents Indicating:		
64	11	Objectives of Acquisition	**High**	**Medium**	**Low**
		Market Expansion	6	1	0
		Acquire New Products	3	4	0
		Acquire New Technology	3	4	0
		Improve Distribution	2	1	1
		Diversify Risk	1	4	2
		Expand Production	1	2	1
		Improve EPS	4	2	0
		Tax Benefits	0	1	4
		Investment	0	1	3