GLOBAL
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JULY 1996

Corporate Finance

Salomon Brothers

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Mergers and Acquisitions
Petros G. Kitsos

The CFO Quarterly: July 1996

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Economic, Policy and Market Trends

Industrial country prospects are improving. Still-strong U.S. growth has shifted the odds in favor of a Federal Reserve rate hike in the coming months, while the period of cyclical easing is drawing to an end in Germany. As economic growth quickens, risks lie on the side of higher yields in most major markets. The long-term outlook for the U.S. dollar versus the Deutschemark remains favorable.

Equity Market Trends

The second quarter of 1996 featured an unprecedented level of activity in the equity markets: All sectors of the capital markets were extremely busy. Market volatility in the latter part of the quarter resulted in a number of public offerings being withdrawn or postponed. Particularly hardest hit were the technology and health care sectors.

Corporate Equity Derivative Trends

Corporations can use a variety of option overlay strategies to facilitate the purchase or sale of common stock. In this report, we review how the sale of call and put options can be used to monetize buy or sell decisions.

Merger-and-Acquisition Trends

Industry consolidation, "mergers-of-equals," and transactions driven by regulatory changes pushed merger-and-acquisition activity to new heights in the first half of 1996. Large transactions in telecommunications, media, health care and aerospace led the volume rankings, with additional significant activity in retail, utilities, oil and gas and financial services. Asset repackaging transactions also continued at high levels with significant transactions announced by Dun & Bradstreet, Hanson PLC, W.R. Grace, Dial Corp., and Tenneco.

Fixed-Income Market Trends

This quarter's focus topic is Salomon Brothers' new generation of tax-advantaged preferred stock: Trust Preferred Stock℠ Units or TRUPS℠ Units. This structure introduces a fundamentally new innovation to traditional tax-advantaged preferred securities by adding a "Preferred Purchase Contract" that ensures an issuer's access to core capital at any time. The rating agency advantages and enhanced financial flexibility of this approach are described in detail.

Liability Management Trends

As Treasury yields hover near the higher end of recent trading ranges, cash-rich companies are stepping up the pace of their debt repurchase initiatives. 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. This section is a continuation of the discussion of cash-financed debt repurchase in April's *CFO Quarterly* publication.

Topic of the Quarter

Contrary to conventional wisdom, empirical evidence suggests that there is no systematic payoff for firms that use pooling accounting in merger and acquisition transactions. There is no clear evidence that firms which justify higher acquisition prices because of pooling treatment are creating value for owners. Further, "purchased" goodwill appears to have value while it is being amortized despite lower reported earnings.

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Question 1

What is the economic growth outlook for major industrialized countries?

Answer 1

Industrial country growth prospects are improving. The latest figures indicate that the Japanese economy is growing more strongly than previously forecast. The U.S. expansion has quickened, and growth likely accelerated further in the second quarter. European growth appears to have picked up in the second quarter, with prospects for moderate growth in the second half of 1996.

Question 2

What are the economic policy prospects for major industrialized countries?

Answer 2

Still-strong U.S. growth has shifted the odds in favor of a Federal Reserve rate hike in the coming months, while the period of cyclical easing is drawing to an end in Germany. At the same time, Japanese short-term rates are expected to rise, as new fiscal measures are implemented.

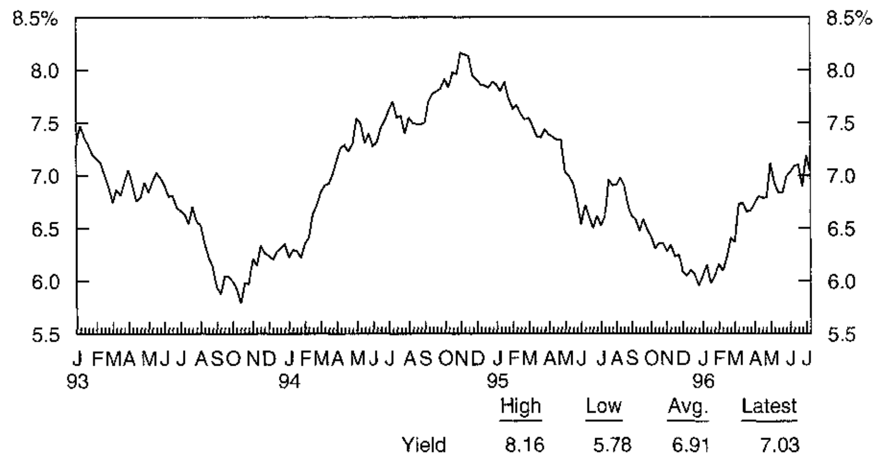
Question 3

How have the major markets performed in the first half of 1996?

Answer 3

In the first half of 1996, the economy performed better than expected, pushing Treasury yields and the S&P 500 higher (see Figure 1). As a result, total Treasury and Corporate returns declined somewhat, while high yield and emerging markets did well (see Figure 2).

Figure 1. 30-Year U.S. Treasury Yields, 3 Jan 93-15 Jul 96



Source: Salomon Brothers Inc.

Figure 2. Total Rates of Return of Selected Asset Classes, 2Q 95-2Q 96

Asset Class	2Q 96	1Q 96	4Q 95	3Q 95	2Q 95
Treasury	0.44%	-2.22%	4.64%	1.68%	6.21%
Corporate	0.35	-2.45	4.94	2.23	7.28
Mortgage	0.68	-0.47	3.37	2.02	5.18
High Yield	1.30	1.58	3.38	3.01	6.14
Emerging Markets	9.17	4.46	9.31	6.58	22.31
S&P 500	3.89%	4.80%	5.39%	7.28%	8.80%

Source: Salomon Brothers Inc.

Question 4 *What is the near-term market outlook?*

Answer 4

As economic growth quickens, risks lie on the side of higher yields in most major markets. Fed action will cap the U.S. bond sell-off, and help set the stage for future yield declines, buoyed by moderating growth and subdued price pressures. Noncore European markets will benefit from falling inflation and deficits, as well as low German rates. Japanese markets likely will reflect the longer-term worries caused by the slow pace of structural reforms.

The long-term outlook for the U.S. dollar versus the Deutschemark remains favorable, reflecting the prospect of sustained low inflation and odds favoring a rising national savings rate. In the near term, the prospect of a Fed tightening in coming months also may prompt a temporary strengthening of the U.S. dollar versus the Deutschemark toward DM1.60/US$. However this rate is not likely to be sustained throughout the year, as German growth strengthens and the U.S. economy decelerates. Within Europe, falling inflation and public deficits should continue to underpin the currencies of high-yielding economies versus the Deutschemark. However, the French franc probably will partly reverse its recent gains. Finally, the risk remains of a sizable capital flow into Germany if stubbornly high public deficits in core countries prompt investors to expect a postponement of EMU. Prospects for higher Japanese short-term rates and an end to the trade surplus decline eventually will partially reverse near-term dollar gains versus the yen (see Figure 3).

Figure 3. Summary of Economic Forecast, 2Q 96

	Growth	Monetary Policy	Fiscal Policy
United States	Improving	Neutral	Modestly restrictive
Core Europe[a]	Sluggish	Expansionary	Tightening
Japan	Improving	Neutral	Expansionary

[a] Includes France, Germany and the Benelux countries.

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Wow! The second quarter of 1996 featured an unprecedented level of activity in the equity markets: All sectors of the capital markets were extremely busy. During the second quarter, there was a total of $18.3 billion of capital raised in IPOs, $22.4 billion raised through straight equity offerings in non-IPOs, and $6.8 billion raised through offerings of convertible and equity-linked securities. The total equity capital raised in the second quarter of $47.5 billion compares with the $82 billion raised throughout the whole of 1995.

As for the market indices as a whole, the second quarter performance was only mediocre. The Dow Jones Industrial Average was little changed, up to 5654 from 5637, and the S&P 500 Index was up from 654 to 671. The NASDAQ Composite Index was up a more meaningful 7% to 1185 from 1107. However, this good performance masked a significant fall in the NASDAQ during June and July. Volatility and investor concerns about corporate earnings and interest rates resulted in a difficult new issue environment in which a number of transactions were postponed. Much of the market's upward momentum in 1996 had been sustained by massive inflows into equity mutual funds — $123 billion for the year to date through May. However, mutual fund inflows appeared to have slowed in June, estimated to have dropped to $15.5 billion, which may partially explain the market's softness.

New-Issue Environment — Marked by Postponements.

With increasing investor concern about corporate earnings and interest rates, many institutional investors have changed the composition of their portfolios to include more defensive equity securities. In addition, the reduced mutual fund inflows are limiting the amount of new cash portfolio managers have to invest. Consequently, institutional investors have become increasingly selective in choosing those transactions in which they participate which has led to a dramatic increase in the number and dollar volume of postponed equity transactions in the past two months (see Figure 4).

Figure 4. Volume of Postponed Equity Transactions by Month in 1996 (Dollars in Millions)

Month	Number of Transactions Postponed	Dollar Volume of Postponed Transactions
January	12	$955
February	13	649
March	5	848
April	13	756
May	10	237
June	14	1,150
July[a]	44	3,000

[a] Through July 26, 1996.
Source: Salomon Brothers Inc and CommScann, Inc.

IPOs — Equity Carve-Outs Rule the Day.

The four largest IPOs in the second quarter were all equity carve-out IPOs (that is, the IPO of a subsidiary or division by an already public company).[1] In April, AT&T, Ford and Travelers all completed IPOs of Lucent Technologies ($3 billion), Associates First Capital Corp. ($1.9 billion) and Travelers/Aetna Property Casualty Corp ($970 million), respectively. In May, H&R Block Inc. completed the IPO of its Internet service provider, CompuServe ($550 million).

While valuations of some Internet-related IPOs remain outlandish, few have been able to defy the laws of gravity forever. The largest Internet IPO of the quarter was that of CompuServe on April 18, which priced at $30 per share. After trading up to $35 per share the morning after pricing, the stock price began its fall back to earth. On July 23, Compuserve closed at $11.38. The search engine company, Yahoo!, has fared better, going public in April at $11 per share. Yahoo!'s stock price is now retreating from its high of $43 per share and currently trades at about $16.

Foreign IPOs — Remain Strong.

A steady stream of non-U.S. issuers continued to access the U.S. equity markets during the second quarter. Notably, SGL Carbon became only the second German company to be listed on the NYSE. AXA, the French insurance concern, along with Scania, the Swedish truck manufacturer, also sought listings through a public offering. The emerging markets were well represented by Guangshen Railway and Korea Mobile Telecom. Both companies completed global offerings raising $470 million and $340 million, respectively.

Repackaging Corporate Assets — EDS is the Mother of All Spin-Offs.

Effective June 10, 1996, General Motors exchanged one share of Electronic Data Systems for each share of General Motors Class-E shares outstanding. Thus, the first targeted stock in history (created by Salomon Brothers in 1984) disappeared. It had served its purpose well. Technically, the General Motors exchange offer was a split-off as opposed to a spin-off. However, that was just a result of the targeted stock already being in place. The transaction has more in common with a 100% spin-off to shareholders.

Convertibles — Tax-Advantaged Financing is all the Rage.

Issuers responded with a flurry of tax-deductible convertible preferred issuance to a favorable joint statement from Senate Finance Committee Chairman, William V. Roth, Jr., and House Ways and Means Committee Chairman, Bill Archer, about the nonretroactivity of pending tax regulation proposals regarding the tax deductibility of certain equity-linked products. Kmart ($1 billion), NorAm Energy ($150 million), Greenfield Industries ($115 million), and AnnTaylor ($88 million) completed offerings of tax-advantaged convertible preferred securities (that is, BUCS, MIPs or TOPrS). Also, in an innovative transaction, MCN Corp., completed a $117-million offering of off-balance sheet DECS. Proceeds from the offering were used to purchase U.S. Treasury notes, which were then held as collateral investors' obligation to purchase common stock after three years. Shortly after the DECS offering, MCN completed an offering of senior notes. In combination, these two financings represent a tax-advantaged DECS financing.

[1] See *Repackaging Corporate Assets: Creating Shareholder Value Through Carve-Outs, Spin-Offs, Split-Offs and Targeted Stock*, Andrew MacInnes and Peter Blanton, Salomon Brothers Inc, May 1995.

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With the growth of the listed and over-the-counter (OTC) market for equity options, a number of corporations with investments in other companies ("crossholdings") have employed option overlay strategies to facilitate the purchase or sale of common stock. Below we review how the sale of call and put options is used to monetize buy/sell decisions.

Question 5

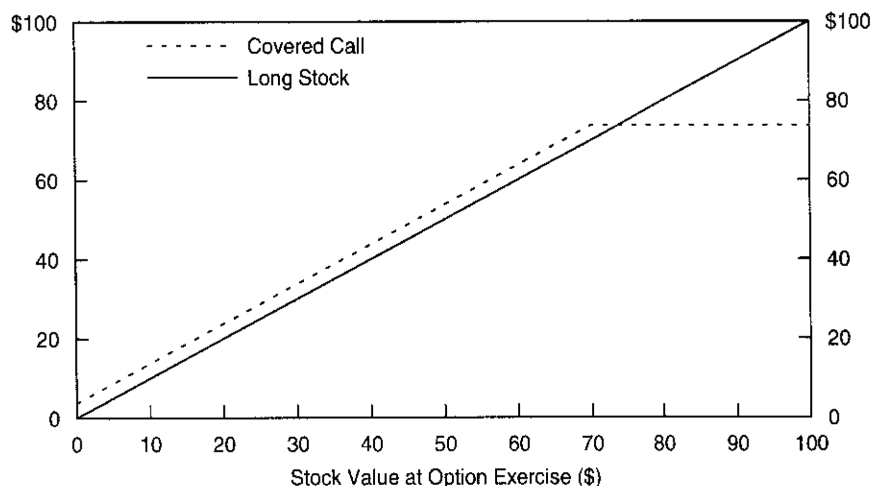
How can corporations use the sale of call options against crossholdings to monetize their sell decision?

Answer 5

By writing (selling) call options against a long stock position, the call writer is granting the option buyer the right to buy the underlying shares at a fixed price (the exercise price) for a fixed period of time. The option may be American-style (exercisable at any time) or European-style (exercisable only at maturity).[2] If the call option is exercised, the effective sale price for the option writer is equal to the exercise price plus option premium received. If the options expire unexercised, the premium has effectively provided a partial downside hedge by increasing the effective yield on the underlying stock position (see Figure 5).

If the call options are executed in the OTC market, the call writer may also have the ability to elect to settle the option in cash on a payment of differences basis (listed options on single stocks are physically-settled only).

Figure 5. Payoff Diagram of a Covered Call Strategy



Source: Salomon Brothers Inc.

Question 6

What issues should a stockholder consider regarding a call writing strategy?

Answer 6

As evidenced in Figure 5, the main strategic consideration is that a corporation with crossholdings trades an up-front option premium for potential stock price appreciation beyond the call strike price. In addition,

[2] Listed options on single stocks are American-style.

while thesale of calls increases the effective yield on the crossholding, it only provides partial protection against a drop in the value of the common stock. Companies seeking greater protection against a sharp decline in the value of their crossholding should consider combining the sale of a call option with the purchase of a put option, thus creating a collar.

Question 7

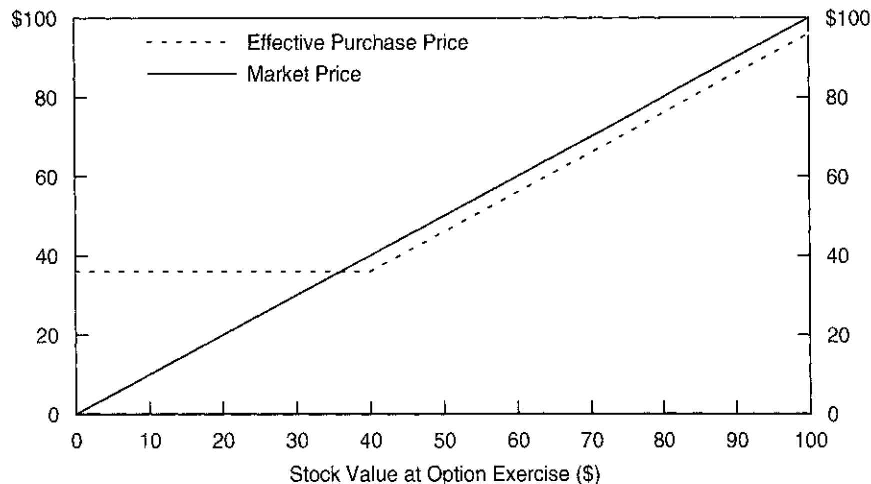
How can corporations use the sale of put options to monetize their desire to purchase stock below the current market price?

Answer 7

By writing put options, the put writer provides the option buyer with the right to sell stock to the put writer at the strike price on a future date in exchange for an up-front option premium. This means that if the put writing company sets the put strike price equal to its target purchase price for the crossholding shares, then it is getting paid for committing to its purchase decision (see Figure 6).

The put writing strategy has been employed by numerous corporations repurchasing their own shares, as well as by companies looking to build a position in a selected stock.

Figure 6. Effective Stock Purchase Price of a Put Writing Strategy



Sources: Salomon Brothers Inc.

Question 8

What issues should a stockholder consider regarding a put writing strategy?

Answer 8

As evidenced in Figure 6, the main consideration regarding the put writing strategy is that the put seller has created a floor price for the purchase of stock. This means that the put writer may pay an above market price for the shares at exercise (if the underlying stock has declined below the put strike price). Companies that have employed the put strategy have taken the view that at some price they are buyers of the stock. In addition, put sellers are often concerned that a steadily rising price may significantly increase the cost of their stock purchases and thus sell puts to hedge this risk.

Question 9

Are there any limits on the number of options stockholders can sell?

Answer 9

As a practical constraint, given the need to actively hedge option exposure by trading in the underlying common stock, market makers will generally only be willing to purchase options representing up to five to ten days trading volume in the underlying equity.

In addition, all listed options have position limits that are set by the option exchanges based on trading volume and shares outstanding in the underlying equity. Position limits range from 4,500 contracts (450,000 shares) to 25,000 contracts (2,500,000 shares) for large, liquid stocks such as American Express and Walt Disney. OTC options are subject to NASD position limits that generally parallel the listed option position limits. Both the listed and OTC position limits have a hedge exemption that would allow a call option writer, who is also long the underlying equity, to sell call options on three times the standard position limit.

Affiliates and holders of restricted stock will have additional issues to consider and should consult with counsel.[3]

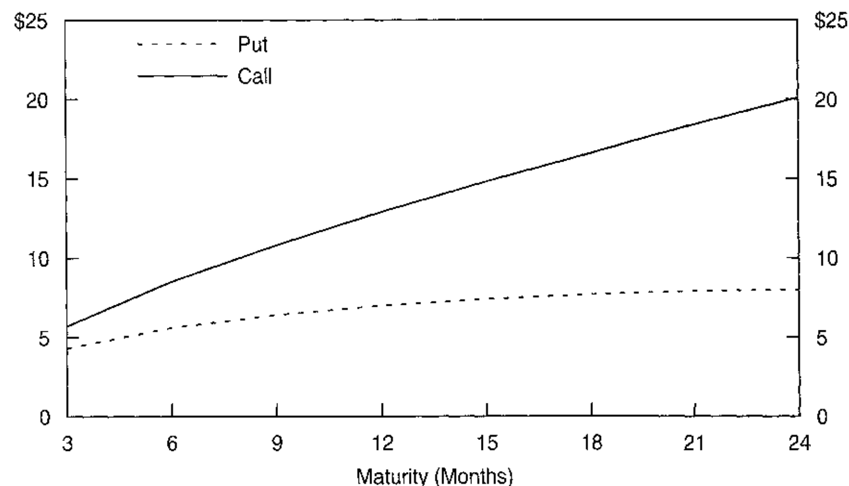
Question 10

How are options priced?

Answer 10

Equity options can be valued using a conventional Black-Scholes option model found on Bloomberg or purchased from a number of software vendors. The key variables input into the option model are option type, maturity, stock price, strike price, common dividend yield, risk-free interest rate, and volatility. The only variable in the model that is not readily available is volatility. To determine volatility, derivative market makers will look at the historical price volatility of the underlying equity and implied volatility in the stock's listed options (if any). Figure 7 illustrates the increase in option premium with time for at-the-money options on a $100 stock with an implied volatility of 25%.

Figure 7. Increase in Option Value Premium versus Maturity



Sources: Salomon Brothers Inc.

[3] See also, *Sale and Hedging of Restricted Common Stock*, Chris Innes, et al., Salomon Brothers Inc, March 1996.

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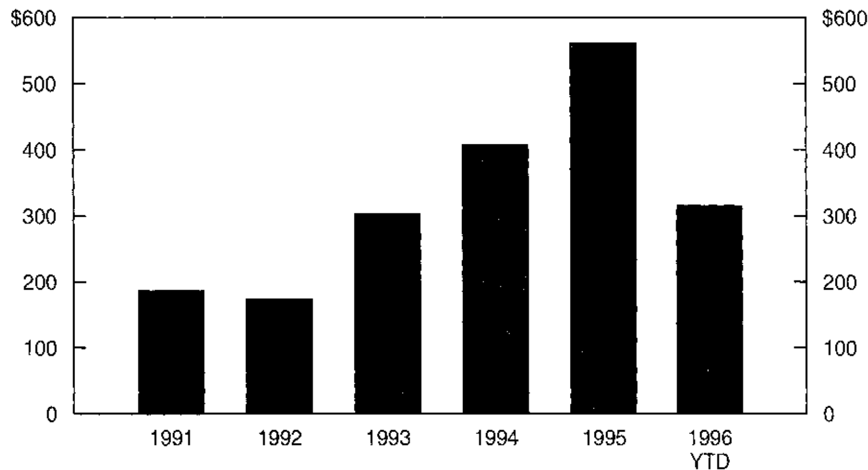
Industry consolidation, "mergers-of-equals" and transactions driven by regulatory changes pushed merger and acquisition (M&A) activity to new heights in the first half of 1996 (see Figure 8). Large transactions in telecommunications, media, health care and aerospace led the volume rankings, with additional significant activity in retail, utilities, oil and gas and financial services. Asset repackaging and divestiture transactions also continued at a brisk pace.

Figure 8. Volume of M&A Transactions, 1991-96 YTD (Dollars in Billions)



M&A: Merger and acquisition. YTD: Year to date.
Source: Securities Data Company. For U.S. domestic announced transactions only, excluding share repurchases, split-offs and recapitalizations.

Fittingly, the first half of 1996 saw the announcement of the second largest M&A transaction in history, the $29.5-billion merger of Switzerland's two pharmaceuticals giants, Ciba-Geigy and Sandoz. The combination will create Novartis, one of the world's largest pharmaceuticals companies.

The first half of 1996 also witnessed major consolidation activity among the Regional Bell Operating Companies: Pacific Telesis merged with SBC Communications, and NYNEX with Bell Atlantic. At the same time, telecommunications reform, as manifested in the Telecommunications Act of 1996, continued to generate heated consolidation activity in other related sectors: The markets saw the consummation of AT&T's restructuring, the spin-off of EDS, the creation of a "new age" integrated communications provider through the stock merger of MFS Communications with UUNet, and the pending acquisition of Continental Cablevision by US West Media.

Two major transactions in aerospace/defense continued to push the edge of the envelope in scale and vertical integration, with Northrop Grumman successfully pre-empting a competitive auction for Westinghouse's defense electronics business and industry giant Lockheed Martin acquiring the historically acquisitive Loral Corp.

The combinations of insurance companies and health maintenance organizations (HMOs) accelerated with the acquisition of US Healthcare by Aetna. Simultaneously, the merger trend in the insurance sector continued

strong and expanded overseas. However, transaction volumes in the commercial banking sector subsided significantly with no transactions larger than $500 million (see Figure 9).

Figure 9. Fifteen Largest M&A Transactions Announced in the First Half of 1996 (Dollars in Millions)

Date Announced	Acquiror/Target	Industry	Approx. Value
03/07/96	Sandoz AG/Ciba-Ceigy AG	Pharmaceuticals	$29,500
04/22/96	Bell Atlantic/NYNEX	Telecommunications	21,350
04/01/96	SBC Communications/Pacific Telesis Group	Telecommunications	16,525
02/26/96	US West Media/Continental Cablevision	Media	10,800
01/08/96	Lockheed Martin/Loral	Aerospace/Defense	8,800
04/01/96	Aetna Life & Casualty/US Healthcare	Health Care	8,725
06/20/96	Westinghouse Electric/Infinity Broadcasting[a]	Media	4,700
04/22/96	Cisco Systems/StrataCom	Telecom equipment	4,225
05/03/96	Sun Alliance Group PLC/Royal Insurance Hold.	Insurance	3,900
06/19/96	El Paso Natural Gas/Tenneco Energy Resources	Gas Utilities	3,750
02/26/96	Thomson Corp./West Publishing Co.	Publishing	3,425
03/27/96	Inco Ltd./Diamond Fields Resources	Mining	3,335
02/15/96	Rentokil Group PLC/BET PLC	Business Services	3,150
06/06/96	Hilton Hotels/Baily Entertainment	Gaming/Lodging	3,035
01/03/96	Northrop Grumman/Westinghouse Defense	Aerospace/Defense	3,000

[a] Salomon Brothers has provided a fairness opinion to Westinghouse Electric in this transaction. M&A Merger and acquisition.
Source: Securities Data Company.

While the volume of large international transactions remained at high levels (approximately $216.4 billion for the six-month period) cross-border volume retreated significantly with only 10% of U.S. targets being purchased by international acquirors (see Figure 10).

Figure 10. Ten Largest Cross-Border Transactions Announced in the First Half of 1996 (Dollars in Millions)

Date Announced	Acquiror/Target	Industry	Approx. Value
02/26/96	Thomson Corp. (Canada)/West Publishing Co. (USA)	Publishing	$3,425
02/15/96	Rentokil Group (Denmark)/BET PLC (UK)	Building Services	3,150
03/28/96	Koninklijke Ahold NV (Netherlands)/Stop & Shop Companies (USA)	Supermarkets	2,755
01/22/96	Farnell Electronics PLC (UK)/Premier Industrial Corp (USA)	Wholesale Electronics	2,730
02/06/96	Fresenius AG (Germany)/National Medical Care (USA)	Medical Devices	2,300
05/08/96	Adia SA (Switzerland)/ECCO (France)	Temporary Personnel Services	2,250
05/07/96	Lucas Industries PLC (UK)/VarityCorp. (USA)	Machinery	1,960
06/07/96	Willamette Industries (USA)/Hanson PLC Timberlands (UK)	Forest Products	1,730
03/11/96	Battle Mountain Gold (USA)/Hemlo Gold Mines (Canada)	Mining	1,535
02/29/96	Robert Bosch GmbH (Germany)/AlliedSignal Brake Systems (USA)	Automotive Parts	1,500

Sources: Securities Data Company. Excludes Privatizations.

Deal volumes in basic industry surged as slowing top-line growth, market share pressures, ongoing asset repackaging, rationalization activity, and, until recently, confidence-building stock market valuations created a confluence of factors that fostered strategic transactions. Notable transactions that demonstrate the depth and breadth of the current M&A market, include the acquisition of Premier Industrial by Farnell Electronics PLC, the mergers of Allegheny Ludlum with Teledyne and of Varity Corp. with Lucas Industries and the divestitures of TRW's Information Systems and Services division and Rockwell International's Graphics Printing business.

Asset repackaging transactions (spin-offs, carve-outs, and the like) also continued at high levels with significant transactions announced by Dun & Bradstreet, Hanson PLC, W.R. Grace, Dial Corp.,[4] and Tenneco. A brief interruption to this trend was caused by proposed legislation that threatened spin-offs in general and the so-called Morris Trust structure in particular. While legislative relief emerged for the short term, it is plausible that Morris Trust transactions could be significantly restricted in the future; consequently we recommend that investors accelerate such transactions to the maximum extent practicable.

Surging equity markets in the first half encouraged the increasing use of stock as an acquisition currency. Stock was the exclusive consideration for 24.9% of domestic announced transactions while another 49.6% included stock as partial consideration. In another departure from conventional wisdom, several unsolicited transactions were also structured as all-stock or cash/stock election offers.

In the first half of 1996, unsolicited transactions amounted to 7.8% of total volume or approximately $23 billion, a slowdown compared with 1995 levels. The largest such transaction, Mattel's hostile bid for Hasbro, was remarkably short-lived as a result of the fierce and rather unconventional multifront defenses mounted by the target. Following a trend established in 1995, unsolicited proposals coupled with proxy fights have become a widely accepted, broadly-applied acquisition technique. In the first, half of 1996, Eaton Corp., Danaher Corp., United Dominion Industries, and Mobil Oil, all launched unsolicited offers for strategically desirable targets.

Importantly, it has become apparent that legal defense tools, although broadly accepted, widely utilized and generally viewed as necessary, only serve as mechanisms that provide Boards of Directors with additional time, flexibility and opportunity to examine and pursue strategic alternatives. Ultimately, however, the focus in contests of control has turned almost solely to transaction economics.

[4] Salomon Brothers has been retained to advise Dial Corp. in this transaction.

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This quarter's focus topic is Salomon Brothers' new generation of tax-advantaged preferred stock: Trust Preferred Stock[SM] Units or TRUPS[SM] Units. This structure introduces a fundamentally new innovation to traditional tax-advantaged preferred securities by adding a "Preferred Purchase Contract," which ensures an issuer's access to core capital at any time. The rating agency advantages and enhanced financial flexibility of this approach are described below.

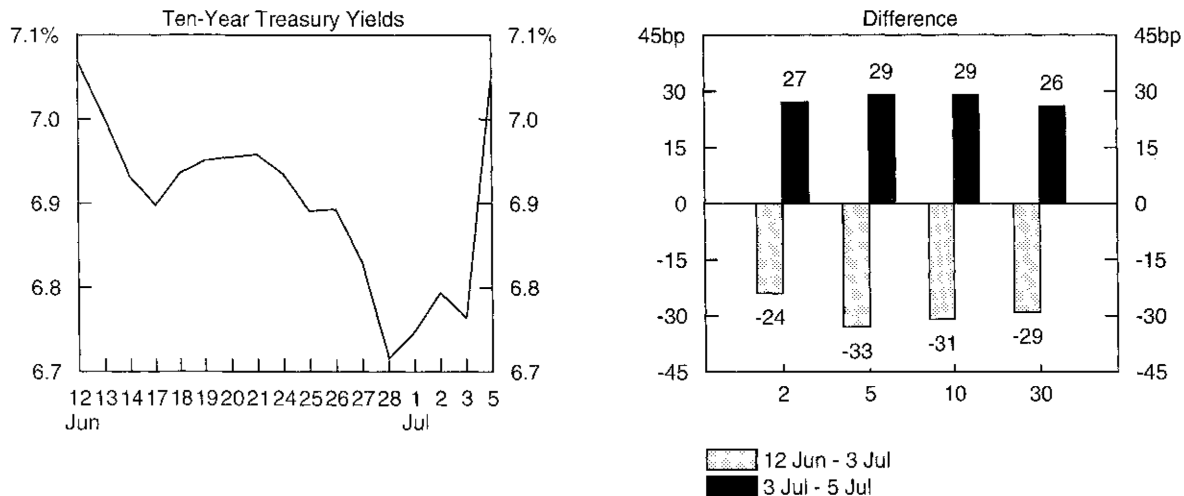
Treasury/Corporate Bond Market Update

Market sentiment appeared to be shifting in the second half of June. There was a renewed confidence that the economy would slow, inflation fears would prove to be unfounded, and bonds yields would experience the gravitational pull of a disinflationary economic environment. This rosier outlook was reflected in intraday performance. Robust economic data — in the form of housing, retail sales, durable goods, and purchasing managers' reports — was unable to restrain Treasury yields from improving by 25-30 basis points at end of June.

The Treasury market finished the second quarter on an optimistic note, only to be torpedoed by a robust employment report on July 5.

However, on July 5, the Treasury market's progress was abruptly interrupted. In response to a surprisingly strong jobs report, bond yields reversed all the hard-earned gains of the prior three weeks (see Figure 11).

Figure 11. Comparison of Market Moves: 12 Jun-3 Jul 96 and 3 Jul-5 Jul 96



Source: Salomon Brothers Inc.

Where do we go from here?

By mid-July, the bond market had achieved a remarkable turnaround, erasing most of the jobs report setback, but failing to achieve meaningful stability. Fed Chairman Alan Greenspan's Humphrey-Hawkins testimony — although underscoring the need for "heightened surveillance" — was broadly interpreted as signifying the Fed's willingness to defer a tightening of policy.

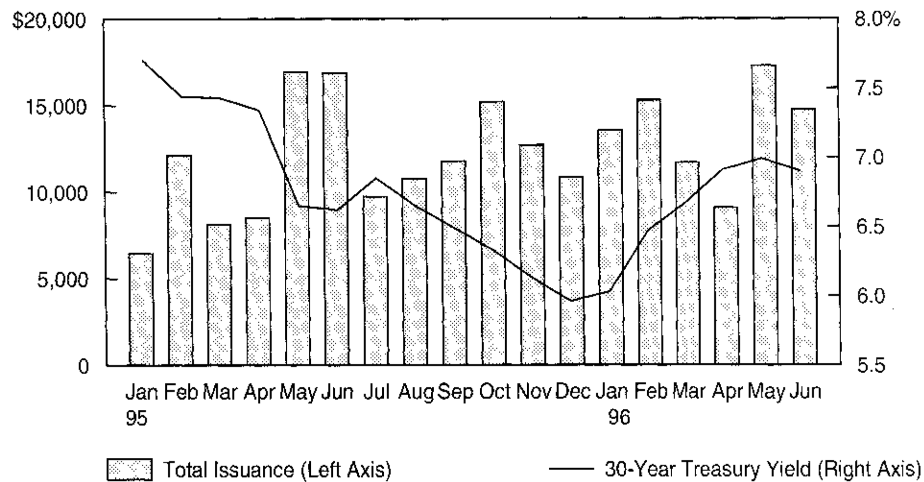
Nonetheless, fixed-income investors remain on edge. Should they buy bonds now based on a belief in an eventual second-half slowdown or wait until some hard evidence has been logged in? A faith in benign longer-term inflation fundamentals may support the market and limit significant further deterioration. Investors will carefully monitor the response of the Federal Reserve in both word and deed.

Corporate bonds, in contrast, remain in excellent technical shape.

The end of the second quarter witnessed some softening in corporate bond spreads as investors rebalanced portfolios at the end of the June. But any weakness in corporate bonds spreads was short-lived, as fixed-income investor demand continues to outpace supply.

The market's ability to absorb product was clearly reflected in Lockheed Martin's ability to distribute $5.0 billion of securities in a span of less than five weeks. The first $3.5-billion offering (six tranches) in May actually enjoyed a more enthusiastic reception than the second $1.5-billion offering (three tranches) in June, as the "scarcity" value had eroded and the second offering's maturities proved to be less popular. Lucent Technologies — the telecom equipment carve-out of AT&T — was also successful in issuing $1.5 billion of five- and ten-year debt in July. The pace of issuance is expected to slow this summer, keeping spreads firm (see Figure 12).

Figure 12. Monthly Corporate Debt Issuance, Jan 96-Jun 96 (Dollars in Billions)



Source: Securities Data Company.

Tax-advantaged preferred securities have become a fundamentally new source of capital, combining the equity content of traditional preferred stock and the tax advantages of debt.

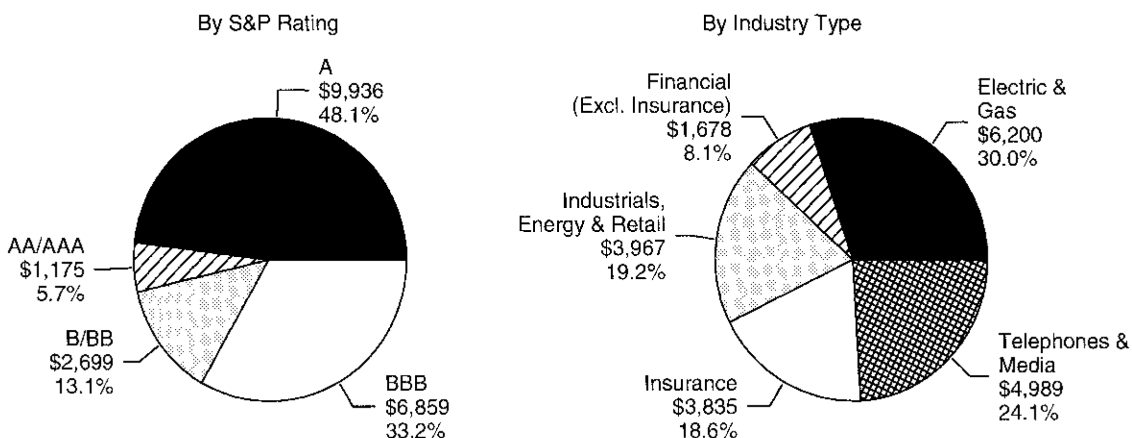
Focus of the Quarter: Salomon Brothers' Trust Preferred Stock Units

Tax-advantaged preferred securities have enjoyed a meteoric rise in popularity since the first version of the structure was introduced in October 1993. Over the past three years, more than $20 billion has been issued by companies of different credit quality and industry type (see Figure 13).[5]

Salomon Brothers' *Trust Preferred Stock*SM *Units,* or *TRUPS*SM *Units,* introduce a fundamentally new approach to this class of securities and provide both issuers and investors with significant advantages.

[5] Variations on the basic structure have also been introduced with adjustable-rate coupons and common stock conversion provisions.

Figure 14. Profile of Tax-Advantaged Preferred Issuers (Dollars in Billions)



Sources: Securities Data Company and Salomon Brothers Inc.

The inaugural issuance of TRUPS Units was priced on June 27, 1996, for Salomon Inc and raised $345 million, an increase from the announced size of $250 million.

As expected, lower credit-quality issuers have typically found reason to use the tax-advantaged preferred structure to strengthen their balance sheets. Of the $20 billion-plus of tax-advantaged preferred securities issued to date, almost 47% has been issued by companies with an S&P rating of BBB or below.

In terms of industry breakdown, the electric utility sector has tended to dominate the issuance of tax-advantaged preferred securities because of the significant amount of traditional perpetual preferred stock already on their balance sheets. For these companies, a strategy that includes calling traditional preferred stock with dividend rates of 7%-9% and refinancing with tax-advantaged preferred securities can capture annual savings of 150-300 bp. Tender offers and exchange offers have also been used by utilities and other issuers to replace traditional perpetual preferred stock with tax-advantaged preferred securities.[6]

Treasury Creates First-Quarter Moratorium

Issuance of tax-advantaged preferred securities slowed after December 7, 1995, when the Treasury Department issued a tax proposal to eliminate the deductibility of interest payments on these securities. The Republican Congress mitigated this concern after Representative Bill Archer (Chairman of the House Ways and Means Committee) and Senator Bill Roth (Chairman of the Senate Finance Committee) issued a joint statement on March 29, 1996, that the choice of effective date would be the lawmakers' decision, not that of the Treasury Department. This statement was broadly interpreted to mean that no laws would be retroactive and all transactions

[6] A number of industrial companies and commercial banks that experienced earnings pressure in the early 1990s used traditional perpetual preferred stock to placate the rating agencies. As their operating performance improved in the mid-1990s, these companies sought a strategy to take advantage of the new tax-advantaged structures, although the stock was not yet callable. Many of these industrial companies used tender offers (Transamerica, IBM, GM) and exchanges offers (McDonald's, RJR Nabisco, Ford) to refinance with tax-advantaged preferred securities before the first call date. However, commercial banks continued to utilize traditional perpetual structure in order to preserve the Tier 1 regulatory capital status of the issue, a benefit that the new structures did not offer.

completed before legislation was enacted would be "grandfathered." Although a "window of opportunity" currently exists, tax-advantaged preferred securities may be a politically threatened, if not endangered, species.

The key characteristics of tax-advantaged preferred securities have remained static...until TRUPS Units.

TRUPS Structural Innovation

The structural design of tax-advantaged preferred securities has evolved from overseas limited partnerships (LPs) to more streamlined trust structures, the current standard. Despite this lengthy evolution and some technical improvements, three basic characteristics have remained fundamentally unchanged (see Figure 14).

Figure 14. Key Characteristics of Tax-Advantaged Preferred Securities

Aspect	Characteristic	Rationale
Accounting	Minority Interest Mezzanine	Special purpose vehicle issues preferred securities and lends proceeds to issuer
Rating Agency	High Equity Content	Securities have a long maturity, are subordinated, and the issuer can defer interest payments for a fixed period of time (typically, 5 years)
Tax	Deductibility	Company deducts interest payments on subordinated debt but Trust passes taxes onto security holders

Source: Salomon Brothers Inc.

Salomon Brothers' TRUPS Units utilize the same minority-interest-like accounting structure and maintain the tax advantages, but fundamentally change the source of rating agency equity content.

TRUPS Units resemble existing tax-advantaged preferred securities in that a business trust is established to issue securities to the market and lend the proceeds back to the company. Unlike other tax-advantaged preferred securities, the TRUPS Units add a second component, a *Preferred Purchase Contract*, that requires the holder to purchase the company's perpetual preferred stock at any time until the contract's maturity (typically 25 years). This contract provides the company with unconditional access to preferred equity capital.

TRUPS Units offer a number of advantages over existing tax-advantaged preferred securities.

Advantages from the *issuer's* perspective.

The rating agencies view TRUPS Units as nearly identical to perpetual preferred stock and superior to existing tax-advantaged securities in terms of **equity content**. TRUPS Units maintain their rating agency equity content over the life of the securities, whereas the equity content of other tax-advantaged preferred securities erodes over time.

TRUPS Units provide an issuer with **guaranteed access to perpetual preferred stock**, thereby eliminating refinancing risks.

TRUPS Units give an issuer the **ability to react to changes** in the tax, accounting, or rating agency treatment of tax-advantaged preferred securities.

Advantages from the *investor's* perspective.

Issuers do **not have the ability to defer interest payments** on the TRUPS Units, unlike on other tax-advantaged preferred securities.

Payments received on the TRUPS Units are **not treated as OID income** for tax purposes.

The investors have an **option to "double up" their investment** when the issuer converts the TRUPS Units to traditional perpetual preferred stock.

TRUPS Units are priced at a cost comparable to that at which an issuer would issue other tax-advantaged preferred securities. Now that dealers and investors are more comfortable with the structure, Salomon Brothers believes that the advantages of TRUPS Units to investors may lower the cost relative to other tax-advantaged preferred securities.

First TRUPS Units offering successfully priced.

In the face of strong demand and significant institutional participation, Salomon Brothers' TRUPS Units issuance was increased in size from $250 million to $345 million (including the greenshoe).

The market for TRUPS Units remains favorable, and issuers in need of low-cost capital rich in rating agency equity content may find TRUPS Units to be a unique capital-raising opportunity.

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As Treasury yields hover near the higher end of recent trading ranges, cash-rich companies are stepping up the pace of their debt repurchase initiatives. 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. This section is a continuation of the discussion of cash-financed debt repurchase in April's CFO Quarterly.

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 15).

Figure 15. 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.

Avoid characterization as a "creeping tender offer."

Although the rules governing the execution of an open market debt repurchase program are minimal, companies must avoid the characterization of its activity as a "tender offer." Although no "bright-line" definition of a tender offer exists, the presence of a substantial number of the following eight factors is generally thought to constitute a tender offer:

(1) Active and widespread solicitation of holders:

-The number of holders solicited is a key consideration, and

-No clear limit exists, but fewer than 10 holders is likely safe;

(2) A substantial percentage of the debt issue is targeted;

(3) Offer is made at a substantial premium to prevailing market prices;

(4) Terms of the offer are firm, rather than negotiable;

(5) Offer is contingent on a minimum participation;

(6) Offer is open for a limited period of time;

(7) Pressure on holders to sell; and

(8) Public announcement precedes or accompanies a rapid accumulation of bonds.

Typically, the majority of open market repurchase programs do not meet most of these factors.

Below, we discuss some tactical considerations that may be critical to ensure the success of a debt buyback program.

Interdealer brokers may not be the best place to source bonds.

In contrast to the exchange-traded framework available for many common stocks, the secondary market for corporate bonds is completely "over-the-counter." Most activity takes place between Wall Street traders, intermediated by interdealer brokers such as Chapdelaine, Murphy & Durieu, and Cantor Fitzgerald. Available bids and offers at these interdealer brokers may be limited to the most liquid bonds, often dominated by recent deals. Hence, it may be difficult to even find offerings of the security that a company has targeted.

In addition, if bonds are available, it may be counter-productive for a company's repurchase agent to indiscriminately "lift offerings in the street" (that is, buy securities from brokers). The reason is simple: Such activity may alert the broker community to possible buying activity in the particular security, leading to an eventual ratcheting up of offering prices.

Target institutional holders discreetly.

Given the limited available float for most corporate bonds, removing these bonds from the market is likely the *worst* possible thing to do. In fact, the agent's goal should be to preserve the "float" and deftly target bonds held directly by institutional investors for "surgical" removal from the market. The discretion of most institutional investors will tend to shield such transactions from the glare of market attention. Furthermore, traders would adopt an indirect approach — focusing more on the attractiveness of a new investment ("bond swap" candidate), rather than the target bond itself.

Competition between dealers may be counter-productive.

While many companies open up debt buyback programs to multiple dealers, we continue to believe that such an approach is ultimately self-defeating. Assuming that dealers are being compensated for bonds repurchased, prices will have a natural tendency to rise with multiple dealers working a program.

For example, suppose a block of target bonds are put up for a competitive bid at a specified time during the trading session. This auction approach is one frequently used by institutional investors when they seek to liquidate multiple holdings quickly. In this situation, repurchase agents will be bidding against each other to buy the block for resale to the company. The dealer's objective is to earn his agreed-upon commission, *not* to achieve the lowest possible price for his client. The multiple-dealer approach establishes incentives for the agent that are inconsistent with the company's ultimate objectives.

Loose lips sink bond buybacks.

Leakage of information is clearly minimized by the use of an exclusive agent. But information about a debt buyback program can also filter into the marketplace from well-intentioned but naive sources that have contact with the company: accountants, lawyers, commercial paper dealers, and the like. With the common assumption in the market that the company has the "best bid" for securities, dealers may attempt to ferret out information on company intentions, often by dangling attractive, but less-than-firm, offerings of selected bonds. Controlling the flow of information is an important ingredient in a successful debt repurchase initiative.

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Contrary to conventional wisdom, empirical evidence suggests that there is no systematic payoff for firms that use pooling accounting in merger and acquisition transactions. There is no clear evidence that firms which justify higher acquisition prices because of pooling treatment are creating value for owners. Further, "purchased" goodwill appears to have value while it is being amortized despite lower reported earnings.

With M&A activity at record levels, the associated large acquisition premiums are frequently assigned to goodwill under the purchase accounting method. Except under specific circumstances, such as asset sales, amortized goodwill is not tax deductible. Thus, goodwill typically has two negative effects: it reduces reported earnings without the benefits of cash flow-increasing tax deduction.

Consequently, some corporate executives like to avoid the recognition of goodwill by structuring transactions as "poolings of interests," which merges two firms by essentially adding the book values of their net assets. Though pooling accounting needs to satisfy various restrictive criteria, some executives place a high value on the accounting effects of pooling and may even pay higher acquisition premiums for transactions in which pooling accounting is allowed.

In pooling accounting, the balance sheet appears smaller because of the use of book values and the exclusion of goodwill. As such, pooling accounting typically results in higher net incomes, earnings per share and returns on equity. It has been suggested that managers might be inclined to choose pooling accounting because: (1) their compensations might be tied to accounting earnings which would be typically higher under pooling; (2) they are attempting to hide large acquisition prices; or especially because (3) they are concerned with how the market will react to earnings dilution. There is, however, no empirical support for reasons one and two. Reason three, on the other hand, has been an issue in a variety of empirical studies.

Conventional wisdom suggests that pooling accounting is beneficial to an acquirer's stock price; while the proponents of efficient markets argue that cosmetic changes which do not affect underlying cash flows have no lasting effects on value. A significant amount of empirical literature has addressed this controversy by studying and comparing the effects on market prices of firms that have chosen each type of accounting treatment. This literature concludes that:[7]

(1) In general, upon announcements of the transactions, stock prices of companies that pool do not react more favorably than those of companies that use purchase accounting.

(2) During the period following transactions when goodwill has already been recorded and is being amortized, stock prices of companies that use purchase treatment generally perform as well as those of companies that use pooling. This suggests that goodwill is a valued asset in the market reflecting future earnings and cash flow generating power that offsets lower reported current earnings.

[7] For further details, see (1) "The Purchase vs. Pooling Controversy: How the Stock Market Responds to Goodwill," Michael L. Davis, *Journal of Applied Corporate Finance*, Spring 1996. (2) "Pooling vs. Purchase: The Effects of Accounting for Mergers on Stock Prices," H. Hong, R. Kaplan, and G. Mandelker *The Accounting Review* (January 1978). (3) "Differential Market Reactions to Pooling and Purchase Methods, "M. L. Davis, *The Accounting Review*, July 1990.

In summary, the market does not reward firms for using pooling accounting *per se*. In general, economic (cash flow) benefits are what matter in market valuations and acquisition prices should reflect those benefits and not the choice of accounting method. These conclusions, however, reflect the empirical evidence, and may not apply to each and every transaction. Therefore, it is important that every corporate manager whose prospective transaction hangs on the availability of pooling ask the following question: What makes my transaction different from the broader group of transactions for which pooling has made no noticeable difference to shareholder value?

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