THE FINANCE OF BUYOUTS AND ACQUISITIONS (FNCE 251)

The Wharton School – University of Pennsylvania

Fall 2011, TTh 10:30, 1:30

Professor Pavel Savor

Office:	Steinberg Hall - Dietrich Hall 2427
Tel:	215-898-7543
Email:	psavor@wharton.upenn.edu
Office Hours:	T 4:30-6:30 (please use webCafé to sign up)
Student Lunches:	By appointment

webCafé: https://webcafe.wharton.upenn.edu/eRoom/fnce/251-fa11-1

Teaching Assistants: Daniel Hellwig (d.p.hellwig@googlemail.com),
Wen Mao (wenmao@wharton.upenn.edu)
Feyi Olopade (oolopade@wharton.upenn.edu)
Jared Solomon (jsolo@wharton.upenn.edu)

TA Office Hours: By appointment

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 finance angle, should also find the course worthwhile, 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, so will likely receive significant attention in class. You can find both a detailed class schedule and a list of case questions further below. Please check the webCafé regularly for various course updates and announcements.

GRADING AND PREPARATION

The overall grade will be made up of three components that are described just below. I rely on school-recommended guidelines with respect to the distribution of final grades.

1) Class participation and attendance 25%

I expect you to prepare for every class involving a case. While it is perfectly 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. Please make your points in a constructive and efficient manner, and keep in mind that their principal objective is to help your classmates understand an issue better. A great comment is one that helps the rest of us learn something valuable. Thoughtful questions and flawed but courageous arguments can be very valuable to others' learning.

Your final participation score will be the cumulative result of your efforts during the semester: I will assign grades for participation on a weekly basis, and your final one will simply be the sum of those grades. Frequency is weighted 30%; usefulness to what other members of the class learn is weighted 70%.

I may engage in cold calling. I do this for two reasons: 1) it helps ensure students adequately prepare for class; and 2) some students would otherwise never engage in classroom discussion, and this way I hope to involve them more. 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.

Always have your class cards out, as I might otherwise not properly recognize your attendance and contributions.

2) 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. More details about the scope of and expectations for these projects will be given in class. The best proposals may 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.

You are also encouraged to use your teams to prepare for case discussions, but this is not required. You can work on cases by yourself or with colleagues outside your team.

3) Exams 45%

We will have two in-class exams, the first one covering buyouts and the second one acquisitions. Each exam will be weighted equally (i.e., it will represent 22.5% of your final grade). The exams will be open-book, and you will likely need a laptop to work on them. In accordance with university rules, exam postponements require a waiver from the MBA Program Office.

REGRADING POLICY

Any requests for a regrade of an assignment must be submitted in writing *within one week* of the date on which it has been distributed back. Before making such requests, please note that the *entire* assignment will be regarded, so that your score may decrease as well as increase.

PREREQUISITES / RELATED COURSES

There are no explicit prerequisites for taking this course. However, it does require and apply many of the concepts and techniques learned in corporate finance (FNCE 100). 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 251 is intended to serve as a complement to MGMT 249 (Corporate Development: Mergers and Acquisitions) and FNCE 250 (Venture Capital and the Finance of Innovation). MGMT 249 studies mergers and acquisitions from the perspective of a business development executive or a management consultant and takes a strategic view, while FNCE 250 covers venture capital investing.

MATERIALS

The course mainly draws from lecture slides, cases, and two textbooks.

Bruner, Robert, "Applied Mergers and Acquisitions," Wiley Finance, 2004.

Gaughan, Patrick, "Mergers, Acquisitions and Corporate Restructuring," Wiley, 2010.

There is no required textbook for the course, so you *do not need* to purchase these texts. All necessary chapters are in the course pack, which you can buy from Wharton Reprographics. All cases and other assigned readings are available online at *Study.net*.

All slides, spreadsheets, and other materials used in class (copyrighted items being the only exception) will be made available after class at the course's webCafé.

While I understand the desire to have my lecture notes distributed in advance for note-taking purposes, I cannot accommodate this preference on the grounds it would adversely impact student involvement. I like to ask questions during my lectures, but the purpose of these questions would be defeated if the students can simply read off the answers from the next slide. Moreover, and perhaps more importantly, with my answers immediately available, it is likely the class would miss out on other perspectives, which very often enhance everyone's understanding of the issues we will be covering.

I will sometimes not hand out case analyses after the in-class discussion, because there are often no absolutely right answers or single correct recipes to be followed. The best cases are deliberately written to provoke debate and present issues that reasonable people can disagree about.

SPECIAL NOTICE

This syllabus describes how I intend to run the course and the material I plan to cover. While I will do my best to not deviate from it, you should be aware that anything herein is subject to change, including evaluation methods, texts, materials, and scheduling. Apart from scheduling changes, which are likely because of shifting guest speaker preferences, these changes are low-probability events. I will communicate all changes to the class in a prompt and clear manner.

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 8**
  Administrative Issues
  Introduction to Buyouts - I

- **Class #2: Sep 13**
  Introduction to Buyouts - II
  Readings:
    The Economics of Private Equity
    Gaughan, Chapter 7
    The Carlyle Group (HBS 9-409-050)

- **Class #3: Sep 15**
  Private Equity Partnerships and Fundraising
  Case: Francisco Partners (HBS 9-200-063)

- **Class #4: Sep 20**
  Case: The Fojtasek Companies and Heritage Partners (HBS 9-297-046)

- **Class #5: Sep 22**
  Valuation: Review and the "LBO Method"
  LBO Modeling – I

- **Class #6: Sep 27**
  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 #7: Sep 29**
  LBO Design
  Case: Bain Capital and Domino's Pizza

- **Class #8: Oct 4**
  The Whole Deal View
  Case: MediMedia International, Ltd. (UV0247)

- **Class #9: Oct 6**
  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)

- **Class #10: Oct 13**
  PIPEs
  Case: MicroStrategy, Inc.: PIPE (UV0275)

- **Class #11: Oct 18**
  Guest Speaker

- **Class #12: Oct 20**
  Exam I (22.5%)

- **Class #13: Oct 25**
  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*
  Deal Proposal Due (15%)

- **Class #14: Oct 27**
  Valuation Issues in Mergers: Synergies, Liquidity and Control
  Readings:
    Bruner, Chapter 11

- **Class #15: Nov 1**
  Guest Speaker

- C**lass #16: Nov 3**
  Guest Speaker

- **Class #17: Nov 8**
  Identifying and Valuing Synergies
  Case: Valuing the AOL Time Warner Merger (HBS 9-802-098)

- **Class #18: Nov 10**
  Merger Arbitrage
  Case: Risk Arbitrage: Abbott Labs and Alza (A) (HBS 9-203-003)

- **Class #19: Nov 15**
  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 17**
  Bidding Strategy
  Case: The Acquisition of Consolidated Rail Corporation (HBS 9-298-006)

- **Class #21: Nov 22**
  Hostile Bids
  Case: Peoplesoft vs. Oracle (Stanford Case)
  Readings:
    Bruner, Chapters 32 and 33

- **Class #22: Nov 29**
  M&A Empirical Findings

- **Class #23: Dec 1**
  Exam II (22.5%)

- **Class #24: Dec 6**
  Guest Speaker

- **Class #25: Dec 8**
  Comparing Offers
  Governance and M&A
  Case: The MCI Takeover Battle: Verizon versus Qwest (HBS 9-206-045)
  Deal Proposal Due (15%)

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?

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?

MicroStrategy, Inc.: PIPE (UV0275)

1. What has been MicroStrategy's strategy to date for financing the company? How does strategy.com fit within MicroStrategy's other businesses?
2. How critical are additional funds to MicroStrategy's future? If Saylor believes that additional funds are necessary, what alternatives does he have if he decides not to issue the PIPE?
3. How does a floating convertible bond compare to a fixed-rate convertible bond? What circumstances would favor the issuance of a floating-rate convertible over a fixed-rate convertible?

4. What combinations of options (puts, calls) are contained within a fixed-rate convertible? A floating-rate convertible? What is the value of the proposed PIPE offer?
5. Assess the advisability of the alternatives Saylor is considering: (1) accept the Promethean offer as proposed; (2) renegotiate the terms with Promethean or new investors (what terms would you change?); or (3) cut back on MicroStrategy's plans.
6. What should Saylor do in June 2000?

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?

The MCI Takeover Battle: Verizon versus Qwest (HBS 9-206-045)

1. What factors should MCI's board consider in evaluating the two offers?
2. Value the two offers. Which represents a better deal for MCI shareholders?
3. Are there any circumstances in which MCI's board should not choose the higher-value offer?
4. Which offer should MCI's board accept and why?