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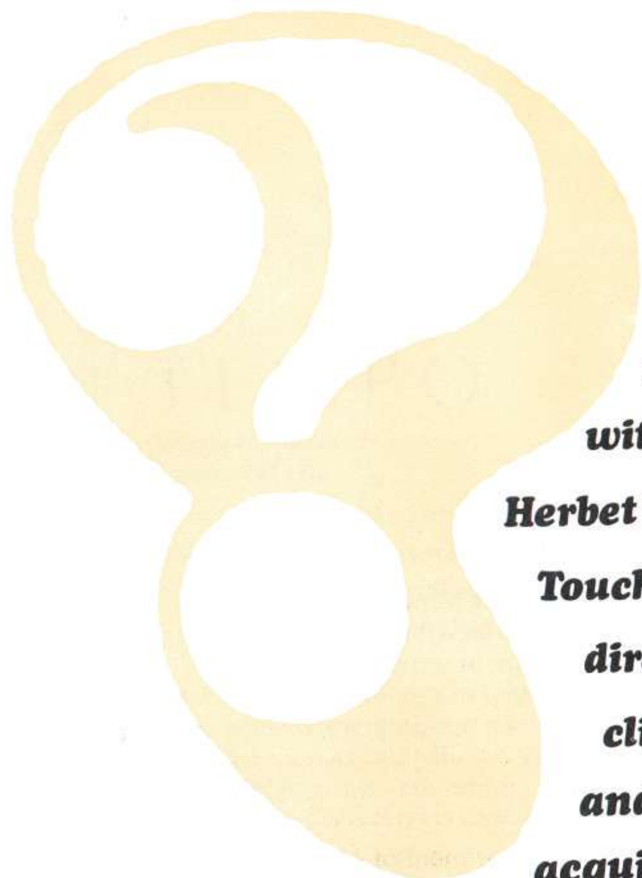

a talk with Herbet Weiner, Touche Ross director of client mergers and acquisitions

The Money Makers

Peter Hollitscher

Norman J. Schuster

Herbert Weiner

After extended discussion—and heated controversy—the Accounting Principles Board of the American Institute of Certified Public Accountants adopted in July new rules on accounting for corporate mergers. Designed to reduce the reporting options open to merging companies, the rules will have a definite effect on new business combinations—probably leading executives to seek even more guidance in these delicate dealings.

At Touche Ross the man they will continue to turn to is our Director of Client Mergers and Acquisitions, Herbert Weiner, a partner with extensive experience with the intricacies of combining businesses.

Here Mr. Weiner talks with two new associates, Peter Hollitscher and Norman Schuster, about the ingredients that bring two companies together in a successful union.

Because many discussions of mergers and acquisitions are concerned with specific techniques and mechanics, Mr. Weiner has chosen to stress the general characteristics of a successful deal—and how APB Opinions 16 and 17 will affect them.

For your convenience, we have included at the end a summary of the opinions prepared by the AICPA.

The ingredients for closing

We find it difficult to tell in advance if a deal—and here we mean any kind of transaction—is going to close. We've seen some that looked certain to fall apart. Why did this happen?

You can tell if a deal has the *ingredients* for closing, but they have to be mixed correctly before a deal can occur. Obviously, everyone would like to prevent a long and costly pre-closing experience that ends in frustration.

The ingredients are a satisfactory "chemistry" between the parties and an apparent sound economic benefit for each party. For the right chemistry you need mutual respect and the ability to work out problems together. Before every transaction closes problems that were not originally contemplated will be uncovered. If the people involved can't talk the problems out to a reasonable solution, the deal will fall apart.

So "chemistry" is the ability to communicate?

Not entirely. To me it is more than that—it is the ability to create collectively.

What about the economics?

Economic benefit is the essential motivation for the closing, and price is the key factor in the economic picture. Remember that price includes not only the cash, notes and securities, but also compensation contracts, representations and warranties, and elements of control. If I had to select the one key factor that would culminate a deal—would change the status quo—I would select price. With an attractive price a buyer or seller will often close the transaction in spite of poor chemistry.

The function of a catalyst

There has to be something else—a catalyst or maybe a go-between to prevent outside elements from interfering and to help the chemistry and economics to work?

Right. It is quite possible for the parties to work out a deal by themselves—even with great chemistry and economics—and still have it fail. Today, some expertise is often needed to shape or mold the proposed deal. For example, the attitude of an outside party, such as the government, whose approval may be required, can prevent the closing. I prefer to shape the transaction so that a closing can occur even if the outside party does not agree. I suppose you might say I hate openings and like closings. Preliminary shaping by an expert can test whether the ingredients for a closing are present. If they are not, breaking off saves the time and expense of conducting negotiations that are doomed to failure.

A deal with the right chemistry but wrong economics

Can you illustrate a deal that has good chemistry but lacks sound economics?

Sure. A case I had involving a customer-supplier relationship demonstrates the situation. A manufacturer—a public company—wanted to acquire a leading specialty regional retailer—a private company—by issuing its capital stock in exchange for the stock of the retailer. The managements had worked together for over 20 years and had demonstrated mutual confidence. The manufacturer's stock was selling at 15 times earnings and it was willing to pay 12 times earnings for the retailer. The marriage was projected to be beneficial because

1. the manufacturer was not strong in the retailer's region so it had little business to lose,
2. the retailer could shift almost exclusively to this manufacturer's materials without loss of sales and profits,
3. thus the manufacturer would have incremental sales and profits from an under-utilized plant, and
4. the retailer felt it could help acquire more captive retail business in other regions.

On the face, it appeared that this transaction had both

chemistry and economics.

The transaction did not close because the manufacturer felt the economic benefits were only short-run. Apparently, the manufacturer's marketing and sales people reasoned that if they could get the equivalent additional sales from non-captive retailers, the profits of the manufacturer would rise faster because fewer shares would be outstanding (those saved by not acquiring the retailer in question).

There probably was concern, too, that independent retailers, in other geographic regions where the manufacturer was already strong, might decide to shift business to other manufacturers who were not likely to set up captive and competing retailers.

Both parties wanted to continue their excellent relationship. As soon as it appeared the proposed acquisition would create economic problems, they broke off negotiations. The conflict arose not on the basic price, predicated on earnings, but on what appeared to be a technical matter—the size of certain book reserves.

Usually, when the deal makes sense, the balance sheet does not take on such importance. In effect, this was an indirect way for the manufacturer to announce he wanted a lower multiple of earnings applied to the retailer's business to take care of his uncertain evaluation, as buyer, of the long-term economic benefits of the transaction. The retailer could have lowered its price, but it did not. It evaluated its future as an independent optimistically, based on its past record and its current trend.

So you see, although the chemistry was excellent and the transaction had favorable short-run benefits, the deal fell apart because the long-run benefits could not be projected with adequate certainty by both parties. Their long-run benefits seemed more secure to both parties if they stayed separate. I don't have any personal feelings about the conclusion. All I know is that each party in substance decided that the proposed transaction lacked sound economics at the price the other party found satisfactory.

Economics great, chemistry poor

What about the reverse?—an illustration of a transaction where the economics were great but the chemistry poor?

I witnessed a good example in the purchase of a large service business. There buyer and seller had very little in common and aborted the negotiations several times. One thing kept them together—the price. The buyer placed a high potential value on the business. In effect the buyer paid about 20 times earnings in cash.

So far the buyer has been right. Pre-tax operating profits doubled within five years of the deal.

Was the seller wrong?

Probably not. After the transaction was closed, it was learned that the seller had tried unsuccessfully for six months to sell the business at about 16 times earnings. Small wonder that the buyer was able to repair the negotiations each time they broke apart. In the eyes of each party, the price looked good.

The seller wanted to diversify his investment. The buyer wanted a growth business. Each got what he wanted on the merits of price.

Why the buyer buys

Essentially, what do you feel a buyer looks for? Opportunity?

Right. From an investment standpoint a buyer generally looks for above-average return on investment, consistent with safety. A buyer must consider realistically the alternative opportunities for investment. Courage is the essential characteristic of a buyer. The seller is presumed to know all about his industry and his company. If the seller is willing to dispose of the business, what makes a buyer think it is a good opportunity? Mostly the courage to believe that the situation will hold opportunities to make money. To be a buyer one must be an optimist dedicated to seizing and using the opportunity.

Why the seller sells

What is the seller's goal? Insurance?

Yes. The seller owns the business, so he already has opportunity; but in selling, he seeks to protect his downside risk. The seller is really buying insurance to terminate or reduce his risk.

What is the right price?

With these conflicting interests—and as you said earlier that price is critical in putting a deal together—how do you arrive at the "right" price? It seems to us that it is especially difficult today. The sellers think it is still 1968 and value their companies at 20 times earnings while the buyers think 1970 will go on forever and value the same companies at 5 times earnings.

Value is in the eyes of the beholder. There is no "right" price. My experience has shown price to be generally elastic. There is a series of "right" prices—a range in which the buyer can still see opportunity and the seller

can gain insurance. One expert can determine a fair price that differs from the price of another expert for the same situation and facts.

One technique I use to pinpoint value, and to avoid confusion, is to give the range of "right" prices in terms of all cash. This eliminates the intricate and often confusing valuation problems that exist with notes, bonds, securities, warrants, and so forth. The all-cash price is like home base because it is from that price that modifications can be evaluated.

Say, for example, you have a company manufacturing a proprietary product with sales of $2 million, pre-tax profits of $400,000 and after-tax profits of $200,000. Assume no long-term debt, a net worth of $1,500,000 and prospects for growth in earnings. What is the range of "right" prices, all cash, for the business?

Remembering we are in a world where American Telephone & Telegraph common is selling at 10 times earnings and its bonds are yielding 9% to 10%, I would price the business in a range of 12 to 14 times earnings, or $2,400,000 to $2,800,000, all cash, depending on the evaluation of the growth trend. Of course, some buyers might refuse to go over $2,000,000 and the seller might not budge for a price below $3,000,000. Each might base his position on excellent reasons, but $2,400,000 to $2,800,000 expresses the range in which I estimate a buyer and seller could agree.

That seems to be a fair range, but how did you come up with it?

Well, that takes some knowledge and a lot of experience. It is an evaluation of alternative uses of $2,400,000 in cash. At interest this money would bring $240,000 annually before tax with safety of principal. At greater risk —in this illustration, it will bring $400,000 before-tax income. Notice also that the price range is less than twice the book net worth. All of this has been simplified as an all-cash transaction.

Obviously, refinements of contingent payouts (with a lower cash price at closing) or the use of excess cash in the seller's business will affect the price.

Does the company's size affect the price?

Yes. Growth in a small company may be more sustained than in a large company, but I value growth in a larger company at a higher multiple than the equivalent growth of a small company. A large company has developed greater resistance to failure (more depth of management and greater resources to find new management, for example) and is, therefore, worth more. In a larger company, the multiple of earnings might be from 14 to 16 instead of 12 to 14. Also the prices I quoted apply to 100% ownership and not to situations in which there are minority interests.

Can every company be categorized as either a buyer or a seller?

Such a classification really says: is a company actively seeking opportunities to employ its assets or is it attempting to minimize its risk-taking? The answer is not given in terms of sale activity, but on how management views the business. Stockholders and creditors have an investment in the gross assets. Does management believe a profit can be produced? Will the profitability be competitive with that of other businesses? What steps can be taken to improve profitability? Does the business have the management to achieve greater profitability? These and other questions go to the heart of the investment situation and determine whether the business is essentially a buyer or a seller. In a large corporation, one division may be a seller, but on balance the corporation may be a buyer. In a small business, management may be looking for more equity capital, in which case the business would be considered a buyer because management expects to remain in control. If capital cannot be obtained on those terms, however, management may quickly become a seller. Generally, I would say that most companies are both buyers and sellers—and often simultaneously.

Effect of the lack of liquidity

We'd like to shift gears now, Herb, from the general area to certain current problems. What do you feel is the effect on mergers and acquisitions of the lack of corporate liquidity today?

I think some businesses lack liquidity even in boom periods. The term "liquidity" puts the problem on too generalized a basis. It makes more sense to me to refer to each business as a special case—I like to talk about the short-term maturities of a particular business. In boom times there are bankruptcies mostly of smaller companies—that does not mean all small companies will go bankrupt. So now in a period of recession, if some large companies are getting into trouble—and, of course, there was the bankruptcy of the giant Penn Central Transportation Co., it does not follow that all large corporations face bankruptcy. Each company is a different credit risk and each, accordingly, has a different resistance to adversity. That is more meaningful to me than the general status of lack of corporate liquidity.

The role of short-term maturities

In your view, the credit risk of a company is based substantially on its short-term maturities?

The credit risk depends on profitability—cash profitability, cash flow. The nature of the industry, the posture of a particular company, the quality of management—all have a measure in determining credit risk. It is also important to know who the credit grantor is. Some credit people are far more savvy in particular industries than are others. The short-term maturities define the time interval available to management for using the assets without interference.

What do you mean by short-term maturities? Bank loans and other creditor debt coming due within a year?

Yes, and much more. To me it is every cash requirement that must be met within a two- to three-year period. Why such a long time? Because it takes time to arrange financing, to sell a division or other assets to get cash, to close down an unprofitable plant, to turn around a loss operation. The one-year rule is a general principle for financial reporting. The two- to three-year period I look at covers cycles of business in general as well as cycles of a particular company. When you look further ahead you tend to provide alternative and backup means of financing.

Then a high rent cost or interest charge would be included in your definition of short-term maturities?

Certainly. If the gross profits from operations drop, it may not be possible for the business to cover fixed charges such as rent and interest. Then the business has to program the working capital requirements to permit adequate time, either to improve gross profits or to cut overhead.

Pitfalls of short-term maturities

In your experience what types of mistakes are made in planning to meet short-term maturities?

There are many examples that I have seen and they include these:

a. Borrowing short to invest long—If you borrow to build an additional plant and would need five years to repay, don't start unless you have five-year financing. Don't depend on a refinancing or public offering to solve the problem. The timing may not be convenient. Other examples of this are short-term loans to buy a business, or revolving loans to cover fixed investments. The only safe course is to face up to the facts—make the financing match the company's ability to repay from operations or assets.

b. Underestimating the time and expense required to make a new operation self-sustaining or to terminate an old operation. With inflation, extra time has meant higher costs than contemplated. Often it is necessary to bring in equity capital or long-term money in larger proportions than appears needed in order to adjust for this problem. Financial foresight is necessary, otherwise, some *other* people in the business management will enjoy the good things when they happen because present management will not survive.

c. Delay in starting to use internal means for improving cash flow. Management may not give high priority to selling excess real estate, or to deferring taxes under special rules or to refinancing debt ahead of time. The management that delays these responsibilities—which do not appear essential in good times but may not be feasible because too late in poor times—is giving itself less time and fewer options for solving unexpected problems. By taking these steps early, management may discover that the business cannot afford all the expansion that it planned.

Herb, it sounds as if now is a bad time to negotiate acquisitions?

No. What I *am* saying is that today one must think of survival before one thinks of growth. We are experiencing difficulty in refinancing short-term maturities because of:

1. a business recession coupled with higher cost of wages and interest,
2. a stock market drop that makes public offerings very competitive, and sometimes impossible, and
3. a tight bank and institutional money market that sees interesting alternative uses for money. With this background, management must weigh acquisitions more carefully and must recognize that prices have been adjusted downward for the immediate future.

I think we will see very good acquisition opportunities in the next few years, priced more realistically than we've seen for a long time. But management must plan and shape the deals carefully to assure survival in uncharted waters. In fact, divestitures and mergers will be ways to solve the emergencies being created by current business conditions.

The effect of the new pooling rules on mergers

The merger movement has already been effectively curtailed by a declining stock market, tight money, and antitrust worries. Do you think the new rules on pooling will further curtail it?

Blame for any further curtailing of mergers should not be placed on the doorstep of the new pooling rules. There is no question that the new rules will reduce reported earnings where applicable, but I have never found accountants to be a cause for creating or killing business.

An artist may express his view of the same object in different ways at different times. So, too, accountants may in the future express the financial impact of mergers in a more restricted way than they did in the past.

It would be wonderful if everything were simple, but life isn't simple and financial reporting even less so. The new rules will be put into practice and financial analysts will explain how one company's earnings under the rules compare with another company's earnings not subject to the rules. As I said, the rules won't make things any simpler, but in my view, they will not prevent normal business activity.

What is the major merger accounting change of the proposed pooling rules?

In my opinion, reduction of post-merger earnings by the amortization of goodwill, heretofore not required. Speaking generally, if the combination qualifies as a pooling, the old rules continue with some limitations. The merger qualifies as a pooling if the combination involves the exchange of common stock only for substantially all the common stock interest of the acquired company. If the combination does not qualify as a pooling, it must be accounted as a purchase, which technique requires charging the goodwill in the acquisition against earnings over a period of not more than 40 years. In purchase accounting, the difference between the price paid for the acquired company and its book net assets should be assigned first to all net assets to bring them from a book basis to a current value basis; any unassignable difference is goodwill. In the past, however, this was not always done because the goodwill was not required to be charged to earnings as it now is.

Will size alone make the difference of whether the post-merger earnings must be reduced by goodwill amortization?

No. During the development of the proposed rules in pooling, relative size of the merger partners was very important. To avoid conflict over this issue, the size test was dropped.

If the merger qualifies as a pooling, there need be no accounting for goodwill?

That is correct.

What type of industry could suffer from acquisition in purchase accounting?

Service businesses where the net assets are not large. The value of the business may be four times net worth—growth of earnings being a factor to increase the multiple of earnings. Marketing companies or consumer product companies where net assets may not be large, and where advertising is a large factor may also fall into this new rule. In other words, where the goodwill is a large figure in relative terms.

Well then don't you feel that prices for these companies will be depressed since if they are purchased the post-merger earnings could be reduced by goodwill amortization?

Not really. First of all, they don't have to be part of any merger. If the earnings grow the stock market will reward the management for the earnings increases by a fair multiple. Second, a merger could be made with a company on an exchange of common stock only so the pooling rules would apply. It is my feeling people will always recognize a fine company.

Have the new tax rules of 1969 hurt mergers and acquisitions?

Not to any great degree. A limitation has been imposed on a corporation's deduction of interest on certain bonds issued on the acquisition of another corporation's stock or assets. But this will not hurt many corporations for various technical reasons, one of which is an annual $5,000,000 interest exemption from the new rule. Effectively then the limitation on the interest deduction is $5,000,000 when attributable to acquisition debt, subject to certain adjustments.

Installment method reporting of gain on sale of a business has been made somewhat restrictive in that it could be harder to meet the 30% test because payments in the year of sale now include certain evidences of indebtedness designed to make them tradable in an established securities market. But it is still possible to use the installment method if care is exercised in designing the evidence of indebtedness.

Following is a summary of the conclusions reached by the APB in its Opinion #16, *Business Combinations,* and Opinion #17, *Intangible Assets:*

Business combinations

The purchase method and the pooling of interests method are both acceptable in accounting for business combinations although not as alternative accounting procedures for the same business combination. A business combination which meets specified conditions requires accounting by the pooling of interests method. All other business combinations should be accounted for as a purchase of one or more companies by a corporation. The cost of an acquired company should be determined by the principles of accounting for the acquisition of an asset. The cost of an acquired company should be allocated to the assets acquired and liabilities assumed based on the fair values of identifiable individual assets and liabilities, and the remainder of the cost should be recorded as goodwill.

The following conditions must be met if pooling of interests accounting is to be used:

- Each of the combining companies is autonomous and independent and has not been a subsidiary or division of another corporation within two years before the plan of combination is initiated.
- The combination is effected in a single transaction or is completed according to a specific plan within one year.
- A corporation issues only common stock with rights identical to those of the majority of its outstanding voting common stock in exchange for substantially all of the voting common stock interest of another company.
- Each of the combining companies maintains substantially the same voting common stock interest; with no exchanges, retirements, or distributions to stockholders in contemplation of effecting the combination.
- Each of the combining companies reacquires shares of voting common stock only for purposes other than business combinations, and no company reacquires more than a normal number of shares after the date the plan of combination is initiated.
- The ratio of the interest of an individual common stockholder to those of other common stockholders in a combining company remains the same as a result of the exchange of stock to effect the combination.
- The voting rights to which the common stock ownership interests in the resulting combined corporation are entitled are exercisable by the stockholders; the stockholders are neither deprived of nor restricted in exercising those rights.
- The combination is resolved at the date the plan is consummated and no provisions of the plan relating to the issue of securities or other consideration are pending.
- The combined corporation does not agree directly or indirectly to retire or reacquire all or part of the common stock issued to effect the combination.
- The combined corporation does not enter into other financial arrangements for the benefit of the former stockholders of a combining company, such as a guaranty of loans secured by stock issued in the combination, which in effect negates the exchange of equity securities.
- The combined corporation does not intend or plan to dispose of a significant part of the assets of the combining companies within two years after the combination except to eliminate duplicate facilities or excess capacity and those assets that would have been disposed of in the ordinary course of business of the separate company.

Under poolings it has been possible to include the profits of an acquired company in net income reported to stockholders even though the pooling took place after the end of the year reported on. This will now be prohibited.

Intangible assets

A corporation should record as assets the costs of intangible assets acquired from others, including goodwill acquired in a business combination. A corporation may record as assets the costs to develop identifiable intangible assets but should record as expenses the costs to develop intangible assets which are not specifically identifiable, such as goodwill.

The cost of each type of intangible asset should be amortized from date of acquisition by systematic charges to income over the period estimated to be benefited. The period of amortization should not exceed forty years.

Effective date

The provisions of the Opinions are effective for business combinations initiated after October 31, 1970 and apply to intangible assets recognized in those combinations or otherwise acquired after October 31, 1970.

As defined in Opinion #16, date of initiation is the earlier of (1) the date the major terms of a plan, including the ratio of exchange of stock, are announced publicly or otherwise formally made known to the stockholders of any of the combining companies or (2) the date that stockholders of a combining company are notified in writing of an exchange offer.