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Salomon Brothers

The CFO Quarterly — October 1996

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INTRODUCTION AND SUMMARY

Economic, Policy and Market Trends

Industrial country growth prospects are improving. The U.S. expansion has been above-trend during the year's first half, and the recent spending lull likely will prove to be temporary. Renewed above-trend U.S. growth in the coming months likely will justify a Federal Reserve rate hike later this year. As economic growth quickens, near-term risks lie on the side of higher yields in most major markets. The long-term outlook for the U.S. dollar versus European currencies remains favorable. Recent increases in Japanese trade surpluses eventually will partially reverse part of the recent dollar gains versus the yen.

Fixed-Income Market Trends

The Treasury market continued to trace out the same 50-basis-point trading range that persisted in the second quarter. Investors and economists remain unclear whether the economy will slow in the second half and whether inflation risks are real. Although corporate debt issuance volume remained constrained by market uncertainty, the put bond structure has soared in popularity. The focus essay of this quarter describes the process of rating agency management from the perspective of the financial executive.

Liability Management Trends

In-substance defeasance is a liability management tool that removes debt from the balance sheet through creating an irrevocable trust of matching Treasury securities. This tool will no longer be available starting in 1997; a new accounting rule (FAS 125) will eliminate in-substance defeasance from the current rules for debt extinguishment (and update the remaining rules) as currently set out in FAS 76.

Merger-and-Acquisition Trends

During the traditionally slower summer quarter, the merger and acquisition (M&A) market showed no signs of retreating. Activity in media and telecommunications, utilities and retail continued unabated while the third quarter saw the resurgence of interest in significant transactions in the financial services sector. Despite a downturn early in the quarter, record stock market valuations supported an unprecedented number of stock-for-stock transactions while asset repackaging transactions (divestitures, spin-offs etc.) continued. At the market's current pace, transaction volume for 1996 is likely to exceed 1995's record by a substantial margin.

Equity Market Trends

The third quarter of 1996 included some sizable equity offerings following on from the heavy equity carve-out activity in the previous quarter. Salomon Brothers lead managed the largest domestic offering in the quarter for MFS Communications raising $1.32 billion in gross proceeds. Other large offerings included those for Electronic Data Systems ($933 million) and Lear Corporation ($503 million).

Corporate Equity Derivative Trends

With the sharp rise in the stock market over the past few years, many companies have seen their economic and accounting exposure from employee stock options (ESOs) dramatically increase. Most companies fund their ESO requirement by purchasing stock from time to time in the open market. While this ultimately offsets the accounting dilution, it ignores the economic cost and interim accounting dilution of an ESO program. In this report, we review two proactive strategies for hedging the economic exposure and dilution created by employee stock options.

Topic of the Quarter

As discussed previously, actively managing the rating agency relationship can have a real "bottom-line" impact on a company's financial performance. The rating agency process relies on both quantitative and qualitative factors. Even though the qualitative aspects of a credit-rating model are critical, the Salomon Brothers Credit Rating Model can often explain 90% of the variation in ratings for companies in a given industry. Consequently, we recommend that companies consider using a statistical Credit Rating Model in addition to qualitative factors in managing their "rating-agency" relationships and planning capital structure strategies.

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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 U.S. expansion has been above-trend during the year's first half, and the recent spending lull likely will prove to be temporary. The Japanese economy continues its moderate recovery, although a growth slowdown is looming in 1997. European growth is picking up, albeit unevenly, with prospects for trend growth or slightly higher in 1997.

Question 2

What are the economic policy prospects for major industrialized countries?

Answer 2

Renewed above-trend U.S. growth in the coming months likely will justify a Federal Reserve rate hike later this year, while the period of cyclical easing appears to be completed in Germany. At the same time, Japanese short-term rates are now expected to remain on hold indefinitely, in light of the more contractionary stance of fiscal policy.

Question 3

How have the major markets performed in the third quarter of 1996?

Answer 3

Figure 1. Total Rates of Return of Selected Asset Classes, 3Q 95-3Q 96

Asset Class	3Q 96	2Q 96	1Q 96	4Q 95	3Q 95
Treasury	1.67%	0.44%	-2.22%	4.64%	1.68%
Corporate	2.01	0.35	-2.45	4.94	2.23
Mortgage	2.10	0.68	-0.47	3.37	2.02
High Yield	4.08	1.30	1.58	3.38	3.01
Emerging Markets	10.41	9.17	4.46	9.31	6.58
S&P 500	2.49%	3.89%	4.80%	5.39%	7.28%

Source: Salomon Brothers Inc.

Question 4

What is the near-term market outlook?

Answer 4

As economic growth quickens, near-term risks lie on the side of higher yields in most major markets. However, eventual Fed action will cap the U.S. bond sell-off, and help set the stage for future yield declines. Noncore European markets will benefit from low inflation and falling deficits, as well as low German short-term rates. Japanese markets 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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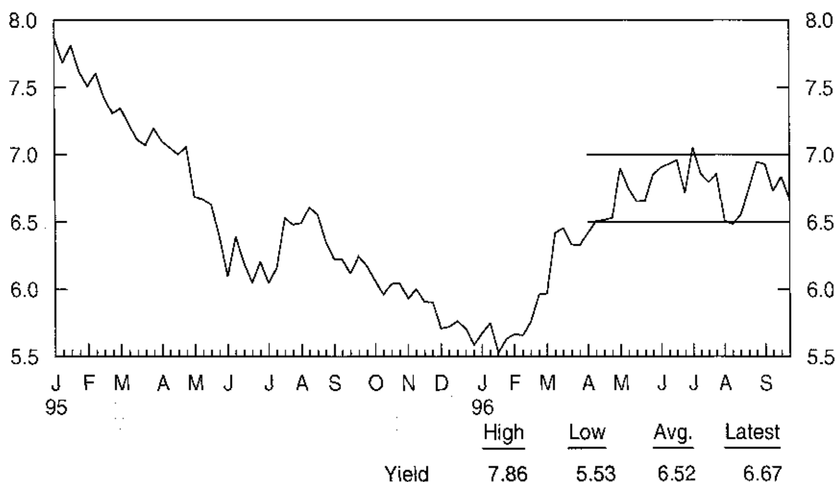
The Treasury market continued to trace out the same 50-basis-point trading range that persisted in the second quarter. Investors and economists remain unclear whether the economy will slow in the second half and whether inflation risks are real. Although corporate debt issuance volume remained constrained by market uncertainty, the put bond structure has soared in popularity. The focus essay of this quarter describes the process of rating agency management from the perspective of the financial executive.

"Sound and fury signifying nothing"... the Treasury market remained range-bound in the third quarter despite high volatility.

Treasury yields have varied in a 50-basis-point (bp) range over the last six months, reflecting market ambivalence about the robustness of the U.S. economy and its impact on wage inflation and consumer prices. For example, 10-year rates peaked in early July (7.06%) and bottomed in mid-August (6.48%), but closed the quarter within ten bp of where they started (see Figure 1). The Treasury market continues to be buffeted by often conflicting data on corporate capital outlays, the consumer's willingness and ability to spend, and the sustainability of both job growth and current price levels. Salomon Brothers remains long-term bullish, but still concerned about the risks of a consumer snapback and the resulting pressure on interest rates.

Figure 2. Ten-Year Treasury Yields: 3 Jan 95-30 Sep 96



Source: Salomon Brothers Inc.

Whither Fed policy?

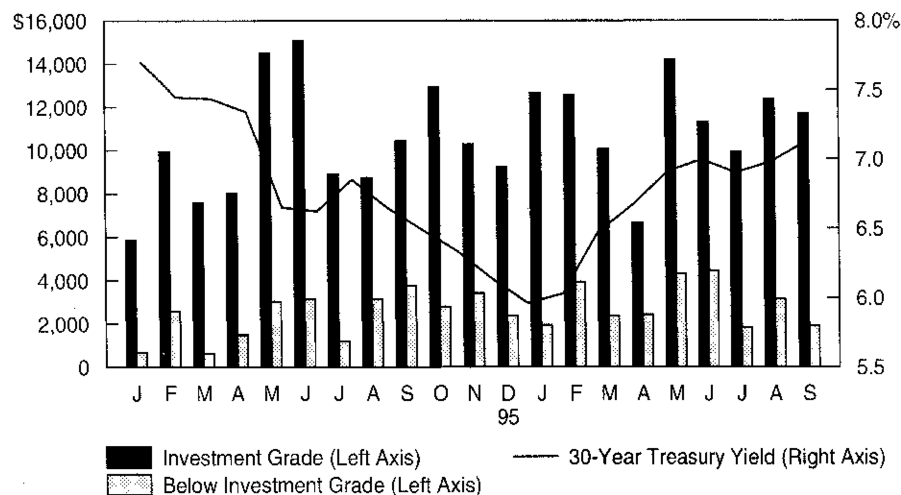
Fed watchers may be tempted to jump to two erroneous conclusions after the Fed's recent decision (on September 24) to leave rates unchanged: First, some observers may believe that Fed Chairman Allan Greenspan's reticence was inspired more by the impending presidential election than economic statistics. This is unlikely given Greenspan's uncompromised commitment to an independent Fed and recent evidence on retreating consumer activity that likely influenced the Fed's decision. Second, we do not believe that a shift in Fed policy is ruled out at the November 13 FOMC meeting. Rather, the Fed will continue to monitor incoming growth and inflation data and fine-tune policy accordingly.

Merger activity and the repackaging of corporate assets through spin-offs remain two prime sources of debt financing activity.

In July, **Lucent Technologies** — the telecom equipment business carved out of AT&T — issued $1.5 billion in an inaugural debt offering of five-year and ten-year notes. The issue was well-received given the company's strong credit profile (the notes were rated A2/A), global presence and expectation of only limited issuance going forward. The ten-year notes were priced at a spread of +45 bp. The proceeds of the offering termed out some of the $4 billion of commercial paper assumed by Lucent in establishing its new capital structure.

The other megadeal of the quarter was **Aetna Service**'s offering of $1.4 billion in a four-tranche offering of five-year, ten-year and 30-year bullets and a 40 put/8 structure in mid-August. The bonds were rated A2/A-. The ten-year notes were priced at a spread of +65 bp. Proceeds were earmarked for the refinancing of $1.4 billion in commercial paper that Aetna used to acquire U.S. Healthcare.

Figure 3. Monthly Corporate Debt Issuance, Jan 95-Sep 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.

Put bonds are breaking records in 1996.

The Popularity of Put Bonds: "It's the Shape of the Yield Curve!"

Put bonds are back with a vengeance. Corporate issuers have already raised over $10 billion of put bonds year to date in 1996, eclipsing the all-time high of $8.8 billion set in 1989. The goal of this section is to explain the appeal of the put bond structure to both issuers and investors.

Diversity of issuer type, issuer rating and structure.

Put bond issuers this year have not been limited by industry sector or credit quality. Industrial companies, utilities and financial institutions have all been participants in the put bond issuance spree. Although historically the 30 put/10 structure has dominated, alternative structures have recently proliferated. Final maturities range from ten to 30 years and put dates vary from two to 12 years. More exotic structures have included multi-put structures and put bonds with subsequent call or make-whole call provisions.

What is a put bond?

Despite the name, a put bond is better thought of as an "extendible" bond. For example, a 30 put/5 bond is really a five-year bond where the issuer

has sold the investor an option to "extend" the bond for another 25 years (i.e., when the five-year bond matures, the investor has a one-time call option to purchase a new 25-year bond with the same coupon). In contrast to a callable bond, the issuer is selling rather than buying an option and the option is *European* rather than *deferred American*.

How are put bonds valued?

The pricing of put bonds is important because it helps answer the question why the structure is so popular. The difference between 30-year and five-year Treasury yields is currently near 1/2%. In such an environment, the value of the extension option is about 14 bp, consistent with recent pricing (see Figure 4). What if the curve steepens, pivoting on the 5-year yield? The value of the extension option drops to almost nothing.

Figure 4. Pricing of Put Bonds Relative to the Shape of the Yield Curve

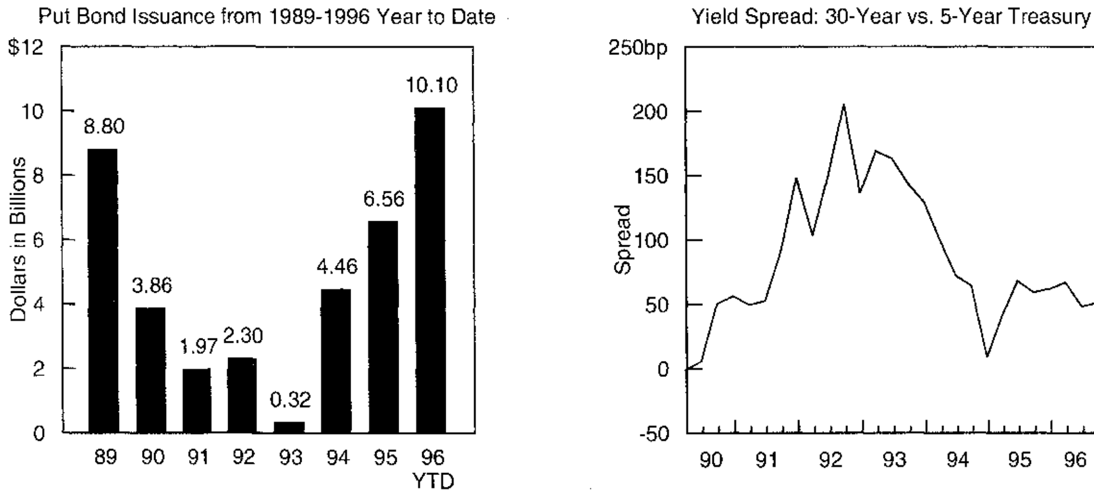
Yield Curve Steepness	Yield Curve Slope[a]	Forward Rate[b]	Value of Extension Option
Current	43bp	7.17%	14bp
Steeper	156	9.06	0.5
Flatter	16	6.76	30

[a] Measured by difference between 30-year and 5-year Treasury yields. [b] Twenty-five year maturity forward rate, five years forward.
Source: Salomon Brothers Inc.

The shape of the Treasury yield curve is critical.

Why? Because a steep yield curve implies high forward rates and therefore the extension option is deep out-of-the-money. Similarly, in a flat yield curve, the value of the extension option more than doubles to 30 bp and investors would likely be reluctant to sacrifice this amount of yield. Hence, 50 bp of yield curve steepness is the "sweet spot" of put bond issuance. This theoretical observation is consistent with the historical record (see Figure 5).

Figure 5. Put Bond Issuance versus the Historical Yield Spread Between 30-Year and Five-Year Treasury Yields, 4Q 89-2Q 96



Source: Salomon Brothers Inc and Securities Data Company.

The role of volatility.

Investors take a critical look at the valuation implicit in put bond pricing. Option prices depend on a *volatility* assumption. Corporate put bonds are priced with volatilities of 8%-10%. Volatility in the derivatives market is often closer to 14%. Investors conclude that put bonds are a vehicle to buy cheap options, or cheap volatility. So-called asset swappers often sell the option in the derivatives market and create attractive floating-rate assets.

The role of convexity.

Positive *convexity* is another appealing characteristic of put bonds for investors. Callable bonds and mortgages have negative convexity, meaning that, in practice, these securities underperform in rallies. Put bonds correct this problem by outperforming in rallies and providing a natural hedge.

Issuer perspective.

Finally, why do issuers like put bonds? A 30 put/5 bond is either a five-year bullet or a 30-year bullet. In both cases, the issuer enjoys savings. If the extension option is exercised, the issuer has a 30-year bond with a coupon significantly below currently-prevailing market levels. In many cases, the yield savings that a put structure creates helps the issuer achieve an all-in cost bogey under 7%.

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The rating agency dialogue should be a continuous one, particularly as strategic actions impact credit quality.

Focus of the Quarter: Managing the Rating Agency Dialogue

For better or worse, the rating agencies have a significant impact on a company's cost of capital. With acquisitions, restructurings and spinoffs playing a larger role in corporate strategy, credit quality can be volatile. Actively managing the rating agency relationship can have a real "bottom-line" impact on a company's financial performance. We believe that the issuer can benefit from the insights of an experienced ratings advisor to help avoid some of the pitfalls of the often opaque, and occasionally contentious, relationship with the rating agencies.

Companies can achieve ratings that are stronger than those implied by historical credit ratios.

The rating agency process is multi-faceted, involving both quantitative analysis of credit ratios, qualitative assessment of a business position and an often subjective evaluation of management depth. Companies typically underappreciate the "softer" qualitative factors, but both sides of the story needs to be part of a well-crafted management presentation.

For example, rating agencies look as carefully at forecasted credit statistics as they do at historical financial performance. If the business plan is credible, rating agencies may incorporate the next two to three years of forecasts into the evaluation process to avoid a rapid succession of ratings changes. The concept of a company "growing into" its rating is broadly accepted and can help a company achieve a targeted rating.

We would emphasize here that credibility is key. Companies need to deliver what they promise or risk a ratings penalty. Failure to achieve debt reduction targets, for example, will require an explanation of the mitigating business circumstances and a timetable by which the promised deleveraging will occur.

Don't underestimate the importance of commitment.

The qualitative aspects of a company's presentation often bear more heavily in the rating decision than the detailed pro formas. Credit analysts need to understand the company's philosophical attitude toward credit quality, its creditors in general and bondholders in particular. Does management have a healthy appreciation and respect for its providers of debt capital? Does management believe that an investment-grade rating or, for example, a strong single-A rating is a critical element in the company's strategic plan? What approach has the company historically adopted toward acquisition financing? Is management slavishly devoted to a high dividend payout policy? Has management engaged in actions that could be viewed as abusive to bondholders?

Again, it is important to have a well-balanced outlook incorporating optimism and caution without over-promising. If a company has an aggressive acquisition strategy, it will need to clarify the possible balance sheet pressures that will result. If management believes that a spike in leverage can be managed down over a realistic time frame, a negative ratings action may be avoided.

Understand how the agencies and their analysts think.

Changes in rating agency personnel can be frequent. Such changes can be both a challenge and an opportunity. Although issuers bemoan having to educate a new analyst, the strategy to help that process along can bear fruit.

One of the less well-known aspects of the rating process is the use of industry-specific rating criteria. Relevant criteria identify the important factors comprising industry structure, the company's business position, specialized accounting matters, and industry credit ratio norms. Unlike

static numeric benchmarks, current criteria include industry, agency and analyst "hot buttons" which can greatly affect ratings. Individual issuers may not be aware of the specific changes to criteria, but they reflect the agency's changing views of industry prospects. Your advisor should alert you to these factors and assist you in addressing these concerns.

Experienced advisors will benefit first-time borrowers . . .

For a first-time public market debt issuer, management may be unfamiliar with the rating agency process, timeline and content. An experienced ratings advisor can often assist the company in selecting a ratings target, choosing which agencies to approach and designing the presentation to achieve that objective. The agencies — in contrast to the equity analyst community — will likely be more interested in the long-term stability of the business' cash flows rather than prospects for growth. Credit analysts inevitably focus on downside risks, not upside potential. It will be important to discuss how the company fared in recent business downturns and what safeguards are in place to hedge these exposures in the future.

. . . and frequent borrowers that are active in corporate restructuring or merger activity.

The balance sheet of many companies is highly cyclical: weakening in response to the capital requirements of an acquisition and strengthening as cash flow builds and is directed toward debt retirement. A well-articulated M&A philosophy is critical for such companies to avoid unnecessary rating volatility. If the company's target rating is triple-B, state that explicitly and explain why a single-A rating is not part of the company's financing philosophy. As in any business relationship, minimizing surprises is key to a constructive dialogue.

Be sensitive to rating agency challenges.

The responsibility of the ratings analyst has broadened over the last decade. The advent of the high-yield market has required the analyst to master the tools for assessing the creditworthiness of a highly-leveraged capital structure where traditional balance sheet measures are considerably less important. The proliferation of new "equity-content" securities (such as DECS, MIPS and PERCS) has required the analyst to assess the rating impact of these securities consistent with agency policy and individual sector credit conditions. While the issuer may only do one such transaction, the experienced ratings advisor who has worked with the agencies during the product development and rollout stages of new capital markets technology is better positioned to help explain the rating benefits and credit quality impact.

Don't fly blind.

The CFO should view the rating agency relationship as a complex one which needs to be actively managed over a long time horizon. As rating agency personnel change, ratings criteria are modified and rating philosophy evolves, the corporate issuer should keep abreast of these policy shifts. We believe that an advisor who is plugged into the rating agency dynamic can add immeasurable value to navigating the ratings labyrinth.

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Defease It While You Can

In-substance defeasance is a liability management tool that removes debt from the balance sheet through creating an irrevocable trust of matching Treasury securities. This tool will no longer be available starting in 1997: A new accounting rule (FAS 125) will eliminate in-substance defeasance from the current rules for debt extinguishment (and update the remaining rules) as currently set out in FAS 76.

A return to more conservative accounting.

In-substance defeasance, a concept established by FAS 76 in 1983, is one of the few times that assets and liabilities can be netted on the balance sheet. Accounting pundits have long maintained that such netting should occur only upon a legal right of offset or a legal release as primary obligor. FAS 125 returns the accounting standards to this more conservative approach.

Corporations will lose a useful tool . . .

Over the last few years, in-substance defeasance has been a useful complement to debt tender offers and open-market repurchase programs. Although the defeasance approach is typically less economical, it avoids bondholder involvement and hence guarantees success. In addition, in-substance defeasance (1) provides a worst-case scenario for many liability management strategies, and (2) allows balance-sheet tidying through the elimination of near-term maturities and debt tag-ends.

. . . and will find covenant defeasance less attractive.

The new accounting rule also will make executing a *covenant* defeasance less attractive by causing balance-sheet ballooning. Covenant defeasance is a specific debt provision that grants financial-covenant relief upon establishing an appropriate portfolio of Treasury securities. Typically it is more economical to remove financial covenants by paying bondholders through a consent solicitation, but a covenant-defeasance provision provides certainty at a price. That price soon will be higher because netting the Treasury portfolio as an in-substance defeasance will no longer be available and might be possible only through a complicated trust structure.

Four forms of defeasance exist currently.

Four forms of defeasance exist currently, with near-identical economics. Eliminating in-substance defeasance will give covenant defeasance the same drawback as economic defeasance: balance-sheet ballooning. Legal defeasance will be unaffected by the accounting change.

Figure 6. Summary of the Four Current Forms of Defeasance

	Economic	In-Substance (Currently)	Covenant (Currently)	Legal
Balance Sheet	On	Off	Off (by being an in-substance defeasance)	Off (legally eliminates liability)
Income Impact	No	Yes	Yes	Yes
Tax Impact	Over time	Over time	Over time	Up front
Governing Rules	None	Accounting Standards	Indenture	Indenture
Comments	Balloons balance sheet	Used to remove balance sheet debt	Used for covenant relief	Required tax opinion typically prohibits

Source: Salomon Brothers Inc.

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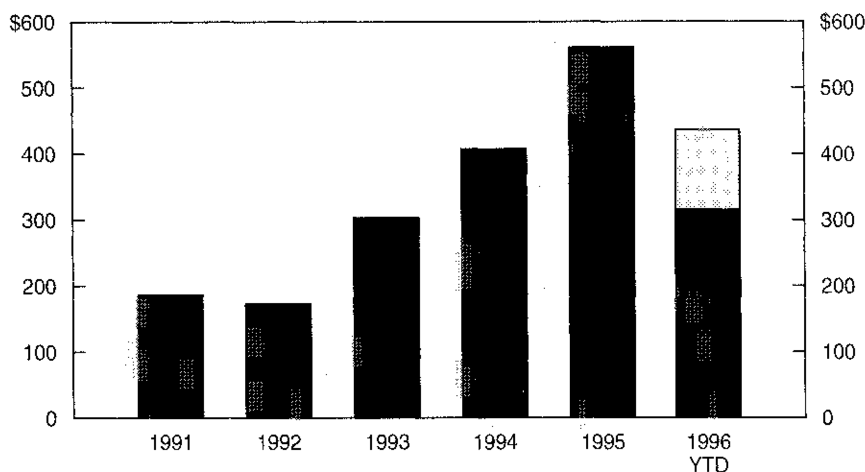
During the traditionally slower summer quarter, the merger and acquisition (M&A) market showed no signs of retreating. Activity in media and telecommunications, utilities and retail continued unabated while the third quarter saw the resurgence of interest in significant transactions in the financial services sector. Despite a downturn early in the quarter, record stock market valuations supported an unprecedented number of stock-for-stock transactions while asset repackaging transactions (divestitures, spin-offs etc.) continued. At the market's current pace, transaction volume for 1996 is likely to exceed 1995's record by a substantial margin.

Figure 7. Volume of Domestic M&A Transactions, 1991-96 YTD (Dollars in Billions)



M&A: Mergers and acquisitions. YTD: Year to date.
Note: For U.S. domestic announced transactions only, excluding share repurchases, split-offs and recapitalizations. Shaded area represents 3Q 1996 transaction volume.
Source: Securities Data Company.

Activity in the telecommunications and media sectors continued to lead the charts in terms of transaction size and visibility. Having only announced its intent to merge with UUNet in April, MFS Communications was acquired by WorldCom in the quarter's bellwether transaction that created a telecommunications company that provides one-stop long-distance and business communications services as well as internet access. On the media front, News Corp. agreed to acquire New World Communications expanding its U.S. broadcasting assets; A.H. Belo entered into a merger agreement with the Providence Journal Company, further strengthening its presence in regional publishing and broadcasting; and Silver King Communications vertically-integrated into production by agreeing to acquire Home Shopping Network from Liberty Media.

In a related segment, Hughes Electronics advanced its leadership in direct broadcast satellite television through the acquisition of PanAmSat, gaining complete DBS coverage of the Americas. Simultaneously, Loral Space and Communications, a spin-off of the highly acquisitive Loral Corp., pushed aggressively into Hughes' territory by acquiring AT&T's Skynet system.

Finally, Kirk Kerkorian returned to action. Kerkorian, one of last year's most talked-about characters in the M&A arena, acquired Metro-Goldwyn-Mayer for the third time, with promises of restoring the legendary movie studio to its erstwhile leading reputation.

Ongoing deregulation pressures in the utility sector continue to generate very significant levels of M&A activity. On the contested front, Western Resources was successful in defusing the KCP&L/Utilicorp transaction while MidAmerican Energy Company was unsuccessful in short-circuiting the three-way merger between IES Industries, Interstate Power and WPL Holdings.

Simultaneously, friendly utility mergers continued to grow in size and scope resulting in diversified, broad-based providers of bundled services and continuing the convergence trend between electric and gas utilities. This trend is exemplified by Houston Industries' acquisition of NorAm Energy and Enron's acquisition of Portland General. The merger between Centerior Energy and Ohio Edison combined two nuclear utilities in an effort to keep pace with lower-cost regional competitors.

In the retail sector where fierce competition necessitates ever-higher levels of efficiency and price leadership, numerous transactions were announced in the third quarter: Staples agreed to acquire Office Depot; Phar-Mor signed an agreement with ShopKo Stores; Revco D.S. launched an unsolicited bid for Big B; Thrift Drug announced it will acquire Fay's; Toys "R" Us agreed to acquire Baby Superstore; and Sears signed up Orchard Supply Hardware.

Financial Services, a sector that is also characterized by both deregulation and significant cost pressures, and which has had historically experienced very high levels of consolidation activity, returned to the spotlight with the acquisition of Boatmen's Bancshares by NationsBank, the sale of American Re to Germany's Muenchener Rueckversicherungs, the acquisition of First Colony by GE Capital, and the restructuring of Ford Motor Company's multi-billion dollar transportation and industrial leasing portfolio.

Figure 8. Ten largest M&A Transactions Announced in the Third Quarter of 1996 (Domestic Targets Only, Dollars in Millions)

Date Announced	Acquiror/Target	Industry	Approx. Value
8/26/96	WorldCom/MFS Communications	Telecommunications	$13,350
8/30/96	NationsBank/Boatmen's Bancshares	Banking	9,475
9/12/96	Gillette Co./Duracell International	Consumer Products	7,020
8/14/96	Muenchener Rueckversicherungs/American Re	Insurance	3,745
8/9/96	Houston Industries/NorAm Energy	Electric & Gas Utilities	3,595
9/4/96	Staples Inc./Office Depot	Retail	3,485
7/19/96	Enron Corp./Portland General	Electric & Gas Utilities	3,222
8/1/96	Boeing Co./Rockwell Aerospace & Defense	Aerospace/Defense	3,130
9/20/96	Hughes Electronics/PanAmSat	Telecommunications/Media	3,000
7/17/96	News Corp./New World Communications Group	Media	2,470

Source: Securities Data Company.

Other notable transactions in the third quarter span the entire spectrum of industries and structures: Gillette's acquisition of Duracell that created a consumer goods powerhouse dominated the headlines; Boeing's acquisition of the majority of Rockwell International's Aerospace and Defense assets employed a Morris Trust structure; while Johnson Controls successfully pre-empted what promised to be a "frothy" auction to acquire Michigan-based Prince Automotive. In basic industry, Laidlaw Waste Systems was acquired by Allied Waste Industries while the Potash

Corporation of Saskatchewan agreed to acquire Arcadian. In health care, PacifiCare agreed to acquire FHP International in yet another consolidating transaction in the health maintenance organization (HMO) sector. In technology, Japan's Softbank agreed to acquire Kingston Technology continuing on a path of aggressive growth through acquisitions.

Significantly, cross-border transactions represented approximately one-third of global M&A volume during the quarter. However, only two of the quarter's largest transactions were acquisitions of U.S. targets by overseas acquirors.

Figure 9. Ten Largest Cross-Border Transactions Announced in the Third Quarter of 1996 (Dollars in Millions)

Date Announced	Acquiror/Target	Industry	Approx. Value
9/17/96	Service Corp. International (USA)/Loewen Group (Canada)	Funeral Services	$5,365
8/14/96	Muenchener Rueckversicherungs (Germany))/American Re (USA)	Insurance	3,745
8/27/96	Swiss Re (Switzerland)/Mercantile & General Reinsurance (UK)	Insurance	2,720
9/2/96	Potash Corp. of Saskatchewan (Canada)/Arcadian Corp. (USA)	Fertilizers	1,695
9/17/96	Compagnie de Suez (France)/Tractebel SA(Belgium)	Holdings Companies	1,570
8/15/96	Softbank (Japan)/Kingston Technology Corp.(USA)	Technology	1,500
9/16/96	Independent Newspapers PLC (Ireland)/Wilson & Horton Ltd.(New Zealand)	Media	1,455
9/6/96	Canal + (France)/NetHold BV (Netherlands)	Media	1,440
8/26/96	SKW Trostberg (VIAG AG)(Germany)/MBT (Sandoz) (Switzerland)	Building Products	1,080

Note: Excludes privatizations.
Source: Securities Data Company.

In unsolicited transactions, the third quarter marked a key season for the defense: After more than a year and a proxy fight, Moore Corp. scuttled its unsolicited bid for Wallace Computer Services while Commercial Intertech succeeded in fending off United Dominion. Shareholder rights plans, staggered boards and, most importantly, well-crafted and thoroughly-documented business plans represented the linchpin of both Wallace's and Commercial Intertech's successful "just-say-no" defenses.

Stock-for-Stock Transactions

Despite a short-lived downturn early in the quarter, record stock market valuations supported an unprecedented number of stock-for-stock transactions representing 81.5% of the quarter's total dollar volume. All five of the largest transactions announced in the quarter (see Figure above) were stock-for-stock transactions. Moreover, as the number of stock deals surged and market values have increased, the merger-of-equals concept has become more commonplace.

Mergers-of-equals (MOEs) are defined as stock-for-stock transactions between similar sized companies that represent a business combination rather than an outright acquisition of one by the other. Typical MOEs do not involve a control premium because neither party is viewed as relinquishing control; consequently, the board of directors of the new entity, as well as management positions, name, headquarters locations etc., are "shared" in a balanced fashion. MOEs present an attractive structural alternative, because they are typically less costly than a high premium acquisition and they provide a fair and efficient way for both companies' shareholders to share in consolidation cost savings and other merger benefits. However, MOEs hinge on a host of governance-related issues and provisions which need to be thoroughly analyzed and extensively negotiated.

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The third quarter of 1996 saw some sizable equity offerings following on from the heavy equity carve-out activity in the previous quarter. Salomon Brothers lead managed the largest domestic offering in the quarter for MFS Communications raising $1.32 billion in gross proceeds. Other large offerings included those for Electronic Data Systems ($933 million) and Lear Corporation ($503 million).

The foreigners are coming.

The third quarter saw also sizable issuance of equities in the U.S. by foreign companies: Salomon Brothers lead managed a $3.2 billion global offering for Commonwealth Bank of Australia; a $350 million offering under Rule 144a for SAP of Germany, one of the world's leading business computer software companies; and a $500 million offering for Tag Heuer. Significant placement with U.S. institutional investors was a common theme among these offerings. Furthermore, the pace of foreign equity offerings looks set to increase in the fourth quarter of 1996 with large privatization offerings of Eni S.p.a., the Italian oil company, and the long-awaited offering of Deutsche Telekom shares.

Net Convertible Issuance continues to be negative — merger-related converts and post-Labor Day issuance fills the void.

Much has been made of the benefits for prospective issuers of the negative net issuance of convertible securities in 1995 and for the first nine months of 1996. While issuers have been slow to access the markets directly, additional supply of new convertible securities has come from merger activity which has resulted in almost $4 billion of securities being distributed in 1996 through September (see Figure 10).[1]

Figure 10. Recently Created Merger-Related Convertible Securities, Sep 96 (Dollars in Millions[a])

First Trading Day	Issuer	Security Type	Coupon/ Dividend	Par Amount	Issue Size	Conversion Price	Initial Conv. Premium	Maturity	First Call Date
4/12/96	Premier-Farrell[b]	Cvt Pref ADS	$1.35	$25	$699	$24.17	19.4%	perpetual	NCL
6/13/96	Aetna Inc	DECS	6.25%	76.125	874	92.869	22.0%	7/19/00	7/19/99
6/25/96	TJX Companies[c]	DECS	7.00%	100	150	18.525	20.0%	11/17/98	11/17/98
7/31/96	TeleCommunications Inc[d]	Cvt Pref	5.00%	100	626	20.79	12.4%	7/31/06	8/15/01
8/19/96	AirTouch Comm.[e]	Cvt Pref	4.50%	50	504	36.258	25.0%	8/16/16	8/16/00
8/19/96	AirTouch Comm.	DECS	6.00%	29	500	35.96	24.1%	8/16/99	8/16/99
8/21/96	Inco Limited	Cvt Pref	5.50%	50	500	41.85	26.8%	8/21/06	8/21/01

[a] Except per-share amounts. [b] Company has option to mandatorily convert after April 2001 if 75% of shares converted [c] Holder can only convert into shares of Series A TCI Group shares beginning 7/31/01. [d] Provisional call in year four at 130% of conversion price. Between 8/00 and 8/06 call paid only in common, thereafter cash or common.
Source: First Call and Salomon Brothers Inc.

In addition a flurry of issuance in September raising $2.3 billion in gross proceeds rounded out a fairly active quarter for the convertible market. Two particularly notable transactions included The Sports Authority convertible debenture offering which was marketed overnight, and the $1 billion offering of convertible debentures by the Home Depot. The latter transaction was filed with the SEC on Tuesday, September 24 as an $800-million offering and subsequently priced as a $1 billion transaction with a 3.25% coupon and a 22.08% conversion premium. The company undertook only a limited number of investor meetings and conference calls. The convertible market remains robust as institutional investors flush with cash continue to look for new securities in which to invest.

[1] See *Convertible Securities Monthly*, Anand Iyer, et al., Salomon Brothers Inc, April 1996 and August 1996.

Figure 11. U.S. Convertible Issuance, Sep 96

Offer Date	Issuer (Ticker)	Security Type	Amount ($mm)	Coupon/ Dividend	Initial Conversion Premium
09/16/96	Pep Boys (PBY)	Zero Coupon Cvt Debt	$237	0 (4% YTM)%	22.00%
09/16/96	Wendy's Financing I (WEN)	Tax-Advantaged Cvt Pref	200	5.00	25.00
09/17/96	Sports Authority (TSA)	Cvt Debt — 144A	150	5.25	22.00
09/17/96	Protection One (ALRM)	Cvt Debt	90	6.75	23.79
09/18/96	Robbins & Myers (ROBN)	Cvt Debt	60	6.50	22.47
09/18/96	Pier 1 Imports (PIR)	Cvt Debt	75	5.75	22.30
09/20/96	Saks Holdings (SKS)	Cvt Debt	240	5.50	25.00
09/26/96	Vanstar (VST)	Cvt. Pfd	175	6.75	17.95
09/26/96	Home Depot (HD)	Cvt.Debt	1,000	3.25	22.08
09/30/96	Plasma & Materials Tech. (PMAT)	Cvt Debt — 144A	75	7.13	18.00

Source: Salomon Brothers Inc.

Stock buybacks: The return of the Dutch auction tender.

Reebok International kicked off the third quarter by announcing that it would repurchase up to 24 million shares, or one-third of the total number of shares outstanding, through a Dutch auction self-tender offer. The range for the tender offer was set at $30 to $36 per share. However, the tender offer expired on August 27 with only 17.018 million shares tendered by shareholders with the purchase price was set at $36 per share. Nevertheless, the Reebok self-tender offer was the largest since the Capital Cities/ABC $693 million tender offer completed in December 1993 (see Figure 11).

On September 5, the Campbell Soup Company announced a restructuring package that included the divestiture of its non-strategic assets, a revamped marketing campaign, layoffs, and the commitment to deliver $2.5 billion to shareholders through stock buybacks over the next three years. Campbell's stock price rose from $67.50 to close at $71.875 on the day of the announcement. On September 12, the company began a Dutch auction self-tender offer to purchase up to 18 million shares (approximately 7.2% of the total shares outstanding and 15% of the public market float) at a single price in the range $69 to $80 per share. The offer expired on October 12.

The Dutch auction self-tender is the most common method of quickly repurchasing a large portion of a company's common stock.[2] In a Dutch auction self-tender offer, the company sets a range of acceptable prices from which tendering shareholders select a single price at which they are willing to sell their shares. At the expiration of the offer, the company repurchases the shares according to the ascending order of shareholder holds. However, all shareholders whose shares are accepted receive the highest accepted price.

A Dutch auction self-tender offer has considerable advantages over other methods of stock buybacks when the amount of stock is very large (that is, greater than 10%-15% of the public market float), and speed is important. Consequently, the technique is often used as a part of a major capital restructuring as in the case of Reebok and Campbell Soup. Since 1992, the average Dutch auction tender offer has been for $178 million or on average 12.6% of the total shares outstanding (see Figure 12). Moreover, a Dutch auction self-tender offer provides greater pricing flexibility than a fixed-price self-tender offer. Also, a Dutch auction self-tender offer allows greater participation by retail investors than open-market repurchases by

[2] See *Stock Buybacks: Strategy and Tactics*, Peter Blanton, et al., Salomon Brothers Inc, November 1994.

permitting all shareholders to participate (at least on a pro rata basis if oversubscribed). Although a Salomon Brothers' proprietary Accelerated Share Repurchase[sm] (ASR) program will allow a company to retire a large amount of stock quickly (depending upon the number of shares available for borrow), the ultimate price paid for the shares by the company is based on the weighted average price over the repurchase period.[4]

Figure 12. Dutch Auction Self-Tender Offers Greater than $20 Million, 1992-Present (Dollars in Millions[a])

Announcement Date	Company	Amount Bought	Tender Price	Tender Offer	Shares Acquired	Percent of Shares Outst.
02/28/92	Tandy Corp	$432	$32.00	12.0	13.5	17.5%
05/05/92	APL Ltd	41	44.00	2.0	0.9	6.4
06/08/92	General Dynamics Corp	957	72.25	13.0	13.3	28.7
07/01/92	Andrew Corp	29	33.88	0.8	0.9	8.8
08/18/92	Seafield Capital Corp	34	32.00	2.0	1.1	13.0
11/13/92	Equifax Inc	126	19.25	10.5	6.6	8.0
02/25/93	Precision Castparts	115	23.50	4.7	4.9	27.4
03/23/93	Harnischfeger Industries Inc	49	19.63	2.5	2.5	9.0
09/29/93	Vencor Inc	31	24.00	1.5	1.3	7.2
11/01/93	Capital Cities/ABC Inc	693	630.00	2.0	1.1	6.7
12/13/93	Brown-Forman Corp	402	90.00	4.2	4.5	11.8
01/07/94	Rite Aid Corp	38	18.50	22.0	2.1	2.4
01/17/94	Medical Care America Inc	200	26.00	7.0	7.7	18.2
05/09/94	TransAmerica Corp	246	54.75	4.5	4.5	6.0
06/22/94	MacDermid Inc	26	30.00	1.0	0.9	23.8
08/24/94	Millipore Corp	216	57.25	3.5	3.8	12.9
08/29/94	Tredegar Industries Inc	22	18.25	1.0	1.2	11.4
11/08/94	Instrument Systems Corp	26	8.75	3.0	3.0	8.9
03/10/95	Harcourt General Inc	219	40.50	5.0	5.4	9.5
03/22/95	Varco International Inc	25	8.00	5.3	3.2	9.4
04/11/95	Tredegar Industries Inc	23	23.00	1.0	0.6	7.1
05/12/95	Ecolab Inc	89	25.00	3.0	3.6	5.2
07/25/95	Sun Co Inc	192	30.00	6.4	6.4	6.0
08/04/95	Jostens Inc	168	24.00	7.0	7.0	15.4
08/08/95	APL Ltd	84	30.00	4.0	2.8	10.3
08/23/95	Varian Associates Inc	177	56.50	3.0	3.1	9.3
01/31/96	Zero Corp	71	17.75	4.0	4.0	25.0
02/06/96	Griffon Corp	23	9.75	2.0	2.4	7.8
02/14/96	Jenny Craig Inc	35	10.00	3.0	3.5	14.3
03/11/96	Pennsylvania Enterprises Inc	36	39.00	2.0	0.9	15.9
05/30/96	Fleetwood Enterprises Inc	243	31.00	11.4	7.8	17.0
07/29/96	Reebok International Ltd	613	36.00	24.0	17.0	22.8
08/14/96	Magellan Health Services Inc	73	18.38	3.3[b]	4.0	12.0
08/19/96	CPI Corp	50	NA	NA	NA	NA
09/05/96	Campbell Soup Co	1,082	80.00	18.0	13.5	5.4

NA Not available. [a] Except per-share amounts. [b] Initially, company offered to purchase up to 1.89 million shares.
Source: Securities Data Corporation.

. . . and a stock buyback with a twist from Cross Timbers.

Cross Timbers Oil Company added an interesting twist to its buyback strategy. Instead of giving shareholders cash, the company offered to exchange a convertible preferred security for outstanding shares of common stock. The rationale for the transaction: It was believed that certain longtime shareholders, including management and other insiders, would like to receive a higher dividend than the common stock afforded without sacrificing upside participation through an exchange offer that was **tax-free**. In addition, retiring some shares now will limit the dilution associated with conversion of the company's outstanding 5.25% Convertible Debentures should the company elect to "force" conversion once the security becomes callable in November.[5]

[sm] Accelerated Share Repurchase is a service mark of Salomon Brothers Inc.

[4] See *The Accelerated Share Repurchase*, Chris Innes, et al., Salomon Brothers Inc, November 1995.

[5] The company repurchased approximately $10 million principal amount of the 5.25% Convertible Debentures at a discount to par in 1995 and early 1996. The conversion price for the Convertible Debentures is $23.125 and the initial call price is 103.68%. Consequently, the breakeven stock price for bondholders to convert into shares is $23.98.

Cross Timbers' new $25 par preferred shares carried a $1.5625 dividend and a conversion price of $26 per share.[6] Pricing was quite aggressive with the underlying stock price at $20.125 prior to the announcement, and it provided shareholders little economic incentive to tender their shares. The company offered to repurchase up to 2.75 million shares of common stock. For each share tendered, shareholders would receive 0.86 shares of the convertible preferred stock. During the exchange offer period, Cross Timbers' stock price rose on the back of upgrades by stock analysts at Wall Street firms. With the rising stock price, the value of the convertible preferred lagged that of the common stock. Consequently, by the end of the exchange offer period on September 9, only 1.323 million shares of common stock had been tendered by shareholders. Nevertheless, the transaction can be considered quite a success for the company — approximately 7% of the company's outstanding shares were retired in exchange for a security with a higher conversion premium.

[6] The security is non-callable for three years with an additional year of soft-call protection at 150% of the conversion price.

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With the sharp rise in the stock market over the past few years, many companies have seen their economic and accounting exposure from employee stock options (ESOs) dramatically increase. Most companies fund their ESO requirement by purchasing stock from time to time in the open market. While this ultimately offsets the accounting dilution, it ignores the economic cost and interim accounting dilution of an ESO program. Below we review two proactive strategies for hedging the economic exposure and dilution created by employee stock options.

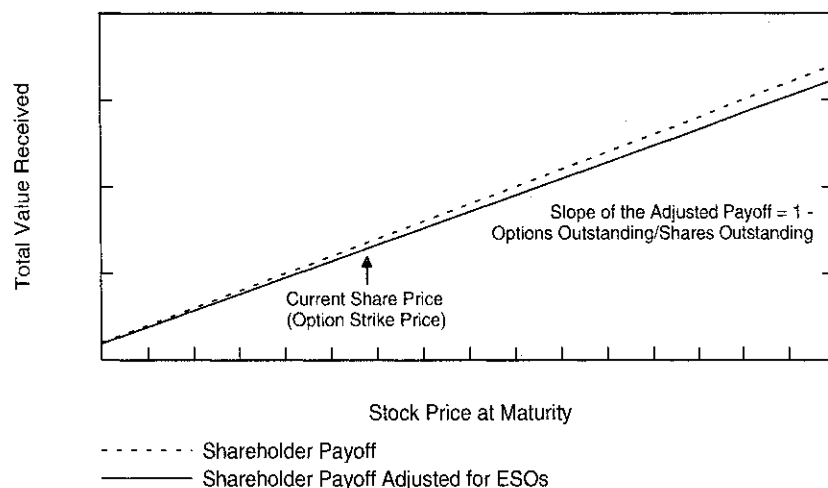
Question 5

By granting options to employees, what exposure does a company create?

Answer 5

When a company grants an employee stock option, the company is creating an unknown and potentially unlimited expense tied to its stock price (effectively a "short call option" position). Although there is no tangible cost associated with the granting of ESOs, this short call position will give rise to dilution, or a transfer of shareholder wealth, if the company's share price appreciates over the term of the option.[7]

Figure 13. Shareholder Payoff Profile



Source: Salomon Brothers Inc.

Question 6

How is the ESO exposure accounted for in a company's financial statements?

Answer 6

The granting of an employee option does not create an expense on the income statement nor exposure on the balance sheet. However, as a company's stock price rises, the in-the-money amount of the ESOs is converted into share equivalents under the reverse treasury stock method (which results in interim dilution prior to the ESO's exercise). In addition, companies disclose information on ESO programs in the footnotes to their financial statements as well as in proxy statements.

[7] See also, *Hedging Executive Stock Options*, Tad Flynn, et al., Salomon Brothers Inc, February 1994 and *Executive Stock Options: Benefits, Costs, and Implications for Investors*, Eric Sorenson, et al., Salomon Brothers Inc, October 1993.

Question 7

What steps can a company take to hedge ESO exposure?

Answer 7

A number of companies have taken steps to hedge the economic and accounting dilution created by employee option grants. Initial hedging activity in this area was accomplished by purchasing customized call options from over-the-counter (OTC) option market makers. However, while the purchase of call options limits the economic exposure and dilution at exercise, it does not offset interim dilution created under the reverse treasury stock method. To fully offset both the economic and accounting exposure without an upfront expense, a number of companies followed Citicorp's lead and executed stock-settled-forward purchase agreements linked to their own shares.[8]

Question 8

How does an options-based hedge work?

Answer 8

A company may purchase customized call options to match the exact strike and maturity of ESOs from a number of OTC dealers. Companies do not need to purchase one call option for every ESO granted because of the inherent tax-asymmetry. That is, the company receives a tax deduction when an employee exercises an ESO, but the payoff on an option on a company's own stock is tax free (thus, the number of call options a company needs to buy is: Number of ESOs granted times [one minus the marginal tax rate]).

A major drawback of the purchase of the call options is the potentially large upfront expense. For example, a ten year at-the-money call option on a typical industrial company will cost approximately $20.00 per share.[9] Purchasing in-the-money call options to match historical option grants is even more expensive. To mitigate this cost, many companies will (1) finance the purchase of calls with the simultaneous sale of puts; (2) hedge compensatory options that will likely be exercised in the next one to three years; and (3) hedge incremental dilution from today's perspective (i.e., purchase at-the-money call options rather than in-the-money call options). While the purchase of call options mitigates economic exposure, current accounting practices do not recognize the potentially anti-dilutive impact (i.e., the purchase of call options will not offset interim accounting dilution created by ESOs under the reverse treasury stock method).[10] To address both economic and interim accounting exposure, the company may want to consider a stock-settled-forward share repurchase program.

Question 9

What are the mechanics of a stock-settled-forward share repurchase?

Answer 9

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 today's price without actually purchasing any shares. For purposes of hedging employee stock options, these forward repurchases are typically structured to have net-share settlement on a quarterly basis.[11] For example, to the extent that the market price of the company's stock price is higher (lower) at the end of each quarter, the differential is received (paid) by the company in its own

[8] As of December 31, 1995, Citicorp had approximately $900 million of forward stock purchase agreements in place (Source: Citicorp 1995 Annual Report, page 62).

[9] Based on an implied volatility of 25% and a 2.0% common dividend yield.

[10] See also, Accounting Principles Board Opinion No. 15, "Earnings Per Share" (APB 15).

[11] The company may also have the option to settle in cash.

shares. This quarterly settlement will offset the share equivalents from ESOs created (eliminated) as the stock price rises (falls) in addition to eliminating the economic exposure to a fluctuating stock price. The forward has also been favored by a number of companies because of the ability to hold the potential future repurchase obligation off-balance sheet.

Companies should consult with their own accounting, tax and legal advisors regarding ESO hedging strategies.

TOPIC OF THE QUARTER: QUANTITATIVE ASPECTS OF CREDIT RATINGS

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As discussed previously, actively managing the rating agency relationship can have a real "bottom-line" impact on a company's financial performance. The rating agency process relies on both quantitative and qualitative factors. In a previous section, we discussed the qualitative factors that make up a rating decision. In this section, we describe our qualitative (statistical) credit rating model. Even though the qualitative aspects of a credit-rating model are critical, the Salomon Brothers Credit Rating Model can often explain 90% of the variation in ratings for companies in a given industry. Consequently, we recommend that companies use a statistical Credit Rating Model in addition to qualitative factors in managing their "rating-agency" relationships as well as planning capital structure strategies.

There are many situations where a company may want to answer one or more of the following questions:

• How much debt capacity does the company have to take on additional leverage and/or repurchase stock while maintaining its current rating?

• What financial parameters are most important to the rating agencies when determining the company's credit rating?

• What are the credit rating implications of various financial transactions such as a merger or acquisition?

• Does the company appear to be under- or over-rated relative to its peers?

There is no substitute for good communications with the rating agencies as a means to help answer these questions; sometimes, however, there may be differences between what the agencies say matters when ratings are determined and the factors that are correlated with actual ratings observed in the market.

Salomon Brothers has developed an analytical approach that attempts to answer these questions by determining the statistical correlation between a broad array of financial variables and credit ratings for a number of different industries. These financial variables may include the following:

• **Variables related to leverage:**

(1) Book value leverage

(2) Market value leverage

(3) Interest coverage ratios

• **Variables related to size:**

(1) Total assets

(2) Total sales

• **Variables related to profitability:**

(1) Cash flow

(2) Return on assets

(3) Return on equity

• **Variable related to financial stability:**

(1) Volatility of cash flows

(2) Historical stability of capital structure

(3) Volatility of return on assets

• **Variables related to industry structure:**

(1) Extent of competition

(2) Extent of regulation

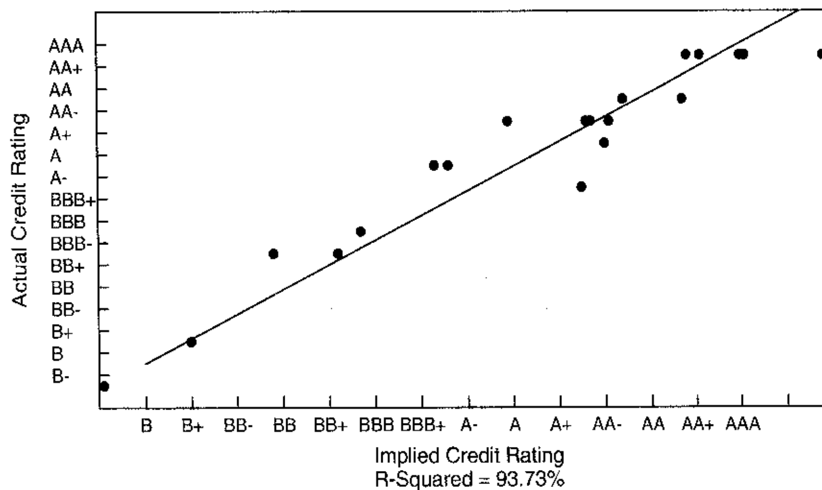
For many industries, we have found that more than 90% of the variation in credit rating can usually be explained by a combination of only two to four of the above factors. Although the specific variables can vary significantly from industry to industry, we can make some general conclusions based on analyses of more than 60 separate industries:

• In almost every industry, a measure of leverage is usually the most highly correlated variable with credit ratings. This reflects the importance the rating agencies place on financial conservatism and commitment to managing financial risk.

• When considering leverage, there appears to be a higher correlation between credit ratings and market value debt-to-capitalization ratios than book value debt-to-capitalization ratios. This reflects the fact that market values reflect the market's expectations of future cash flows and earnings.

• In many cyclical industries, size appears to be the critical and, in some cases, dominant factor that differentiates credit quality among companies. This reflects the qualitative benefits that many larger firms possess, including product and geographic diversity, strong competitive position and market share, and the ability to withstand cyclical downturns.

Figure 14. Actual Versus Implied Credit Ratings



Source: Salomon Brothers Inc.

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