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# The CFO Quarterly: April 1997

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# INTRODUCTION AND SUMMARY

### Economic, Policy and Market Trends

The U.S. economy still is outpacing the G-7, although U.S. growth is likely to moderate. Inflation remains stable almost everywhere, but risks are rising in the United States. Solid U.S. growth and rising wage pressures will prompt the Fed to hike rates further in the next three months. G-3 monetary policy prospects point to a further modest rise in the dollar in the near term. Risks lie on the side of somewhat higher yields in most major markets.

### Fixed-Income Market Trends

Despite a disappointing performance by U.S. Treasuries in 1996, the investment-grade corporate bond market was on a tear. Financing spreads for corporate borrowers continued to narrow, as corporate bonds remained the asset of choice among fixed-income investors.

Marquee debt financing activity in 1996 remained driven by high-profile merger and acquisition (M&A) transactions: acquisitions and spinoffs. First-time issuers remain a darling of the bond market, with "debt IPOs" being priced at aggressive levels. Issuers and investors have helped develop the popularity of selected structures: put bonds, century bonds and capital securities.

### Liability Management Trends

With the sustained pace of strong U.S. economic growth, cash rich companies stepped up the pace of their debt repurchase initiatives in 1996. Financial managers responsible for administering these open market programs need to be aware of the practical constraints of such programs, particularly in contrast with common stock buybacks. Moreover, as a practical matter in a rising interest rate environment we recommend that companies consider prefunding their debt issues.

### Merger-and-Acquisition Trends

The M&A market exceeded all expectations in 1996. With total domestic transaction volume exceeding $650 billion and cross-border transaction volume at an all-time high, M&A activity reached unprecedented levels. Transaction volume for 1996 exceeded 1995's record by a 15% margin. Transaction numbers also expanded, exceeding 10,000 deals for the first time ever. Consolidation activity in utilities, aerospace, retail and health care continued unabated. Despite a preponderance of transactions in these sectors, M&A activity remains extremely broad-based with high transaction volumes in a multitude of industries. Stock market valuations remained robust and continued to support a very large number of stock-for-stock transactions.

### Equity Market Trends

Equity issuance jumped dramatically in 1996 to $160 billion from $108 billion in 1995 and surpassing the prior record of $135 billion set in 1993. The stock market's rapid ascent continued throughout the year without any significant setbacks. Inflows into equity mutual funds which also reached unprecedented highs — $222 billion for the year — were one of the primary reasons for the strength of the new issue markets.

### Corporate Equity Derivative Trends

The rise in stock buyback programs during the past few years has led to the development of numerous innovative equity capital management tools. Companies can now choose from a range of products to accomplish a variety of repurchase goals. This quarter we review the most common objectives and constraints faced by companies preparing to execute a stock buyback program, which can be used as the foundation for formulating a repurchase strategy.

**Topic of the Quarter**

Almost a decade ago, the *Economist* humorously introduced its annual survey of the "hamburger standard." The *Economist* argued that this Big Mac standard could be used as a guide to whether currencies are trading at the right exchange rates. Indeed, a formal National Bureau of Economic Research study finds that relative Big Mac valuations, or relative over or undervaluations of currencies in real terms can be used to predict actual exchange rate changes.

## ECONOMIC, POLICY AND MARKET TRENDS

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**Question 1**

*What is the economic growth outlook for major industrialized countries?*

**Answer 1**

The U.S. economy still is outpacing the G-7, although U.S. growth is likely to moderate. Germany and France lost momentum at the end of 1996, but European growth likely will pick up. In Japan, fiscal drag will slow growth markedly from April onwards. Inflation remains stable almost everywhere, but risks are rising in the United States.

**Question 2**

*What are the economic policy prospects for major industrialized countries?*

**Answer 2**

Solid U.S. growth and rising wage pressures will prompt the Fed to hike rates further in the next three months. In Germany, the Bundesbank will keep policy on hold into 1998, with the odds for a further modest fiscal tightening in coming months. The tightening of fiscal policy in Japan also will keep Japanese short-term rates low. G-3 monetary policy prospects point to a further modest rise in the dollar in the near term.

**Question 3**

*How have the major markets performed in the fourth quarter of 1996?*

**Answer 3**

**Figure 1. Total Rates of Return of Selected Asset Classes, 4Q 95-4Q 96**

| Asset Class | 4Q 96 | 3Q 96 | 2Q 96 | 1Q 96 | 4Q 95 |
|---|---|---|---|---|---|
| Treasury | 2.90% | 1.67% | 0.44% | -2.22% | 4.64% |
| Corporate | 3.46 | 2.01 | 0.35 | -2.45 | 4.94 |
| Mortgage | 2.89 | 2.10 | 0.68 | -0.47 | 3.37 |
| High Yield | 3.90 | 4.08 | 1.30 | 1.58 | 3.38 |
| Emerging Markets | 6.90 | 10.41 | 9.17 | 4.46 | 9.31 |
| S&P 500 | 7.77% | 2.49% | 3.89% | 4.80% | 5.39% |

Source: Salomon Brothers Inc.

**Question 4**

*What is the near-term market outlook?*

**Answer 4**

Risks lie on the side of somewhat higher yields in most major markets. However, Fed action, if needed to curb inflation expectations, would cap any U.S. bond sell-off in 1997. The trend toward yield convergence in Europe probably will resume, but doubts about 1997 fiscal progress in core countries may lead to temporary setbacks again in the spring. Yen bonds likely will reflect the longer-term worries caused by the slow pace of structural reforms, but low inflation will keep yields from rising sharply.

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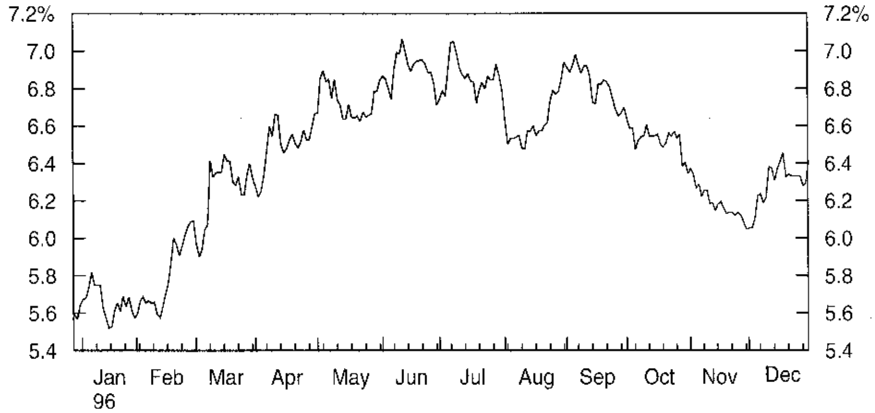
*Despite a disappointing performance by U.S. Treasuries in 1996, the investment-grade corporate bond market was on a tear. Financing spreads for corporate borrowers continued to narrow, as corporate bonds remained the asset of choice among fixed-income investors.*

*Marquee debt financing activity in 1996 remained driven by high-profile M&A transactions: acquisitions and spinoffs. First-time issuers remain a darling of the bond market, with "debt IPOs" being priced at aggressive levels. Issuers and investors have helped develop the popularity of selected structures: put bonds, century bonds and capital securities.*

**Great expectations in 1996.**

The Treasury market began 1996 with great expectations to extend the prior year's impressive rally. But by mid-February those hopes were dashed. Washington's attempt to reach consensus on a balanced budget failed and the manufacturing sector of the economy exhibited surprising strength, eventually driving real GDP growth to accelerate to a 4.7% pace in the second quarter. As a consequence, ten-year Treasury yields raced from 5½% to 7% by mid-June and established a trading range of 6½%-7% for the middle quarters of the year (see Figure 2).

**Figure 2. Ten-Year Treasury Yields, 2 Jan 96-31 Dec 96**



| | High | Low | Avg. | Latest |
|---|---|---|---|---|
| Yield | 7.07% | 5.52% | 6.43% | 6.42% |

Source: Salomon Brothers Inc.

**Year-End Rally Wilts.**

In September, the bond market turned around, regaining its confidence in inflation fundamentals. Investors reasoned — having learnt this lesson in 1994 — that a vibrant manufacturing economy, a healthy consumer, high oil prices and even a tight labor market does not necessarily lead to meaningful inflation in retail prices. But by early December, a spike in net exports, robust commercial construction and a consumption revival aroused investor caution and the ten-year yield closed the year at 6.42%, 83 basis points higher than where it began the year (see Figure 3).

Figure 3. Year-to-Year Change in Key Yields

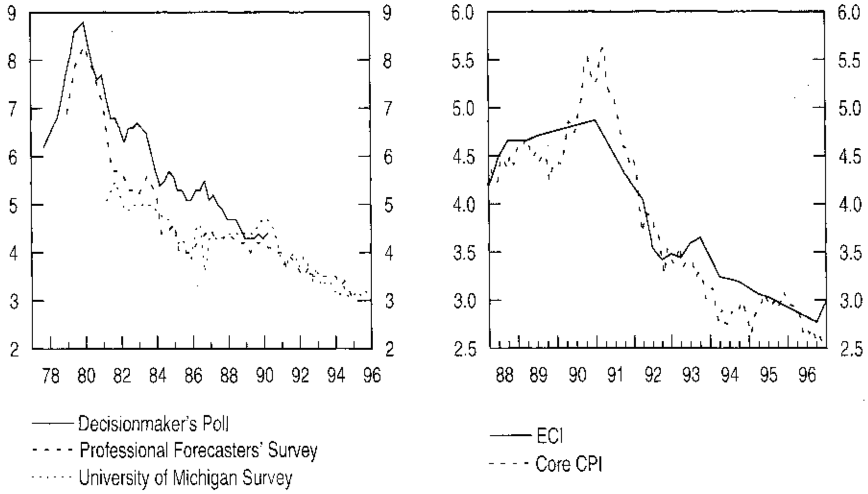
| Maturity | 29 Dec 95 | 1995<br>Change (bp) | 31 Dec 96 | 1996<br>Change (bp) |
|---|---|---|---|---|
| 2 | 5.17 | -252 | 5.88 | +71 |
| 3 | 5.23 | -256 | 6.02 | +79 |
| 5 | 5.38 | -245 | 6.21 | +83 |
| 7 | 5.51 | -234 | 6.34 | +83 |
| 10 | 5.59 | -225 | 6.42 | +83 |
| 30 | 6.00 | -192 | 6.69 | +69 |

bp Basis points.
Source: Salomon Brothers Inc.

**Whither inflation, Fed policy and the bond market in 1997?**

Inflation — actual and expected — drove bond market sentiment and weighed heavily on Fed decisions to fine-tune policy. Broadly speaking, the inflation outlook has consistently improved in this decade: A number of popular surveys of inflation *expectations* show a secular decline from 4%-plus to 3%. The historical record is, in fact, even more compelling with the core Consumer Price Index (CPI) starting this decade at 5.5% and settling out at 2.5% in the mid-1990s (see Figure 4).

Figure 4. Inflation Expectations and Historical Inflation Performance



Sources: Richard Hoey, Federal Reserve Bank of Philadelphia, University of Michigan and Salomon Brothers Inc.

**What are the risks to today's benign inflation profile?**

If the continuous improvement in the U.S. inflation outlook comes to a halt, the source of the disruption will likely be the labor market. Economists have been concerned for some time that the 5.2%-5.3% rate of unemployment that has prevailed since August 1996 may be inconsistent with price stability. Economists attempt to estimate the "natural" or "nonaccelerating inflation" rate of unemployment (NAIRU), below which a tight labor market is expected to precipitate inflation in wages and, eventually, the prices of goods and services.

**Will the Greenspan explanation persist?**

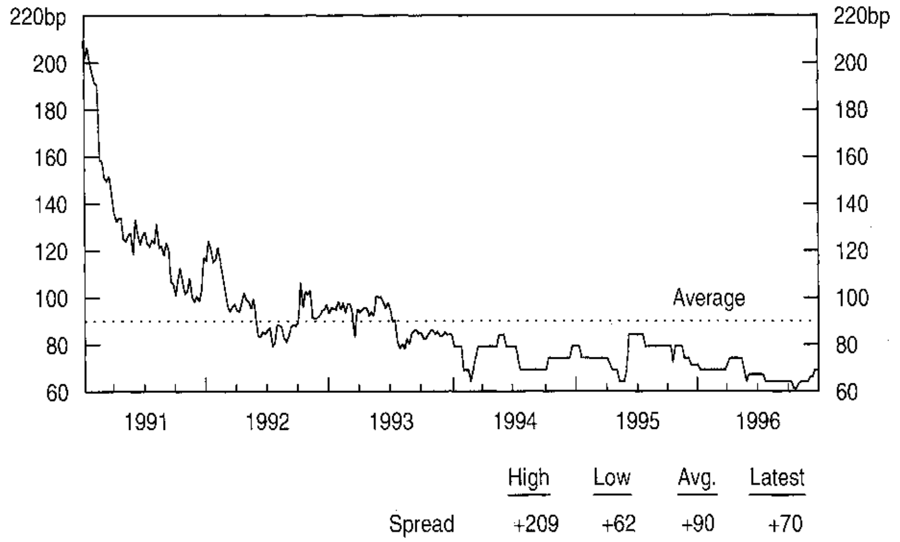
Although labor markets in the U.S. have been tight and some signs of wage inflation have flared, the larger economy has been insulated from broad-based inflationary pressure. For some time Chairman Greenspan has provided a nifty explanation of this phenomenon: widespread workforce downsizing has instilled sufficient job insecurity among workers that demands for wage increases have been effectively discouraged. But how long the demand for higher wages can be stalled remains unclear. Salomon

Brothers believes that Fed decision-makers will tighten Fed policy at some point in 1997 in advance of a meaningful deterioration in the inflation picture in order to dilute its ultimate impact. (Note: On March 15, 1997 the Federal Open Market Committee [FOMC] decided to increase the Fed funds rate by 25 basis points to 5½%. Chairman Greenspan believes that recent economic momentum justifies preemptive policy action. The market has begun to already assess the possibility of further Fed action at the next FOMC meeting on May 20th.)

### Themes in the Corporate Bond Market: M&A, Century Bonds, Put Bonds and Capital Securities

The investment-grade corporate bond market delivered incremental value to fixed-income investors in 1996. Generic spreads for BBB-rated intermediate-term debt issued by industrial companies reached historical lows in 1996 (see Figure 5). For a number of key corporate sectors, this spread improvement was sharply higher. The top performers were airlines, (benefiting from operating performance: -64bp), oil and gas companies (benefiting from rising oil prices: -15bp), tobacco (benefiting from an improvement in its litigation exposure: -17 bp) and lower-quality electric (benefiting from acquisitions and regulatory /legislative commitments to stranded cost recovery: -36 bp).

**Figure 5. New Issue Spread of BBB-Rated Industrial Issuers vs 10-Year Treasuries, 4 Jan 91-27 Dec 96**



Source: Salomon Brothers Inc.

### Strategic Moves Drive Big Deals

On January 16, 1997, U S WEST Capital Funding, the financing arm for U S WEST's nonregulated activities, completed the largest investment-grade corporate bond offering ever, raising $4.1 billion in six tranches. It should come as no surprise that the offering arose from a strategic transaction: the bulk of these proceeds will be used to pay down short-term debt associated with the company's acquisition of Continental Cablevision. This deal upstaged the previous record set by Lockheed-Martin's offering of $3.5 billion in May 1996, that was followed by $1.5 billion in June 1996. *Acquisition*-driven debt financing accounted for some of the largest debt offerings in 1996.

Figure 6. Selected M&A-Driven Debt Issuance in 1996, Ranked by Size

| Issue Date | Issuer | Target | Ratings | Principal Amount |
|---|---|---|---|---|
| 03/22 | Walt Disney | Capital Cities/ABC | A2/A | $1,300 |
| 05/16 | Lockheed Martin | Loral | A3/BBB+ | 3,500 |
| 06/21 | Lockheed Martin | Loral | A3/BBB+ | 1,500 |
| 08/14 | JC Penney | Eckerd | A1/A+ | 600 |
| 11/07 | El Paso Natural Gas | Tenneco Energy | Baa2/BBB | 400 |
| 12/12 | Crown, Cork & Seal | Carnaud Metalbox | Baa1/BBB+ | 1,200 |

Source: Salomon Brothers Inc.

In 1996, corporate *spin-offs* accounted for at least seven new names in the corporate bond market (see Figure 7). Typically, these inaugural debt financings receive an overwhelmingly enthusiastic reception from bondbuyers who often sacrifice spread for "museum" quality. In February 1997, Sherwin Williams tapped the bond market for $700 million in five maturities ranging from three to 100 years to repay short-term that funded its acquisition of Thompson Minwax for $830 million. The deal was extremely well-received with, for example, the ten-year tranche priced at a spread of 44 basis points over the ten-year Treasury.

Figure 7. Selected First-Time Debt Issuers in 1996

| Issue Date | Issuer | Description | Ratings | Principal Amount |
|---|---|---|---|---|
| 01/26 | Darden Restaurants | Spinoff of General Mills | A3/BBB+ | $250 |
| 01/31 | Williams Holdings | Sub of Williams Companies | Baa2/BBB- | 250 |
| 03/04 | 360°Communications | Spinoff of Sprint | Ba2/BBB- | 900 |
| 05/01 | AMERCO | "Debt IPO" | Ba1/BBB | 175 |
| 05/20 | CITGO Petroleum | "Debt IPO" | Baa2/BB- | 200 |
| 05/21 | Worthington Industries | "Debt IPO" | A3/A- | 200 |
| 07/11 | AirTouch Communications | Spinoff of Pacific Telesis | Baa2/BBB+ | 650 |
| 07/17 | Lucent Technologies | Spinoff of AT&T | A2/A | 1,500 |
| 10/09 | Allegiance | Spinoff of Baxter | Baa3/BBB- | 550 |
| 10/10 | Union Pacific Resources | Spinoff of Union Pacific | A3/A | 400 |
| 11/13 | Enron Oil & Gas | Sub of Enron Corp | A3/A- | 150 |
| 11/22 | Millennium America | Spinoff of Hanson plc | Baa3/BBB- | 750 |
| 12/10 | NIKE Inc | "Debt IPO" | A1/A+ | 200 |

Source: Salomon Brothers Inc.

**100-year bonds are back after a tax-inspired hiatus.**

## 100-Year Bonds Ride Again

U.S. corporate borrowers stepped back from century bond issuance in the first quarter in response to the Treasury Department's proposal, released on December 7, 1995, that recommended the elimination of the deductibility of interest on bonds with maturities longer than 40 years. Of course, this proposal had zero impact on non-U.S. issuers of century bonds that, in the first quarter alone, included the People's Republic of China, Tenaga and Korea Electric Power.

On March 29, 1996 the Chairmen of the Senate Finance and House Ways and Means Committees issued a joint statement that it was their intention that the effective date of any such tax change would be no earlier than the date of Congressional action, effectively neutralizing the Treasury's threat.

Emboldened by this commitment, issuers reconsidered the ultra-long maturity alternative. Following a rally in the Treasury market, Dresser Industries reopened the sector with a $300-million offering. The success of Dresser's financing inspired other U.S. corporation to tap this sector in the fourth quarter, leading to total issuance by U.S. corporations of over $2.1 billion of 100-year bonds (see Figure 8).

The Dresser transaction was significant for two reasons. First, the 100-to-30 year spread differential had begun to narrow. It is now possible for a single-A rated borrower to issue 100-years bonds at a spread premium of 10-15 basis points to a 30-year structure. Second, the Dresser bonds were sold to a broad cross-section of insurance companies and money managers, not the select group of institutional investors that had dominated the century bond market in 1995. In December 1996, following a sudden rally in the bond market, IBM priced $850 million of century bonds, the largest ever.

By successfully issuing 100-year bonds, a company sends a powerful signal to all providers of capital, affirming the longevity of the issuer's core business activities. For example, three oil and gas exploration and production (E&P) companies tapped this market and enjoyed an enthusiastic reception, despite the inherent volatility of this business.

**Figure 8. 100-Year Bond Issuance from U.S. Corporate Borrowers, 1993-96 (Dollars in Millions)**

| Issue Date | Issuer | Ratings | Principal Amount | Coupon | New Issue Spread (bp) |
|---|---|---|---|---|---|
| 07/21/93 | Walt Disney Company | Aa3/AA- | $300 | 7.550% | +95bp |
| 07/22/93 | Coca-Cola Company | Aa3/AA | 150 | 7.375 | +80 |
| 11/20/95 | Columbia/HCA Healthcare | A3/BBB+ | 200 | 7.500 | +116 |
| 11/28/95 | BellSouth | Aaa/AAA | 500 | 7.000 | +70 |
| 11/29/95 | News America Holdings | Baa3/BBB | 150 | 7.900 | +165 |
| 12/05/95 | Wisconsin Electric Power | Aa3/AA | 100 | 6.875 | +92 |
| 12/06/95 | BellSouth | Aaa/AAA | 126 | 6.650 | +60 |
| 08/06/96 | Dresser Industries | A1/A | 300 | 7.600 | +86 |
| 10/02/96 | Union Carbide | Baa2/BBB | 200 | 7.750 | +97 |
| 10/11/96 | News America Holdings | Baa3/BBB | 100 | 8.250 | +146 |
| 10/31/96 | Apache Corporation | Baa1/BBB | 150 | 7.625 | +95 |
| 10/31/96 | Union Pacific Resources | A3/A | 150 | 7.500 | +84 |
| 11/07/96 | Times Mirror | A1/A+ | 148 | 7.250 | +74 |
| 11/07/96 | Anadarko Petroleum | A3/BBB+ | 100 | 7.250 | +78.5 |
| 12/03/96 | IBM | A1/A | 850 | 7.125 | +80 |
| 12/12/96 | Crown Cork & Seal | Baa1/BBB+ | 150 | 7.500 | +100 |

Source: Salomon Brothers Inc.

### Fed Decision Sparks $30 Billion Market of "Capital Securities"

On October 21, 1996, the Federal Reserve announced that trust preferred securities would be treated as Tier 1 regulatory capital. At the same time, most Washington observers expected that the Administration's February 1997 budget proposal would likely resurrect Treasury Department tax proposals to eliminate the tax-deductibility of interest payments on such securities, similar to century bonds. Although the effective date of such tax legislation was unclear, many financial institutions decided to err on the side of caution and enter the market as quickly as possible.

Recognizing that filing a debt shelf with the Securities and Exchange Commission (SEC) in the last two months of the year could be challenging, many issuers in this market decided to use the unregistered 144A format. A large subset of these issuers included "registration rights" in the structure to minimize any spread premium required in this unregistered format.

The retail market for tax-advantaged preferred securities grew to almost $28 billion in the three years since its inception in October 1993. A similar amount of capital securities has been issued in the three months following the first issue on November 19, 1996 (see Figure 9).

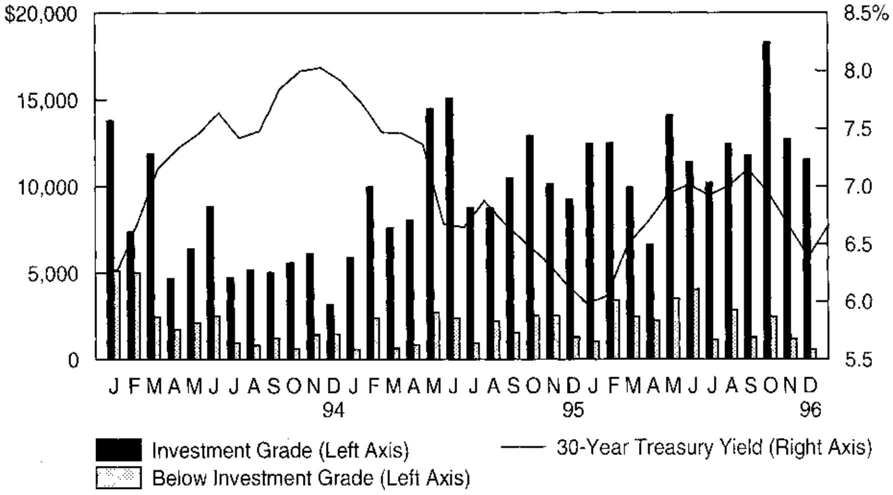
On February 6, 1997, the Clinton administration released its much-anticipated budget proposal as expected, the proposal recommends the elimination of deductibility of interest for debt with maturities greater than 40 years and trust preferred with maturies greater than 15 years. The effective date of the proposed is expected to be the date of "first committee action," which remains uncertain as of the publication of this report.

**Figure 9. Institutional Trust Preferred Issued in 1996**

| Issue Date | Issuer | Ratings | Structure | Principal Amount | Coupon | Format |
|---|---|---|---|---|---|---|
| 11/19/96 | First Bank System | a2/BBB+ | 30 NC/10 | $300 | 8.090% | 144A/RR |
| 11/20/96 | Bank of Boston | baa1/BBB | 30 NC/10 | 250 | 8.250 | 144A/RR |
| 11/20/96 | BankAmerica | a1/A- | 30 NC/10 | 450 | 8.070 | 144A/NRR |
| 11/20/96 | Barnett Banks I | a3/BBB | 30 NC/10 | 300 | 8.060 | 144A/RR |
| 11/20/96 | Republic New York I | a1/A+ | 30 NC/10 | 150 | 7.750 | 144A/RR |
| 11/20/96 | Wells Fargo I | a1/BBB | 30 NC/10 | 300 | 8.125 | 144A/NRR |
| 11/21/96 | Bankers Trust I | a2/BBB+ | 30 NC/10 | 300 | 8.090 | 144A/NRR |
| 11/21/96 | Barnett Banks II | a3/BBB | 30 NC/10 | 200 | 7.950 | 144A/RR |
| 11/21/96 | First Chicago I | a1/A- | 30 NC/10 | 500 | 7.950 | 144A/NRR |
| 11/21/96 | First Union Corp. | a1/BBB+ | 30 NC/10 | 500 | 8.040 | 144A/RR |
| 11/21/96 | H.F. Ahmanson | baa2/BBB- | 30 NC/10 | 150 | 8.360 | 144A/NRR |
| 11/21/96 | Wells Fargo II | a1/BBB | 30 NC/10 | 200 | 7.950 | 144A/NRR |
| 11/22/96 | BankAmerica II | a1/A- | 30 NC/10 | 300 | 7.700 | 144A/NRR |
| 11/22/96 | First Chicago II | a1/A- | 30 NC/10 | 250 | 7.750 | 144A/NRR |
| 11/22/96 | Bankers Trust II | a2/BBB+ | 30 NC/10 | 200 | 7.750 | 144A/NRR |
| 11/22/96 | Provident Bancorp | baa3/BB | 30 NC/10 | 100 | 8.600 | 144A/NRR |
| 11/22/96 | Allstate | a2/A | 49 NC/10 | 200 | 7.830 | Registered |
| 11/22/96 | Conseco | ba2/BBB- | 30 NC/L | 325 | 8.700 | Registered |
| 11/25/96 | Wells Fargo III | a1/BBB | 30 NC/10 | 250 | 7.730 | 144A/NRR |
| 11/25/96 | Bank of New York I | a1/BBB+ | 30 NC/10 | 300 | 7.780 | 144A/NRR |
| 11/25/96 | Chase | a1/BBB+ | 30 NC/10 | 600 | 7.670 | Registered |
| 11/26/96 | JP Morgan | aa2/AA- | 30 NC/10 | 750 | 7.540 | Registered |
| 11/26/96 | Republic New York II | a1/A+ | 30 NC/10 | 200 | 7.530 | 144A/RR |
| 11/26/96 | KeyCorp I | a1/BBB | 30 NC/10 | 350 | 7.826 | 144A/RR |
| 11/26/96 | American General | a1/A+ | 49 NC/L | 500 | 7.570 | 144A/NRR |
| 11/27/96 | Transamerica | a2/A- | 30 NC/L | 225 | 7.650 | 144A/NRR |
| 11/27/96 | Transamerica | a2/A- | 30 NC/10 | 100 | 7.800 | 144A/NRR |
| 11/27/96 | Travelers | a1/A | 40 NCL | 200 | 7.625 | Registered |
| 11/27/96 | Travelers | a1/A | 40 NC/10 | 400 | 7.750 | Registered |
| 12/2/96 | HSBC Americas | a3/BBB+ | 30 NC/10 | 200 | 7.808 | 144A/NRR |
| 12/2/96 | Marshall & Ilsley | a1/A- | 30 NC/10 | 200 | 7.650 | 144A/RR |
| 12/3/96 | Bank of Boston II | baa1/BBB | 30 NC/10 | 250 | 7.750 | 144A/RR |
| 12/3/96 | Mellon I | a2/BBB+ | 30 NC/10 | 500 | 7.720 | Registered |
| 12/5/96 | Union Planters | baa1/BB+ | 30 NC/10 | 200 | 8.200 | 144A/RR |
| 12/5/96 | Wachovia | aa3/A+ | 30 NC/10 | 300 | 7.640 | 144A/NRR |
| 12/6/96 | Fleet | a2/BBB | 30 NC/10 | 250 | 7.920 | Registered |
| 12/9/96 | PNC (Bank) | a2/BBB+ | 30 NC/10 | 350 | 7.950 | 144A/NRR |
| 12/10/96 | NationsBank | a1/A- | 30 NC/10 | 365 | 7.830 | Registered |
| 12/10/96 | Riggs National | baa3/BB- | 30 NC/10 | 150 | 8.625 | 144A/RR |
| 12/11/96 | Countrywide Credit | a3/A- | 30 NC/10 | 300 | 8.000 | Registered |
| 12/11/96 | Advanta | ba2/BB | 30 NC/10 | 100 | 8.990 | 144A/RR |
| 12/11/96 | MBNA | baa1/BBB- | 30 NC/10 | 250 | 8.278 | Registered |
| 12/12/96 | Wells Fargo IV | a1/BBB | 30 NC/10 | 400 | 7.960 | Registered |
| 12/12/96 | CoreStates (Bank) | a1/A- | 30 NC/10 | 300 | 8.000 | 144A/NRR |
| 12/12/96 | WR Berkley | a3/BBB+ | 49 NC/10 | 210 | 8.197 | 144A/RR |
| 12/13/96 | State Street Corp. | a1/A- | 30 NC/10 | 200 | 7.940 | 144A/NRR |
| 12/17/96 | Citicorp | a1/A- | 30 NC/10 | 300 | 7.933 | Registered |
| 12/17/96 | U.S. Bancorp | a2/BBB+ | 30 NC/10 | 300 | 8.270 | 144A/RR |
| 12/17/96 | Bancorp Hawaii | a2/BBB | 30 NC/10 | 100 | 8.250 | 144A/RR |
| 12/17/96 | Firstar | a2/BBB | 30 NC/10 | 150 | 8.320 | 144A/RR |
| 12/18/96 | First Security | a3/BBB- | 30 NC/10 | 150 | 8.410 | 144A/RR |
| 12/18/96 | BankAmerica III | a1/A- | 30 NC/10 | 450 | 8.000 | Registered |
| 12/18/96 | KeyCorp II | a1/BBB | 30 NC/10 | 150 | 8.250 | 144A/RR |
| 12/18/96 | Zions Bancorp | a3/BBB- | 30 NC/10 | 200 | 8.536 | 144A/RR |
| 12/19/96 | Bank of New York II | a1/BBB+ | 30 NC/10 | 300 | 7.970 | Registered |
| 12/19/96 | USF&G | baa3/BBB- | 49 NC/L | 100 | 8.500 | 144A/RR |
| 12/20/96 | Mellon II | a2/BBB+ | 30 NC/10 | 500 | 7.995 | Registered |
| 12/20/96 | Crestar Financial | baa1/BBB | 30 NC/10 | 200 | 8.160 | 144A/RR |
| 12/20/96 | First USA, Inc | ba3/BB- | 30 NC/10 | 200 | 9.330 | 144A/RR |
| 12/23/96 | North Fork Bancorp | baa3/BB+ | 30 NC/10 | 100 | 8.700 | 144A/RR |
| 12/23/96 | Bankers Trust | a2/A- | 30 NC/10 | 250 | 3L+75 | Registered |
| 12/27/96 | First Union Corp. II | a1/BBB+ | 30 NC/10 | 250 | 7.850 | 144A/RR |
| 12/30/96 | First Tennessee | a3/BBB | 30 NC/10 | 100 | 8.070 | Registered |

NC Noncall. Roman Numerals represent different series of issuance.
Source: Salomon Brothers Inc. RR: Registration Rights. NRR: No Registration Rights

**Figure 10. Monthly Corporate Debt Issuance, Jan 94-Dec 96 (Dollars in Billions)**



Notes: Includes industrial, financial and utility companies only. Excludes medium-term notes and Yankees.
Sources: Securities Data Co. and Salomon Brothers Inc.

**The Development of a market for corporate CPI Bonds.**

### Salomon Brothers' CPI Bonds

The U.S. Treasury recently joined other sovereign issuers of inflation-indexed securities, such as the U.K., Canada, and Sweden, by selling $7 billion of 10-year notes linked to the Consumer Price Index (CPI).

The U.S. Treasury's auction on January 29 of Treasury Inflation-Indexed Securities met with considerable investor demand. The 10-year notes carried an initial real yield of 3.449%, well below the range of 3.50% to 3.75% that many market participants had been expecting in early January. As of February 10, Treasury Inflation- Indexed Securities were trading at a real yield of 3.25%.

Salomon Brothers' CPI Bonds ("CPI Bonds") are essentially Treasury Inflation-Indexed Securities for corporate issuers. CPI Bonds are intermediate- to long-term debentures with semiannual coupon payments that vary with the inflation rate as measured by the CPI. In the first week after the Treasury's oversubscribed auction, seven other issuers came to market with a variety of inflation-indexed structure. Salomon Inc sold $450 million of 5-year notes, $200 million more than initially planned, proving that issuers may raise significant proceeds in the CPI Bond market in a single tranche. The Salomon Inc issuance, rated BBB, also proves that demand exists for lower rated investment grade CPI Bonds.

In addition, Federal Farm Credit Banks & Fulnding Corp., Federal Home Loan Bank, JP Morgan, Student Loan Marketing Association, Tennessee Valley Outhority, and Toyota Motor Credit Corp. each came to market during the first week of February in this rapidly expanding market of CPI-Bonds.[1]

[1] For a more in-depth description of CPI Bonds, see *Corporate Issuance Strategy: Salomon Brothers' CPI Bonds* Nazareth Festekjian, et al., Salomon Brothers Inc, February 5, 1997.

# LIABILITY MANAGEMENT TRENDS

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*With the sustained pace of strong U.S. economic growth, cash rich companies stepped up the pace of their debt repurchase initiatives in 1996. Financial managers responsible for administering these open market programs need to be aware of the practical constraints of such programs, particularly in contrast with common stock buybacks.*

**Excess cash may tax shareholder patience.**

Cash can be a mixed blessing. Companies that generate significant cash flow may feel shareholder pressure to put that cash to work quickly or suffer the wrath of irate equity investors. Although cash on the balance sheet may be a "high-class" problem, management may quickly become the target of activist shareholders seeking a more rapid distribution of corporate wealth.

**Cash can be used to bolster the capital structure by paying down debt.**

*Excess cash* is what is left after cash is used to pay interest expense, dividends, taxes, and capital spending requirements. Financial managers that expect persistent excess cash flow have a number of options: hoard cash, use it to finance acquisitions or shrink the total capitalization of the company. The latter can be accomplished by buying common stock, retiring commercial paper/bank debt or repurchasing outstanding bonds. Many companies view the strengthening of the capital structure as a key corporate goal, in order to both enhance financial flexibility and improve bond ratings. For these companies, debt reduction may be an attractive alternative.

**Tax and accounting may drive choice of bond targets.**

The corporate buyer of its own securities is distinguished by both tax and accounting treatment. The issuer is the only buyer of its debt that will recognize a tax event and an accounting item at the time of repurchase (see Figure 11). Premium debt generates a tax benefit and an accounting loss and discounted debt generates a tax liability and an accounting gain.

**Figure 11. Tax and Accounting Impact of Debt Repurchase of $100 Par Amount: Premium versus Discount**

| Issue | Price at 7% Yield | Pretax Gain (loss) | Tax Benefit (Liability) | After-Tax Gain (Loss) |
|---|---|---|---|---|
| 9% due 2006 | 114.21% | $(14.21) | $4.97 | $(9.24) |
| 5% due 2006 | 85.79 | 14.21 | (4.97) | 9.24 |

Note: Assumes a book basis of par and a tax rate of 35%.
Source: Salomon Brothers Inc.

**A brief caveat for corporate bondbuyers.**

While accounting calculations provide some insight into the impact of debt repurchase, financial managers should be wary of the long-term consequences. Companies that find the excess cash situation will reverse in two to three years, may want to focus on shorter-term debt retirement in order to minimize the interest rate risk that will be faced at the end of a relatively short horizon.

Companies that plan to retire debt through open market repurchase activity — rather than more formal tender offer strategies — should be aware of both the technical constraints and tactical considerations that may influence the design and execution of the program.

**Vive la difference.**

Although stocks and bonds are both financial instruments, their differences are important to highlight when repurchasing securities in the marketplace (see Figure 12).

**Figure 12. Stocks versus Bonds from a Repurchase Perspective**

| | Stocks | Bonds |
|---|---|---|
| Number of Issues | Only one issue. | Possibly many different issues with various terms. |
| Size | Outstanding amount equal to market capitalization — possibly several billion. | Typical bond issue is limited to $100 -$500 million. |
| Ownership | Both institutional and retail investors. | Primarily institutional investors. |
| Trading System | Exchange traded or NASDAQ. | Non-exchange interdealer brokers act as intermediaries on street trades. |
| Ability to Effect Short Sales | Substantial flexibility in shorting large share blocks. | Limited due to smaller issue sizes. |
| SEC Disclosure Requirements | If material, requires a public announcement and possibly an 8-K filing. | Limited to review discussion in regular financial statements. |
| Rules Governing Execution of Open Market Repurchase | Avoid *de facto* (or "creeping") tender offer. The safe harbor of Rule 10b-18 limits timing, volume and pricing of repurchase activity. | Avoid *de facto* (or "creeping") tender offer. Rule 10b-5 requires disclosure of material non-public information. |

Source: Salomon Brothers Inc.

For more detailed analyses of these topics, please see the April, July and October 1996 issues of the *CFO Quarterly*.

### Prefunding an Upcoming Maturity

*Rates could trend higher in the near-term, increasing the cost of refinancing issues maturing in the next few months. Companies concerned about refinancing risk exposure should consider prefunding strategies to manage this exposure.*

*Why should a company consider prefunding a debt issue ?*

If a company finds the current level of interest rates attractive, or expects rates to trend higher in the near-term, it should consider raising funds currently in order to "prefund" a debt issue maturing in the near future. Prefunding allows the company to lock-in today's interest rate and credit spread levels and thereby eliminate its exposure to higher cost of funds. This strategy is particularly relevant for high-yield and emerging market issuers who are exposed to sizable movements in credit spreads.

*How can a company evaluate the prefunding decision ?*

Funds raised prior to the maturity of the issue can be invested in short-term investments until the maturity of the issue. Alternatively, the funds could be used to finance a repurchase of the outstanding issue. In either case, the funds would be invested at a yield lower than the cost of funds of the new issue, resulting in a negative carry cost to the issuer.

On the other hand, if the company chooses not to prefund the upcoming maturity, it is exposed to potentially higher refinancing rates. The company should compare the negative carry cost to the potential increase in interest rates in order to determine if a prefunding constitutes an economically attractive alternative.

In the illustrative example below, we calculate the rise in interest rates at which the company would be indifferent between prefunding the bonds and funding them at their maturity in six months. We assume here that the proceeds of the prefunding are used to repurchase the bonds at a premium to the market price.

**Figure 13. Breakeven Increase in Refinancing Rates: an Illustrative Example**

| Settlement Date | 4/1/1997 |
|---|---|
| **Outstanding Issue** | |
| Coupon | 10.00% |
| Maturity | 10/1/1997 |
| Repurchase Spread (over U.S. Treasury) | 50 bp |
| Repurchase Yield | 6.08% |
| Repurchase Price | 101.901% |
| **New Issue** | |
| Cost of Funds | 9.00% |
| Maturity | 4/1/2007 (10 years) |
| Breakeven Rollover Rate | 9.24% |
| Breakeven Spread Increase | 24 bp |

The analysis reveals that if the company's cost of funds rises by more than 24bp within the next six months, prefunding today would be a superior strategy to waiting and funding at the maturity of the bonds.

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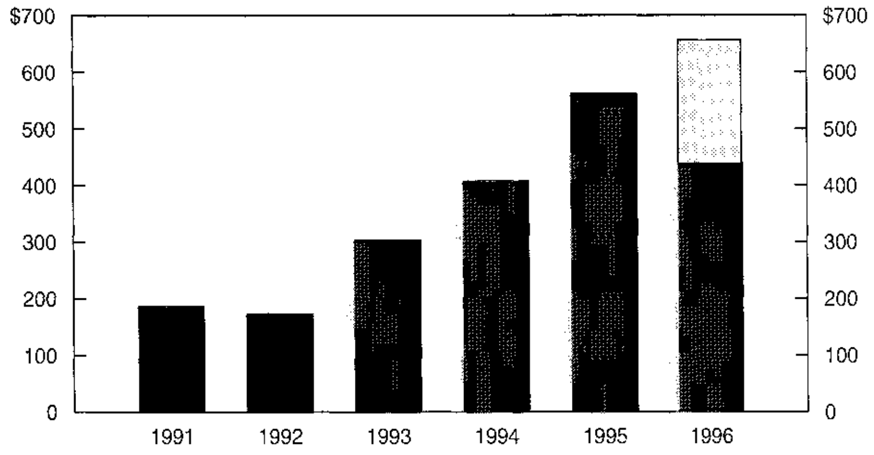
*The M&A market exceeded all expectations in 1996. With total domestic transaction volume exceeding $650 billion and cross-border transaction volume at an all-time high, M&A activity reached unprecedented levels. Transaction Dollar volume for 1996 exceeded 1995's record by a 15% margin. Transaction numbers also expanded, exceeding 10,000 deals for the first time ever. Consolidation activity in utilities, aerospace, retail and health care continued unabated. Despite a preponderance of transactions in these sectors, M&A activity remains extremely broad-based with high transaction volumes in a multitude of industries. Despite seasonal fluctuations stock market valuations remained robust and continued to support a very large number of stock-for-stock transactions.*

**Figure 14. Volume of Domestic M&A transactions, 1991-96 (Dollars in Billions)**



M&A Mergers and acquisitions.
Note: For U.S. domestic announced transactions only, excluding share repurchases, split-offs and recapitalizations. Shaded area represents 4Q 1996 transaction volume.
Source: Securities Data Company.

During the fourth quarter, activity in the utility, health care and retail sectors lead the charts in terms of transaction size and visibility.

Utility mergers, driven by deregulation pressures, showed no sign of slowing down: Duke Power agreed to merge with PanEnergy Corp. and Pacific Enterprises combined with Enova Corp, the parent of San Diego Gas, further illuminating one of the year's major trends, the establishment of diversified, broad-based providers of bundled power services. Another step was taken in the highly political LILCO saga, when Brooklyn Union Gas agreed to a merger with Long Island's beleaguered electric utility.

British Telecom's acquisition of MCI, the largest ever acquisition of a U.S. company by an international buyer was the bellwether for a record year for cross-border transactions involving U.S. "targets."

Meanwhile, in British Telecom's own backyard, a single transaction established an integrated provider of long distance telephone and cable television services through the combinations and alliances between Bell Cablemedia plc, Cable & Wireless plc, NYNEX CableComms, Mercury Communications, Videotron plc, and Cable Road (UK).

Activity in health care was broad-based across segments with the merger of hospital operators OrNda and Tenet and the combination of Health Systems International and Foundation Health to create the nation's fourth largest managed care organization. The less-common combination of generic drug-maker Ivax with drug wholesaler Bergen Brunswig, however, was not consummated.

In retail, the acquisition of Eckerd by J.C. Penney, and the combinations of Rite-Aid with Thrifty Payless, and Vons with Safeway, propelled the sector to its most active M&A year in a decade. On the international front, high drama surrounded the acquisition of a majority stake in duty-free powerhouse DFS Group Ltd. by French luxury goods maker LVMH in a transaction that pitted two of retailing's strongest personalities (DFS holder Robert Miller and LVMH chairman Bernard Arnault) against each other.

Insurance-related transactions dominated the activity in financial services: Aon Corp. agreed to acquire Alexander & Alexander Services establishing a new leader in the insurance brokerage industry, while Dutch insurance giant Aegon agreed to acquire the insurance operations of Providian Corp. in a "Morris Trust" transaction which also established Providian Bancorp as an independent, publicly traded, entity. ABN-AMRO, another Dutch financial institution also continued its aggressive expansion in the U.S. with the acquisition of Michigan-based Standard Federal.

**Figure 15. Ten largest M&A Transactions Announced in the Fourth Quarter of 1996 (Domestic Targets Only, Dollars in Millions)**

| Date Announced | Acquisition/Target | Industry | Approximate Value |
|---|---|---|---|
| 11/01/96 | British Telecommunications plc/MCI Communications Corp. | Telecommunications | $21,275 |
| 12/17/96 | The Boeing Company/McDonnell Douglas Corporation | Aerospace/Defense | 13,340 |
| 10/23/96 | Norfolk Southern/Conrail | Railroads | 10,500 |
| 10/15/96 | CSX/Conrail | Railroads | 9,750 |
| 11/25/96 | Duke Power Co./Pan Energy Corp. | Electric & Gas Utilities | 7,700 |
| 12/27/96 | Aegon NV/Providian Corp (Insurance Operations) | Insurance | 3,500 |
| 11/04/96 | J.C. Penny Co./Eckerd Corp. | Retail | 3,225 |
| 10/17/96 | Tenet Healthcare Corp./OrNda Health Corp. | Hospital Management | 3,040 |
| 12/30/96 | Brooklyn Union Gas Co./Long Island Lighting Co. (LILCO) | Electric & Gas Utilities | 3,010 |
| 10/14/96 | Enova Corporation/Pacific Enterprises Inc. | Electric & Gas Utilities | 2,870 |

Source: Securities Data Company.

With 53% (or $350 billion) of total transaction volume represented by transactions over $1 billion, 1996 could very well be the year of the so-called "mega-merger." Seven transactions were announced that were larger than $10 billion. The largest number of mega-mergers occurred in telecommunications/media, utilities, oil and gas, health care, retail and financial services.

**Figure 16. Ten Largest Announced M&A Transactions for 1996**

| Date Announced | Acquisition/Target | Industry | Approximate Value |
|---|---|---|---|
| 04/22/96 | Bell Atlantic Corp./NYNEX Corp. | Telecommunications | $21,335 |
| 11/01/96 | British Telecommunications plc/MCI Communications Corp. | Telecommunications | 21,275 |
| 04/01/96 | SBC Communications Inc./Pacific Telesis Group | Telecommunications | 16,525 |
| 12/17/96 | The Boeing Company/McDonnell Douglas Corporation | Aerospace/Defense | 13,340 |
| 08/26/96 | WorldCom, Inc./MFS Communications | Telecommunications | 13,350 |
| 02/26/96 | US West Media Group/Continental Cablevision | Media | 11,400 |
| 10/23/96 | Norfolk Southern/Conrail | Railroads | 10,500 |
| 10/15/96 | CSX/Conrail | Railroads | 9,750 |
| 08/30/96 | NationsBank/Boatmen's Bancshares | Banking | 9,750 |
| 04/01/96 | Aetna Life & Casualty/US Healthcare | Insurance/Health Care | 8,775 |
| 01/08/96 | Lockheed Martin Corporation/Loral | Aerospace/Defense | 8,760 |

Source: Securities Data Company.

The volume of unsolicited and contested transactions continued to increase as heated competition for attractive strategic assets intensified. In a rare move, German chemicals giant Henkel KGaA launched a successful unsolicited offer for Connecticut-based adhesives maker Loctite Corporation. Moreover, the "battles" for Santa Fe Pacific Gold and Conrail clearly delineated the importance placed by corporate management on expansion through acquisition as a means to accelerate growth in mature, lower-growth industries an effective driver of industry consolidation.

Other notable transactions in the fourth quarter span the entire spectrum of industries and structures: Boeing's long-rumored merger with McDonnell Douglas Corporation closed the most active M&A year yet for the aerospace and defense industry. The Boeing/McDonnell combination created a giant contractor with extraordinary leadership positions in commercial and military aircraft design, missiles and space and came immediately after Boeing's acquisition of the majority of Rockwell International's aerospace assets. HFS Inc. further enhanced its portfolio of product offerings through the acquisitions of PHH, the leasing services giant and Avis Car Rental. Unocal completed its plans to dispose of 76 Products, its retail gasoline station operations by announcing a sale of the unit to Tosco. Berkshire Hathaway also made a very sizable acquisition in the fourth quarter, buying FlightSafety International in a transaction valued at $1.5 billion.

Financial buyer activity in 1996 reached its highest levels since 1989. Total transaction volume exceeded $20 billion. KKR, the world's largest buyout firm realigned its portfolio with the sale of Stop & Shop, American Re and Duracell while raising its biggest-ever buyout fund ($5.7 billion). Thomas H. Lee and Bain Capital made headlines with the acquisition of Experian Corporation from TRW and the subsequent sale of Experian to Great Universal Stores, transactions that generated enormous returns in less than a year. Finally, Hicks, Muse, Tate & Furst continued its numerous investments in the technology and contract manufacturing services sectors.

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*Equity issuance jumped dramatically in 1996 to $160 billion from $108 billion in 1995 and surpassing the prior record of $135 billion set in 1993. The stock market's rapid ascent continued throughout the year without any significant setbacks. Inflows into equity mutual funds which also reached unprecedented highs — $222 billion for the year — were one of the primary reasons for the strength of the new issue markets.*

**Equity Carve-Out IPOs Speak Volumes.**

### IPO Market Review

Issuance volumes in the IPO market during 1996 at $62 billion fell just short of 1993's record level of $63 billion. However, the market did accommodate some of the largest IPOs in history — including the largest IPO in the U.S. by Lucent Technologies which raised more than $3 billion (see Figure 16) IPOs in the technology, health care, telecommunications and retail sectors accounted for approximately 45% of total issuance volume. Several of the year's largest IPOs represented equity carve-outs from existing public companies continuing a trend of recent years for companies to repackage their corporate assets into separately traded public companies. There were $9.9 billion of equity carve-out IPOs placed in the U.S. during 1996. Following the IPO by Lucent Technologies, AT&T completed a tax-free spin-off of the company's remaining 80.4% stake in Lucent Technologies to AT&T shareholders in December. Of the ten largest IPOs in 1996, four were equity carve-outs including Associates First Capital (Ford), New Holland (Fiat Spa), Travelers/Aetna Property Casualty (Travelers) as well as Lucent Technologies (AT&T).

**Figure 17. Top Ten Largest IPOs, 1996 (Dollars in Millions)**

| Offer Date | Issuer | Industry | Amount Offered in U.S. | Price Chg 12/31/96 |
|---|---|---|---|---|
| 04/03/96 | Lucent Technologies | Telecommunications-Equipment | $2,647 | 71% |
| 05/07/96 | Associates First Capital Corp. | Financial Svcs | 1,652 | 52 |
| 11/17/96 | Deutsche Telekom, AG | Telecommunications-Services | 1,606 | 8 |
| 10/31/96 | New Holland N.V. | Machinery-Farm Equipment | 750 | (3) |
| 10/09/96 | Gulfstream Aerospace | Aerospace/Aircraft | 710 | 0 |
| 04/22/96 | Travelers/Aetna Property Casualty Corp. | Insurance-Property & Casualty | 709 | 42 |
| 04/01/96 | Scania Aktiebolag | Auto/Truck-Manufacturers | 677 | (11) |
| 07/01/96 | Telefonica Del Peru S.A. | Telecommunications-Services | 599 | (8) |
| 03/13/96 | Cameco Corp. | Energy-Alternate Source | 524 | (28) |
| 11/21/96 | Compania Anonima Nacional Telefonos De Venezuela (CANTV) | Telecommunications-Services | 472 | 22 |

Source: Salomon Brothers Inc and Securities Data Company.

**Selling Shareholders are Invited to the Party.**

### New Issue Equity Market Review

In previous years, the new issue buyers frowned upon selling shareholders — those "sophisticated" investors such as financial buyers, pension funds and "insiders" — that sought to unload stock in a public offering. In 1996, however, investment bankers courted potential selling shareholders in an effort to persuade them that equity market conditions were unprecedented and that it was time to sell their shares and diversify. Many bankers succeeded in bringing their dates to the party. Among the ten largest public share offerings in 1996, six represented shares sold exclusively by selling shareholders (that is, where proceeds did not go the company).

Several such offerings represented part of an ongoing monetization strategy by the selling shareholder. For example, Kohlberg Kravis Roberts & Co. (KKR) had utilized the new issue market to monetize its stake in AutoZone on several occasions since the company's IPO in April 1991. The offering of AutoZone shares in June 1996 represented the fifth time the company had been to the new issue market since its IPO and the fourth time the selling shareholders had disposed of shares. Investcorp also had been able to capitalize on a strong market for luxury goods stocks in 1995 to take Gucci public in October of that year at $22 per share. Five months later with Gucci's stock price at $48 per share, Investcorp was back in the market with a 100% secondary share offering pocketing gross proceeds of $1.3 billion. Tenneco Corporation's sale of shares of Case Corporation in March at $53.75 represented Tenneco's third offering of Case shares since the company's IPO in June 1994 at $19. In each of the follow-on offerings, as well as the IPO, shares were offered exclusively by Tenneco.

**The MFS Success Story.**

The offering by MFS Communications was notable for several reasons. The offering itself at $1.2 billion globally was the largest non-IPO ever for a Nasdaq-listed stock. More impressive still however, was the company's stellar performance since its IPO in 1990. At the time of the IPO, MFS was valued at $1 billion. By July 1996, the company had an equity market capitalization of $8.7 billion. In December 1996, Worldcom Inc acquired MFS Communications for 2.1 Worldcom shares for each MFS share.

**Figure 18. Top Ten Largest Secondary Offerings, 1996 (Dollars in Millions)**

| Offer Date | Issuer | Industry | Selling Shareholder(s) | Amount Offered in US |
|---|---|---|---|---|
| 07/23/96 | Pharmacia & Upjohn | Healthcare-Drugs/Pharmaceutical | Volvo | $1,380 |
| 07/01/96 | MFS Communications | Telecommunications | Issuer | 943 |
| 05/23/96 | HFS Incorporated | Dining & Lodging Hotels | Issuer | 857 |
| 07/16/96 | Electronic Data Systems | Computers & Electronic Svcs/Software | General Motors Special Hourly Employees Pension Trust<br>General Motors Hourly Rate Employees Pension Plan | 793 |
| 06/06/96 | AutoZone | Retail-Automotive Parts | KKR | 770 |
| 03/07/96 | Case Corporation | Machinery-Farm Equipment | Tenneco Corp. | 735 |
| 07/15/96 | Koninklijke Ahold N.V. | Retail-Supermarkets | Issuer | 697 |
| 03/28/96 | Gucci Group | Retail-Apparel | Investcorp | 696 |
| 07/01/96 | Telefonica Del Peru S.A. | Telecommunications-Services | Government | 599 |
| 05/08/96 | Berkshire Hathaway, Inc. | Diversified Operations-Conglomerates | Issuer | 500 |

Source: Salomon Brothers Inc and Securities Data Company.

**In the Convertible Market, Size, Structure and Speed All Favor the Issuer.**

## Convertible Market Review

High redemption levels in the convertible market in recent years have left an ever-increasing number of market participants chasing fewer securities. This recipe has resulted in increased flexibility for issuers — size, structure and speed have all been in favor of the issuer. The ten largest convertible offerings in 1996 demonstrate both the diversity of product as well as issuer and included two exchangeable transactions (see Figure 18). Exchangeables are convertible securities which can be converted for common stock of a third party (that is, not the common stock of the issuer). In 1996, issuance of convertibles totaled $23.9 billion and issuance of exchangeables totaled $3.6 billion.

**Acronym Phobia Can be Overcome.**

Potential issuers of equity-linked securities should not be put off by the infinite number of acronyms created by investment banks to describe otherwise identical products and structures. The convertible market can be broken down into three families of convertibles: convertible debentures, convertible preferred and mandatorily convertible securities. Approximately 60% of the new convertible issue volume in 1996 was comprised plain vanilla convertible debentures (that is, 5, 7 or 10-year maturity with typically three years of hard call protection) (see Figure 19).

The convertible preferred family of convertibles includes traditional perpetual convertible preferred securities as well as the more recently created trust-issued convertible preferred securities such as BUCS (also commonly known as convertible TOPrS and convertible MIPS). Trust-issued convertible preferred securities have more equity-like characteristics than convertible debentures. For example, trust-issued securities have a longer maturity than most convertible debentures and also an interest deferral feature. However, trust-issued preferred securities still permit issuers to deduct interest expense for tax purposes. Issuance of perpetual convertible preferred totaled $2.9 billion in 1996 while issuance of trust-issued convertible preferred securities reached $3.8 billion.

Mandatorily convertible securities include the DECS structure created by Salomon Brothers in 1993 as well as Limited Appreciation Stock (ELKS and PERCS). These securities may be issued as short-term preferred stock or alternatively as a unit comprised of a forward stock purchase contract and a fixed-income note.

**Figure 19. Top Ten Largest Convertible Offerings, 1996 (Dollars in Millions)**

| Offer Date | Issuer | Security Type | Amount Offered | Yield At Issue (%) | Initial Premium/Cap (%) |
|---|---|---|---|---|---|
| 06/06/96 | Kmart | BUCS | $1,000 | 7.75 | 25.0 |
| 09/26/96 | Home Depot | Cvt Debt | 1,000 | 3.25 | 22.1 |
| 11/04/96 | News Corp [a] | Exchangeable BUCS (TOPrS) - 144a | 1,000 | 5.00 | 20.0 |
| 12/17/96 | Microsoft | SPECS | 1,000 | 2.75% | 28.0[b] |
| 06/04/96 | Apple Computer | Cvt Debt — 144a | 650 | 6.00 | 18.0 |
| 10/31/96 | Loral Space & Communications | BUCS — 144a | 600 | 6.00 | 25.9 |
| 11/25/96 | Host Marriot | BUCS | 550 | 6.75 | 23.0 |
| 11/25/96 | Berkshire Hathaway [c] | Exchangeable Debt | 440 | 3.00 | 10.3 |
| 04/23/96 | Alza | Cvt Debt | 435 | 5.00 | 30.0 |
| 10/31/96 | SunAmerica | ELKS | 375 | 8.50 | 35.0[d] |

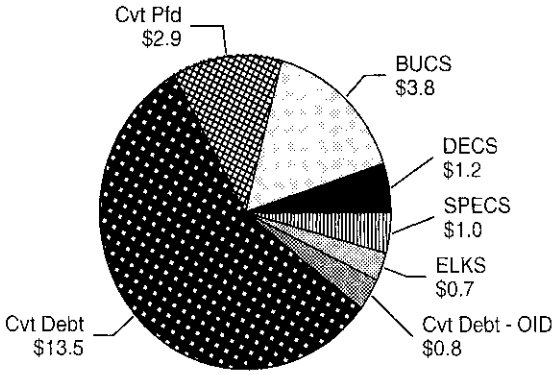
[a] Exchangeable for shares of British Sky Broadcasting. [b] Investors receive 100% of stock price appreciation up to cap level 28% above Microsoft stock price at issuance. [c] Exchangeable for shares of Salomon Inc. [d] Investors receive 100% of the stock price appreciation up the cap level of 35%. BUCS Beneficial Unsecured Convertible Securities. SPECS Short-tern Principal-Protected Exchangeable Collared Securities. ELKS Equity-Linked Securities.
Source: Salomon Brothers Inc and Securities Data Company.

### New Product: Microsoft SPECS.

The only "new" product of 1996 was the Microsoft Convertible Exchangeable Principal-Protected Preferred Shares (also known as SPECS). The Microsoft structure is a modified version of Limited Appreciation Stock. As with Limited Appreciation Stock, investors receive 100% of the upside associated with the stock until a cap level (that is, 28% above Microsoft's stock price at the date of issue); thereafter, investors will receive none of the upside of the stock. However, in turn for capping their upside, investors will have no downside price risk. The Microsoft structure was issued as a preferred security has a maturity of three years and can be settled with cash or stock at maturity at the issuer's option. Microsoft has the option to exchange the preferred security for a convertible debenture with essentially similar terms at its option.

From an issuer's perspective the SPECS security represents a low-dividend convertible preferred financing (which may be exchanged for a tax-deductible debt structure with similar terms). In addition, issuers that believe that their stock is undervalued, or likely to appreciate significantly, can deliver a declining number of shares as the stock price exceeds the cap price. In the event that the stock price declines, the issuer may settle the security with cash or in stock. If stock delivery is chosen in these circumstances, unlimited dilution may be experienced. Microsoft used the proceeds from the offering for general corporate purposes and to repurchase common stock.

**Figure 20. Convertible Issuance by Product Type, 1996 (Dollars in Billions)**



Source: Salomon Brothers Inc.

**Greater Diversity of Exchangeable Product Issuance.**

In 1996, the Exchangeable DECS continued to be the monetization vehicle of choice. Since Salomon Brothers created the structure in 1993 for American Express more than 26 Exchangeable DECS have been issued raising gross proceeds of approximately $7 billion. In 1996, issuance of Exchangeable DECS accounted for 44% of the total dollar amount raised through issuance of exchangeable securities (see Figure 21). News Corporation accessed the market through a trust-issued exchangeable preferred security. The securities may be exchanged for shares of British Sky Broadcasting held by News Corporation. The trust structure avoids News Corporation reporting the security as long-term debt on the balance sheet and thus inflating the company's reported leverage ratios.

**Contingent Debt Regulations Enhance Attractiveness of Exchangeable Debt.**

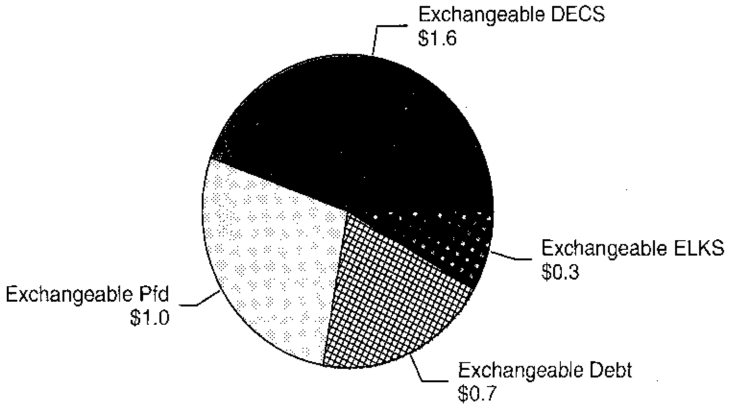
In November, Berkshire Hathaway issued a $440 million Original Issue Discount (OID) 1.00% Senior Exchangeable Notes ("the Notes") that are each convertible into 17.65 shares of Salomon Inc stock. The Notes were issued at a price of $907.78 per Note with a yield to maturity of 3.00%. While the transaction was noteworthy for several reasons, few market participants fully appreciated the significant tax benefits afforded Berkshire Hathaway by the recently passed Contingent Payment Regulations.[2]

The Contingent Payment Regulations require issuers of contingent debt instruments to apply the "noncontingent bond" method to determine accruals of income, gain, loss and deduction with respect to a contingent debt obligation. For example, Berkshire Hathaway must accrue interest expense at a yield of 6.31% per Note. Accordingly, after taking into consideration the cash yield of 1.1%, Berkshire Hathaway is required to

[2] Effective for debt obligations issued on or after August 13, 1996.

accrue additional interest expense of 5.21%. Thus, the value of the underlying stock at maturity is projected — solely for tax purposes — to be $1,174.87. Consequently, at maturity the accrued, but unpaid, interest expense is $267.09 (that is, $1,174.87 less the issue price of $907.78). If the exchange were to occur at maturity in December 2001, Berkshire Hathaway will have additional ordinary expense (or income) to the extent that the "actual fair market value" of the Salomon Inc shares is greater (or less) than the "projected value" of $66.56 per share (that is, $1,174.87 divided by 17.65 shares per Note). Again assuming exchange, Berkshire Hathaway would realize a capital gain equal to the difference between Berkshire Hathaway's cost basis for the Salomon Inc stock and the actual fair market value of Salomon Inc stock at the time of the exchange.

**Figure 21. Exchangeable Issuance by Product Type, 1996 (Dollars in Billions)**



Source: Salomon Brothers Inc.

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*The rise in stock buyback programs during the past few years has led to the development of numerous innovative equity capital management tools. Companies can now choose from a range of products to accomplish a variety of repurchase goals. This quarter we review the most common objectives and constraints faced by companies preparing to execute a stock buyback program, which can be used as the foundation for formulating a repurchase strategy.*

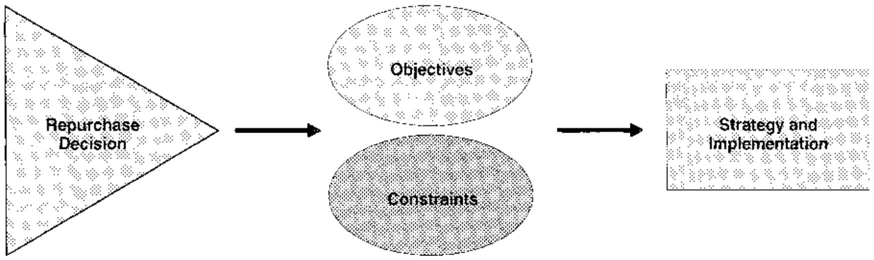
**Question 5**

*Once a company has decided to repurchase its shares, what factors influence its execution strategy?*

**Answer 5**

The key issues a company must consider are: price view, repurchase time horizon, trading volume of its common stock, the availability of cash or financing, balance sheet/rating agency sensitivity, expected blackouts and the importance of preserving the ability to consummate a pooling of interests combination in the future.

**Figure 22. Formulating a Repurchase Strategy**



**Objectives**
Send Positive Signal to Market
Offset Dilutive Options or Acquisitions
Enhance Shareholder Value
Optimize Use of Excess Free Cash Flow
Support Share Price
Capital Management

**Constraints**
Price View/Risk Profile
Time Horizon
Trading Volume
Availability of Cash or Financing
Balance Sheet Sensitivity
Blackouts/Distributions
Pooling of Interests

Source: Salomon Brothers Inc.

**Question 6**

*Once a company has considered the constraints it faces, what are the capital management tools available for implementation?*

**Answer 6**

The most common repurchase technique is an open market repurchase program, which allows the company to repurchase shares from time to time in the open market through an agent. An open market program provides the greatest flexibility and potentially achieves the lowest economic cost for programs of modest size relative to total market capitalization. However, an open market purchase program does have some disadvantages:

the company will be subject to blackout periods, the program requires the most management time to administer, the repurchase may require substantial time to complete and the accounting benefits of a share repurchase (earnings per share and return on equity [ROE] increases) are not fully realized until the program is complete.[3]

For large programs (greater than 10% of shares outstanding), the company may want to consider a self-tender offer. In a self-tender, the company makes an offer, good for 20 business days, to repurchase a fixed amount of stock at a fixed price or a range of price (a "Dutch" auction tender). A tender can be completed quickly thereby addressing the main limitations of an open market repurchase, but is usually only compelling on an economic basis for larger programs. In addition, a tender does not provide share price support following the brief tender period and may have complex signaling consequences.

**Question 7**

*What other execution strategies are companies employing?*

**Answer 7**

The most popular enhancement strategy continues to be the **sale of put warrants**. The put strategy hedges the company's exposure by monetizing the company's commitment to repurchase its shares at a fixed price (below today's price) for a fixed period of time (usually three to 24 months).

The **Accelerated Share Repurchase**$^{\text{SM}}$ **(ASR)**$^{\text{SM}}$ allows a company to repurchase a large block of its shares today with the final price of those shares determined by the average market price over a fixed period of time. The ASR accelerates accounting benefits, allows the company to disconnect its repurchase from the market impact and eliminates the administrative burden associated with a daily share repurchase program.

As an extension of the popular put warrant strategy, a number of companies have combined the sale of puts with the purchase of call options (collectively, a **collar**), to establish a floor and a cap on its range of future share repurchase prices. The collar has been used by companies looking to lock-in today's price without an upfront cash commitment. However, the spread between the put strike and call strike prices may result in a higher repurchase price than a standard repurchase financed with debt.

A **forward repurchase** obligates the company to purchase its shares on a future date at a price per share that is fixed at today's price plus a financing charge. This allows the company to lock-in the forward price without actually retiring any shares today. The forward has been favored by some companies as a hedge for employee stock options because the quarterly settlements offset changes in share equivalents related to accounting for employee stock options.[4] However, in addition to potential legal concerns surrounding the forward share repurchase, many companies have found the program too expensive because the interest rate paid on the forward (typically LIBOR plus 25bps to 75bps) is not tax-deductible.

[3] See *Stock Buybacks: Strategy and Tactics*, Chris Innes, et al., Salomon Brothers, February 1997.

SM The Accelerated Share Repurchase and ASR are servicemarks of Salomon Brothers Inc.

[4] Under the reverse treasury stock method, the in-the-money amount of employee stock options must be converted into share equivalents, potentially diluting a company's reported EPS.

Figure 23 below compares and contrasts these hybrid strategies with conventional repurchase programs.

*Companies should consult with their own accounting, tax and legal advisors regarding stock buyback strategies.*

**Figure 23. Factors in Selecting a Repurchase Strategy**

| | Open market Repurchase | Sale of Put Warrants | Self-Tender | Accelerated Share Repurchase | Collar | Forward Repurchase |
|---|---|---|---|---|---|---|
| **Price View/ Risk Profile** | Neutral to bullish, depending on timing of execution. | Bullish / committed to repurchase. | Most bullish / committed to repurchase. | Neutral / committed to repurchase. | Bullish. | Bullish. |
| **Time Horizon of Repurchase** | Flexible/ over time. | Hedge for buyback over time. | Immediate. | Immediate. | Delayed until maturity of collar. | Delayed until maturity of forward. |
| **Trading Volume** | Volume limits timing. Generally, companies may average up to 25% of average daily volume over time. | Volume limits establishment of initial hedge.<br>Up to 5 to 10 days of volume can be hedged with puts. | Not limited by trading volume. | Initial purchase not limited by volume.<br>Averaging period constrained by volume. | Volume limits establishment of initial hedge.<br>Up to 10 days of volume can be collared in aggregate. | Similar to open market- volume limits initial timing (because counterparty must first purchase shares to lock-in price). |
| **Availability of Cash or Financing** | Can be financed from ongoing cash flow or debt. | No upfront cash required. | Upfront cash required. | Upfront cash required. | No upfront cash required. | No upfront cash required. |
| **Balance Sheet Impact** | Book equity reduced over time. | Immediate reduction in book equity. | Immediate reduction in book equity. | Immediate reduction in book equity. | Book equity reduced at maturity. | Book equity reduced at maturity. |
| **Blackouts / Distributions** | Company must stop purchases during blackouts and distributions. | Generally, blackouts and distributions only impact initial sale of puts. | Company must stop open market purchases for tender and 10 days thereafter. | Generally, blackouts only impact initial sale. Distribution halts averaging period. | Generally, blackouts and distributions only impact initiation of program. | Generally, blackouts and distributions only impact initiation of program. |
| **Pooling of Interests** | Purchased shares tainted. | Under current rules, shares not tainted until actually repurchased. | Purchased shares tainted. | Purchased shares tainted. | Under current rules, shares not tainted until actually repurchased. | Under current rules, shares not tainted until actually repurchased. |

## TOPIC OF THE QUARTER: BIG MACS AND EXCHANGE RATES

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*Almost a decade ago,* The Economist *humorously introduced its annual survey of the "hamburger standard. "* The Economist *argued that this Big Mac standard could be used as a guide to whether currencies are trading at the right exchange rates. By 1996, the survey which had started with 15 countries had expanded to 33 countries.*

A recent National Bureau of Economic Research paper formally investigates whether a high (low) U.S. dollar price of a Big Mac can be used to predict whether a given currency will depreciate (appreciate) relative to the U.S. dollar.[5]

The article reaches the following four conclusions:

(1) Average dollar prices of Big Macs differ substantially across countries. Big Macs are most expensive in Denmark and Sweden and cheapest in Hong Kong. Differences in taxes, labor costs, and rents probably contribute to these differences in Big Mac prices.

(2) Once these average differences are taken into account, the deviations from Big Mac parity are temporary. It takes only about a year for half of a deviation to disappear.

(3) Deviations from Big Mac parity can be used to forecast exchange rates. For example, a 10% relative undervaluation is associated with a 3½% currency appreciation over the following year.

(4) Deviations from Big Mac parity seem to help in forecasting relative local currency prices. Stated differently, when the U.S. dollar price of Big Macs is high in a country, the relative local currency price of Big Mac in that country is likely to fall during the following year.

These findings support the long-held economic hypothesis that Purchasing Power Parity (PPP) holds in the long run. Indeed, for high-inflation countries, and for countries in close monetary union, PPP appears to hold even in the short run. On the other hand, for low-inflation countries PPP is less likely to hold in the short run.

Companies evaluating cross-border M&A opportunities should carefully investigate whether the currency of the target investment is close to PPP. In addition, the PPP adjusted buying power of local residents may affect the valuation of target investment opportunities.

[5] See, *Forecasting Exchange Rates and Relative Prices with the Hamburger Standard: Is What You Want What You Get With McParity?* Robert Cumby, National Bureau of Economic Research Working Paper No. 5675, 1996.

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