THE FINANCE OF BUYOUTS AND ACQUISITIONS (FNCE 751)

Fall 2008, TTh 9:00, 12:00

The Wharton School – University of Pennsylvania

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Webcafé: https://webcafe.wharton.upenn.edu/eRoom/fnce/251-fa08-1
Teaching Assistants: Eduard Lemle, Amy Rice, Beverly Wee, Robert Whipple

COURSE OBJECTIVE

The course focuses on financial tools, techniques and best practices used in buyouts (financial buyers) and acquisitions (strategic buyers). While we will touch upon various strategic, organizational and general management issues, our main lens for studying these transactions will be a financial one. We will explore how different buyers approach the process of finding, evaluating, and analyzing opportunities in the corporate-control market; how they structure deals and how deal structure affects both value creation and value division; how they add value after transaction completion; and how they realize their ultimate objectives (such as enhanced market position or a profitable exit).

CAREER FOCUS

The course is aimed at students with three different goals. Most obviously, it is designed for students interested in working for leveraged buyout or other types of private-equity organizations. Students considering corporate careers, especially those with a financial angle, should also find the course useful, as it is quite likely they will find themselves working for an acquirer or target firm at some point in their careers. Finally, the course is intended for students whose jobs might involve interaction with financial or strategic buyers, whether as entrepreneurs, investment bankers, consultants, commercial bankers, or money managers.

ORGANIZATION

The course is divided into two broad modules. The first module covers buyouts by private equity partnerships, and the second one studies mergers and acquisitions. Both modules will be taught through a mix of lectures and cases. For each case, I will assign study questions concerning the case. These are meant to highlight those issues that are most relevant for class discussion.

I will not hand out case analysis after the in-class discussion, because there are usually no absolutely right answers. The best cases are deliberately written to provoke debate and present issues that reasonable people can disagree about. Moreover, handouts tend to circulate, which is a problem for multiple-section courses.

GRADING AND PREPARATION

The overall grade will be made up of five components:

1) Class participation 25%

I expect you to prepare for every class involving a case, even if no write-up is required. While it is OK to be wrong during our discussions, your grade will suffer if you are habitually late to class, if you do not participate, or if your contributions reveal a lack of preparation. If you plan to miss a class or attend unprepared, you should let me know in advance. Everyone can do so twice without any explanations. All subsequent absences will require an official excuse. Please make your points in a constructive and efficient manner. Always have your class cards out, as I might otherwise not properly recognize your attendance and contributions.

2) LBO-modeling exercise 10%

This assignment is designed to give everyone some practice with the basics of LBO modeling. It is designed as a simplified proxy for exercises many buyout shops use as a part of their recruiting process. You may work in groups, but everyone must turn in a separate spreadsheet.

3) Deal proposals 30%

Students should form four-person teams at the beginning of the semester. Each team will represent a financial buyer in the first half of the semester and a strategic buyer in the second half. The best proposals will be presented in class for extra credit (and recognition). To ensure similar contribution across group members, every student will evaluate other group members at the end of the semester.

4) Final exam 35%

The final examination will be a take-home case analysis, which each student should complete individually. You will have between three to six days to work on the assignment.

PREREQUISITES / RELATED COURSES

There are not explicit prerequisites for taking this course. However, it does require and apply many of the concepts and techniques learned in corporate finance (FNCE 601). All classes assume students are familiar with the material covered in that course. Those who are not might have problems following or participating in discussions.

The course places a strong emphasis on presentation and discussion skills. It will be important for students to explain their positions and arguments to each other and to try to argue for the implementation of their recommendations.

FNCE 751 is intended to serve as a complement to MGMT 721 (Corporate Development: Mergers and Acquisitions) and FNCE 750 (Venture Capital and the Finance of Innovation). MGMT 721 studies mergers and acquisitions from the perspective of a business development executive or a management consultant and takes a strategic view, while FNCE 750 covers venture capital investing.

MATERIALS

There is no required textbook for the course. The course mainly draws from two books and lecture slides.

Bruner, Robert, “Applied Mergers and Acquisitions,” Wiley Finance, 2004.

Gaughan, Patrick, “Mergers, Acquisitions and Corporate Restructuring,” Wiley, 2007.

You do not need to purchase these texts. All necessary items are available in the course pack. The cost of additional handouts distributed in class is not included in the cost of this course pack and will be billed separately at the end of the semester. Most spreadsheets and materials handed out in class (copyrighted items being one of the exceptions) will be made available after class at the course's Webcafé.

Special Disclaimer

This syllabus describes how I intend to run the course and the material I plan to cover. However, you should be aware that anything herein or elsewhere is subject to change. This includes but is not limited to evaluation methods, texts, materials, and scheduling.

SCHEDULE

This schedule is tentative - we might shifts things around in order to accommodate our guest speakers. Guest lectures are scheduled between 4.30pm and 6pm, and will substitute for class on that day.

- **Class #1: Sep 4**
  Administrative Issues
  Introduction to Buyouts - I

- **Class #2: Sep 9**
  Introduction to Buyouts - II
  Readings:
    The Economics of Private Equity
    Gaughan, Chapter 7

- **Class #3: Sep 11**
  Private Equity Partnerships and Fundraising
  Case: Francisco Partners (HBS 9-200-063)

- **Class #4: Sep 16**
  Case: The Fojtasek Companies and Heritage Partners (HBS 9-297-046)

- **Class #5: Sep 18**
  Valuation: Review and the "LBO Method"
  LBO Modeling – I

- **Class #6: Sep 23**
  Guest Speaker

- **Class #7: Sep 25**
  LBO Modeling – II
  Buyouts and Organizational Incentives
  Readings:
    Baker and Wruck, 1989, Organizational Changes and Value Creation in Leveraged Buyouts – The Case of the O.M. Scott & Sons Company, *Journal of Financial Economics*

- **Class #8: Sep 30**
  Guest Speaker

- **Class #9: Oct 2**
  Case: Sungard (Chicago GSB Case)

- **Class #10: Oct 7**
  LBO Design
  Case: Bain Capital and Domino's Pizza
  LBO Modeling Assignment Due (10%)

- **Class #11: Oct 9**
  The Whole Deal View
  Case: MediMedia International, Ltd. (UV0247)

- **Class #12: Oct 16**
  No class

- **Class #13: Oct 21**
  Exiting Investments
  Private Equity Framework (if time allows)
  Private Equity in Emerging Markets (if time allows)
  Case: Apax Partners and Xerium S.A. (HBS 9-804-084)
  Deal Proposal Due (15%)

- **Class #14: Oct 23**
  Acquisitions – Why and How?
  Readings:
    Gaughan, Chapter 4
    Bruner, Chapters 7 and 31
    Aiello and Watkins, 2000, The Fine Art of Friendly Acquisitions, *Harvard Business Review*

- **Class #15: Oct 28**
  Deal Proposal Presentations

- C**lass #16: Oct 30**
  Valuation Issues in Mergers: Synergies, Liquidity and Control
  Readings:
    Bruner, Chapter 11

- **Class #17: Nov 4**
  Identifying and Valuing Synergies
  Case: Valuing the AOL Time Warner Merger (HBS 9-802-098)

- **Class #18: Nov 6**
  Merger Arbitrage
  Case: Risk Arbitrage: Abbott Labs and Alza (A) (HBS 9-203-003)

- **Class #19: Nov 11**
  Deal Design: Financing and Risk Management
  Readings:
  Bruner, Chapters 20, 21 (pp. 589-601), and 23 (pp. 636-651)
  Rappaport and Sirower, 1999, Stock or Cash? The Trade-Offs for Buyers and Sellers in Mergers and Acquisitions, *Harvard Business Review*

- **Class #20: Nov 13**
  Guest Speaker

- **Class #21: Nov 18**
  Bidding Strategy
  Case: The Acquisition of Consolidated Rail Corporation (HBS 9-298-006)

- **Class #22: Nov 20**
  Hostile Bids
  Case: Peoplesoft vs. Oracle (Stanford Case)
  Readings:
  Bruner, Chapters 32 and 33

- **Class #23: Nov 25**
  M&A Empirical Findings
  Deal Proposals Due (15%)

- **Class #24: Dec 2**
  Governance and M&A
  Social Issues in M&A
  Case: The Merger of Hewlett-Packard and Compaq (B): Deal Design (UVA-F-1451)

- **Class #25: Dec 4**
  Deal Proposal Presentations
  Take Home Final to be handed out

GUIDING QUESTIONS FOR CASES

Francisco Partners (HBS 9-200-063)

1. What is the rationale for the Francisco Partners fund? What are its key strengths? What are the main risks associated with the fund?
2. How can David Stanton's past performance be best assessed? What issues are posed by the fact that he formerly worked at TPG?
3. Which of the key terms discussed in the case and tabulated in Exhibit 15 are most critical? As a limited partner, which provisions would you push for most aggressively?
4. How would you estimate the total value to Stanton and his partners of starting their own fund? Try to provide quantitative estimates.

The Fojtasek Companies and Heritage Partners (HBS 9-297-046)

1. What are the Fojtasek family's main objectives in this situation?
2. What are the details of each of the three possibilities that the family is considering (a buyout, a leveraged recapitalization, and a "Private IPO")? What are the key concerns about each transaction?
3. Value Fojtasek under both the base and management projections. Use whatever valuation methods and assumptions you feel are appropriate.
4. Would you recommend that Heritage do the proposed transaction?
5. Would you recommend that the Fojtasek family accept Heritage's proposal?
6. How common a problem is the Fojtasek family's dilemma? Does Heritage's "Private IPO" represent a more general solution to such problems?

Sungard (Chicago GSB)

1. Is SunGard a good LBO candidate? Why or why not? Qualitatively, is the deal a good investment for the buyout investors?
2. Quantitatively, is the deal a good investment for the buyout investors? In answering whether the deal is good quantitatively, you will need to do an APV and an IRR analysis. For the IRR analysis, we want to know what IRR the buyout investors would be expecting if they used the projections provided by the management.
3. Should the independent directors of the SunGard board have approved the transaction?

Assumptions: The deal closes at the end of 2004 (i.e., use forecasts beginning with a full year of 2005). The corporate tax rate is 40%. Long run inflation is 2.5%.

Bain Capital and Domino's Pizza (Wharton)

1. Describe the capital structure of the Dominos transaction.
2. Why is the Senior debt issued in three tranches? Why do these tranches have different premia to LIBOR?
3. Why is it necessary to have high-yield debt in this transaction? Why is this debt not replaced by senior debt or by mezzanine debt?
4. Why is preferred stock included in the capital structure?
5. What is the appropriate hurdle IRR Bain should use for this transaction? How would this hurdle rate be a function of the capital structure?

MediMedia International, Ltd. (UV0247)

1. What are the credit risks associated with the bank loan, and what, if anything, mitigates those risks? What approach would you take to secure the borrowings of a publishing company with very few tangible assets?
2. Including fees, and assuming a 200-bps spread between cost of funds and LIBOR, what would be your return on assets for participating in the revolver and term loan? If you were a banker, would you recommend that your bank participate in this deal?
3. What is the expected return to mezzanine debt investors? Would you invest in this debt?
4. What is the expected return on Dun & Bradstreet’s vendor note? If given an opportunity to co-invest in the note, would you do it?
5. Based on the projections, what is the economic value of the equity in MediMedia as of the date of the case? Is the return on equity fair? In this deal, all the equity is provided by the managers rather than a financial institution. Please identify some of the problems that might arise from that feature of the transaction.
6. Why does the deal include ECU financing? Could the benefits of ECU financing be obtained in other ways?

Apax Partners and Xerium S.A. (HBS 9-804-084)

1. What are the difficulties associated with exiting private equity investments? Is the process harder in Europe than the United States?
2. Xerium might in many senses be seen as an ideal LBO: a solid firm that has generated lots of cash, paid down its debt ahead of schedule, and so forth. Why is it, then, that Apax is having so many problems selling the firm? Is there something wrong with the valuation it is asking for the firm? Or have the LBO world’s expectations changed?
3. What should Apax do – sell Xerium, recapitalize the firm, or wait?

Valuing the AOL Time Warner Merger (HBS: 9-802-098)

1. Which synergies do you think are most important for the new company? What is your estimate of the total value of these synergies?
2. How did the market view the deal upon its announcement? What was its estimate of total synergy value?
3. Is this a good deal for AOL's shareholders? How about those of Time Warner?

Risk Arbitrage: Abbott Labs and Alza (A) (HBS 9-203-003)

1. How does risk arbitrage work? What are the risks and opportunities associated with this strategy?
2. Green Circle shorted 312,000 Abbott shares and bought 260,000 Alza shares. How did they determine appropriate relative position sizes? What can you say about the potential returns and expected returns of this investment?
3. Why would you expect positive excess returns from a risk arbitrage strategy? Why wouldn't market efficiency prevent such profits from persisting? What are the strategy's prospects in the long-run?
4. How could the put option discussed at the end potentially help Smith? Does the put increase or decrease the risk of the position? Does it increase or decrease the expected return?
5. As Chris Smith, would you close the position, invest more, or hold on? If you kept the position open, would you use options to hedge?

The Acquisition of Consolidated Rail Corporation (HBS: 9-298-006)

1. Why does CSX want to acquire Conrail?
2. Is CSX overpaying, based on multiples and DCF valuation?
3. What was the structure of the offer? Why did CSX choose this structure?

Peoplesoft vs. Oracle (Stanford GSB case)

1. What are the key factors that are preventing Oracle from acquiring Peoplesoft? What factors have helped them so far?
2. Among the takeover defenses used by Peoplesoft, which are more powerful and which are less effective? Why?
3. Is Peoplesoft acting in the interests of its shareholders in using these defenses?
4. Do board members face any potential conflicts of interest? If so, which ones?
5. Do you think that Ellison really intends to purchase PeopleSoft?
6. What are the implications of this deal for the industry?

Hewlett-Packard and Compaq (UVA -F- 1541)

1. Given the acquisition premium, how dependent is HP on the expected synergies for this deal to be economically attractive to HP shareholders?
2. Please estimate the EPS dilution in this deal.
3. How do the terms of merger allocate power in the board and management of the new firm? Is this a merger of equals or a takeover? By whom and of whom? Does one side seem to emerge with more power than the other?
4. Assess the appropriateness of the exchange ratio proposed in this deal. In terms of the relative contributions of the two firms, is the exchange ratio fair to HP shareholders?
5. Consider the entire set of terms: is this a good deal? For whom?