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Mergers, Acquisitions, Divestitures, and Other Restructurings

A Practical Guide to Investment Banking and Private Equity

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PAUL PIGNATARO

WILEY

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This book is dedicated to every investor pursuing enhanced wealth—those who have gained and those who have lost. This continuous struggle has confounded the minds of many. This book is one small tool to help further said endeavor, and if successful, will be the seed planted to spawn a future of more informed investors and smarter markets.

Preface

Mergers, acquisitions, divestitures, and other restructurings (M&A) have arguably existed as long as the history of business. The processes of merging, purchasing, divesting entities or assets, and restructuring businesses are all major methods of providing growth and value to both large and small corporations alike. The Wall Street–coveted analysis of understanding the drivers leading to growth through M&A has remained somewhat of a mystery to the public, until now.

Although M&A activity has its origins arguably with the dawn of commerce, M&A as a greater business strategic phenomenon began in the nineteenth century in a period known as "The Great Merger Movement." It was at this time that very small businesses were consolidated into large public entities that dominated the markets. Companies like U.S. Steel, International Paper, and Standard Oil created near-monopolistic entities. Today M&A has evolved and changed with regulation, market, and industry. Despite the details of its evolution and progress, M&A still proves to be a key driver for business growth.

A merger or acquisition is the purchase of or combination of at least one business asset or entity into another. The definition of mergers and acquisitions, although not directly stated, often incorporates divestitures and other restructurings as well, which is why I've expanded the title of the book to *Mergers, Acquisitions, Restructurings, and Other Divestitures*. Although the core focus of the book from a technical perspective will be on mergers, it is important to note the other aspects of M&A, which we will define in Chapter 1. This is a book in a series, and subsequent books will dive into cases that reflect the other areas, including divestitures and restructurings. Mergers and acquisitions come in varying forms, the analysis of which helps determine the impact of said purchase, combination, divestiture, or other restructurings on the financial entities involved. Such analyses are important for establishing posttransaction value and helping to determine if the transaction is potentially worth the efforts.

This book seeks to give an investor the fundamental tools to help analyze such transactions and determine and interpret the results. These fundamental tools are used by investment banks and private equity funds worldwide. We will evaluate the potential merger of Office Depot and OfficeMax, utilizing the exact same methods used by the bulge bracket investment banks and top private equity firms. We will also step through the framework behind various types of M&A transactions and give you a conceptual understanding of the analyses. Using the model, you will learn how such transactions are implemented. We will have you step into the role of an analyst on Wall Street to give you a firsthand perspective and understanding of how the modeling process works, and to give you the tools to create your own analyses. This book is ideal for both those wanting to create their own analyses and those wanting to enter the investment banking or private equity field. This is also a guide designed for investment banking or private equity professionals if they need a thorough review or simply an M&A modeling refresher.

The Office Depot and OfficeMax Merger Case Study

Naperville, Ill. and Boca Raton, Fla.—OfficeMax Incorporated (NYSE:OMX) and Office Depot, Inc. (NYSE:ODP) today announced the signing of a definitive *merger agreement under which the companies would combine in an all-stock merger of equals transaction intended to qualify as a tax-free reorganization. The transaction, which was unanimously approved by the Board of Directors of both companies, will create a stronger, more efficient global provider better able to compete in the rapidly changing office solutions industry. Customers will benefit from enhanced offerings across multiple distribution channels and geographies. The combined company, which would have had pro forma combined revenue for the 12 months ended December 29, 2012 of approximately $18 billion, will also have significantly improved financial strength and flexibility, with the ability to deliver long-term operating performance and improvements through its increased scale and significant synergy opportunities.*

Under the terms of the agreement, OfficeMax stockholders will receive 2.69 Office Depot common shares for each share of OfficeMax common stock.

"In the past decade, with the growth of the internet, our industry has changed dramatically. Combining our two companies will enhance our ability to serve customers around the world, offer new opportunities for our employees, make us a more attractive partner to our vendors, and increase stockholder value," said Neil Austrian, Chairman and Chief Executive Officer of Office Depot. "Office Depot and OfficeMax share a similar vision and culture, and will greatly benefit from drawing on the industry's most talented people, combining our best practices and realizing significant savings. We are confident that this merger of equals represents a new beginning for our two companies and will allow us to build a more competitive enterprise for the long term."

"We are excited to bring together two companies intent on accelerating innovation for our customers and better differentiating us for success in a dynamic and highly competitive global industry," said Ravi Saligram, President and CEO of OfficeMax. "We are confident that there will be exciting new opportunities for employees as part of a truly global business. Together, we will have the opportunity to build on our strong digital platforms and to expand our multichannel capabilities to better serve our customers and to compete more effectively. Importantly, this merger of equals transaction will provide stockholders of both companies with a compelling opportunity to participate in the long-term upside potential of the combined company." (OfficeMax, Office Depot press release, February 20, 2013)

In this press release dated February 20, 2013, Office Depot and OfficeMax announce a proposed merger.

OfficeMax provides office supplies and paper, print and document services, technology products and solutions, and furniture to businesses and consumers. OfficeMax consumers and business customers are served by approximately 29,000 associates through OfficeMax.com, OfficeMaxWorkplace.com, and Reliable.com, more than 900 stores in the United States and Mexico, and direct sales and catalogs.

Office Depot provides office supplies and services through 1,628 worldwide retail stores, a field sales force, top-rated catalogs, and global e-commerce operations. Office Depot has annual sales of approximately $10.7 billion, employs about 38,000 associates, and serves customers in 60 countries around the world.

What is the purpose and viability of such a merger? How will the merger be funded? What happens to each entity involved? What happens to the shareholders? What are the potential impact, benefits, and drawbacks to such a merger? There are technical analyses used by Wall Street analysts to help answer such questions. We will walk you through the complete merger analysis as a Wall Street analyst would.

It is important to note that the modeling methodology presented in this book is just one view. The analysis of OfficeMax and Office Depot and the results of that analysis do not directly reflect my belief, but rather, are a possible conclusion for instructional purposes based only on limiting the most extreme of variables. There are other possibilities and paths that I have chosen not to include in this book. Many ideas presented here are debatable, and I welcome the debate. The point is to understand the methods and, further, the concepts behind the methods to equip you properly with the tools to drive your own analyses.

How This Book Is Structured

This book is divided into three parts:

1. Introduction
2. M&A Analyses
3. Office Depot/OfficeMax Merger

In Part One, we explain the M&A framework from a high level, overviewing types of transactions and the M&A process. We will also provide a refresher on the core financial statements, which will help you understand concepts demonstrated in Parts Two and Three.

Part Two will step through the process of an equity raise, a debt raise, a simple asset acquisition, an asset divestiture, and an accretion/dilution analysis. In each analysis we will illustrate the concepts and model example situations. These high-level analyses help us to understand the importance of key variables and are crucial to understanding how various assumption drivers affect potential results. The understanding of these analyses will help conceptualize the mechanics of a fully integrated merger, which will be detailed in Part Three.

In Part Three, we build a complete merger model of Office Depot and OfficeMax. We utilize the companies' historical performance and step through techniques to make accurate projections of the business's future combined performance. The goal of this part is not only to understand how to build a fully integrated merger model but also to understand the merger integration concepts to best interpret the merger results, understand how various drivers affect the analysis, and be able to create a transactional model based on any unique situation.

The book is designed to have you build your own merger models step-by-step. The model template can be found on the companion website associated with this book and is titled “NYSF_Merger_Model_Template.xls.” To access the site, see the “About the Companion Website” section at the back of this book. If you have no prior technical experience in the subject of modeling, I would recommend reading the book that precedes this one, entitled *Financial Modeling and Valuation: A Practical Guide to Investment Banking and Private Equity*, which steps through the building of a core model on Walmart.

Part One

Introduction

Mergers, acquisitions, divestitures, and restructurings (M&A) are fundamental yet complex transactions commonly used in the investment banking and private equity industries. In this part we will overview the types of transactions that can be considered “M&A.” This will help you define and better understand the various M&A strategies and motivations behind large transactions. We will overview the M&A process to give you perspective on how transactions are originated. Finally, to best prepare you for M&A analysis in the subsequent parts, we will provide a financial statement refresher, detailing the core financial statements, including the income statement, cash flow statement, and balance sheet. The concepts behind what drives each statement and how each work together are important to form a functional model.

Chapter 1
Merger and Acquisitions Overview

The distinction between a merger, an acquisition, a divestiture, and other types of restructurings warrants some clarification. Transactions can come in a multitude of forms, can be a hybrid of several classifications, or in new markets can create a brand new classification altogether. Often some of the definitions are used interchangeably or are categorized differently. There has really been no set standard for these definitions, but I will attempt to simplify and clarify ahead. It is important to understand these core structures to better classify any individual transaction explored. Note that there are many excellent books that go through the subjective, regulatory, and legal aspects of mergers and acquisitions. This book is designed to give a technical and procedural approach, so I will brief you only on the major keywords.

Merger: A merger is fundamentally the combination of two or more business entities in which only one entity remains. The firms are typically similar in size. (Company A + Company B = Company A).

Consolidation: A consolidation is a combination of more than one business entity; however, an entirely new entity is created. (Company A + Company B = Company C).

Acquisition: An acquisition is the purchase of a business entity, entities, an asset, or assets. Although often used interchangeably, an acquisition differs from a merger in that the acquiring company (the acquirer) is typically significantly larger than the asset or entity being purchased (the target).

Acquisitions can take several forms, including the following:

- **Acquisition of assets**: An acquisition of assets is the purchase of an asset or group of assets, and the direct liabilities associated with those assets.
- **Acquisition of equity**: An acquisition of equity is the purchase of equity interest in a business entity. The differences between an acquisition of assets and an acquisition of equity are important from a legal, regulatory, accounting, and modeling perspective and will be detailed further later in the book.
- **Leveraged buyout**: A leveraged buyout (LBO) is an acquisition using a significant amount of debt to meet the cost of acquisition. Please see my book entitled *Leveraged Buyouts: A Practical Guide to Investment Banking and Private Equity* for a thorough analysis of leveraged buyouts.
- **Management buyout**: A management buyout (MBO) is a form of acquisition where a company's existing managers acquire a large part or all of the business entity.

  Acquisitions can be considered *hostile* or *friendly,* depending on the assertive nature of the process.

- **Friendly acquisition**: An acquisition accomplished in agreement with the target company's management and board of directors; a public offer of stock or cash for example is made by the acquiring firm, and the board of the target firm will publicly approve the terms.
- **Hostile acquisition**: An acquisition that is accomplished not by coming to an agreement with the target company's management or board of directors, but by going through other means to get

acquisition approval, such as directly to the company's shareholders; a tender offer and a proxy fight are ways to solicit support from shareholders without direct approval from company management.

Mergers, consolidations, and acquisitions can be categorized further:

- **Horizontal**: A horizontal transaction is between business entities within the same industry. Such a combination would potentially increase market share of a business in that particular industry.
- **Vertical**: A vertical transaction is between business entities operating at different levels within an industry's supply chain. Synergies created by merging such firms would benefit both. A good example is within the oil and gas industry. In the oil and gas industry you have exploration and production (E&P) companies that drill for oil. Once oil is found, the wells are producing, and the energy is refined, distribution companies or pipeline companies transport the product to retail for access to the customer, such as a gas station. So in this example, an E&P company purchasing a pipeline company or a gas station would represent vertical integration—a vertical merger. In contrast, an E&P company purchasing another E&P company is a horizontal merger.
- **Conglomerate**: A transaction between two or more unrelated business entities—entities that basically have no business activity in common; there are two major types of conglomerate transactions: pure and mixed. Pure conglomerate transactions involve business entities that are completely unrelated, while mixed conglomerate transactions involve firms that

are looking for product extensions or market extensions.

Divestiture: A divestiture is the sale of an interest of a business entity, an asset, or group of assets.

Divestitures can be delineated futher:

- **Asset divestiture**: An asset divestiture is the sale of an asset or group of assets. In Part Two of this book we will discuss a simple asset divestiture.
- **Spin-off**: A spin-off occurs when a parent company creates a separate entity and distributes shares in that entity to its shareholders as a dividend.
- **Equity carve-out**: An equity carve-out occurs when a parent company sells a percentage of the equity of a subsidiary to the public. This is also known as a partial IPO.

Other restructurings: Mergers, consolidations, acquisitions, and divestitures can all be considered types of business restructurings as they all involve some level of reorganization aimed to increase business profitability. Although the foregoing are just major categories, other types of business restructurings can be considered to help fuel growth. A share buyback, for example, is when a company buys back shares in the open market. This creates an antidilutive effect, hopefully fueling an increase in company stock price. A workforce reduction is another example of a way to reduce costs and improve earnings performance. Each of these strategies are other restructuring examples which aim in some way to improve business value.

Although not a complete overview, briefing the foregoing terminology should in the least give perspective on the analyses to follow. Again for more subjective detail on M&A definitions and process, there are plenty of M&A books out in the market to complement this book. The purpose of this book specifically is to illustrate the technical analysis quantifying the financial benefits of an M&A situation.

The M&A Process

Although there are many facets to M&A and the industry is constantly evolving, it is important to understand the possible steps an acquirer would take in order to pursue a target business. This will further help one understand the M&A process. The early stages of the process are considered *friendly*, and the latter *hostile*.

Casual pass: A casual pass is an informal inquiry made to business management. This can literally be done via e-mail, a letter, or a phone call. A solicitation to management to discuss "strategic alternatives" can be a suggestion for acquisition. Management can either respond or reject. A rejection would lead the acquirer to one of the next steps, and this can now be considered *hostile*.

Bear hug: A bear hug is a letter to company management regarding an acquisition and demanding a rapid response. The letter is not a proposal but rather a demand and arrives without warning. Often the bear hug action is made public and is utilized to encourage management to negotiate in a friendly manner.

Open market purchase: In an open market purchase the acquirer purchases shares in the open market. Although an interesting tactic, this can often end up unsuccessful if a majority of shareholders are *not* willing to sell their shares. However, if successful, this could lower the overall cost of the transaction as one blanketed control premium is no longer negotiated, among other reasons. We will discuss the control premium later in the book.

Proxy contest: In a proxy contest the acquirer seeks to gain shareholders' support to change the board of directors' or management's decision in some way to allow the acquisition to proceed. A proxy letter can be mailed out to every shareholder in an attempt to garner support in the form of “votes.” Although the proxy strategy comes in several forms, it can prove to be unsuccessful if the target company stock is held by a large number of individuals.

Tender offer: A tender offer is a direct solicitation to purchase shareholders' shares. Because a significant purchase premium is involved in order to try to ensure that enough shareholders would be willing to sell their shares and allow the acquisition to proceed, the tender offer is a costly method of acquiring a business.

These major categories do have subcategories, and other methods of pursuing an acquisition do exist. But these major methods should help provide the most general perspective on acquisition procedure. Of course, *all* of the steps to an acquisition are vast and time-consuming, and consist of legal, regulation, research, and due diligence. But these are the major components designed to help you understand from a very high and investment banking–minded level where these acquisitions come from. Let see how this framework applies to Office Depot and OfficeMax.

Office Depot and OfficeMax

It is important to research various data sources for accurate information on the Office Depot and OfficeMax transaction. I would recommend going to both company websites and www.sec.gov for the most accurate information on the company and transaction. We have already found the February 20 press release from the investor relations section of the company website. To locate this press release, you can navigate to www.officedepot.com. At the bottom of the Office Depot home page is an "Investor Relations" button. (See Exhibit 1.1.)

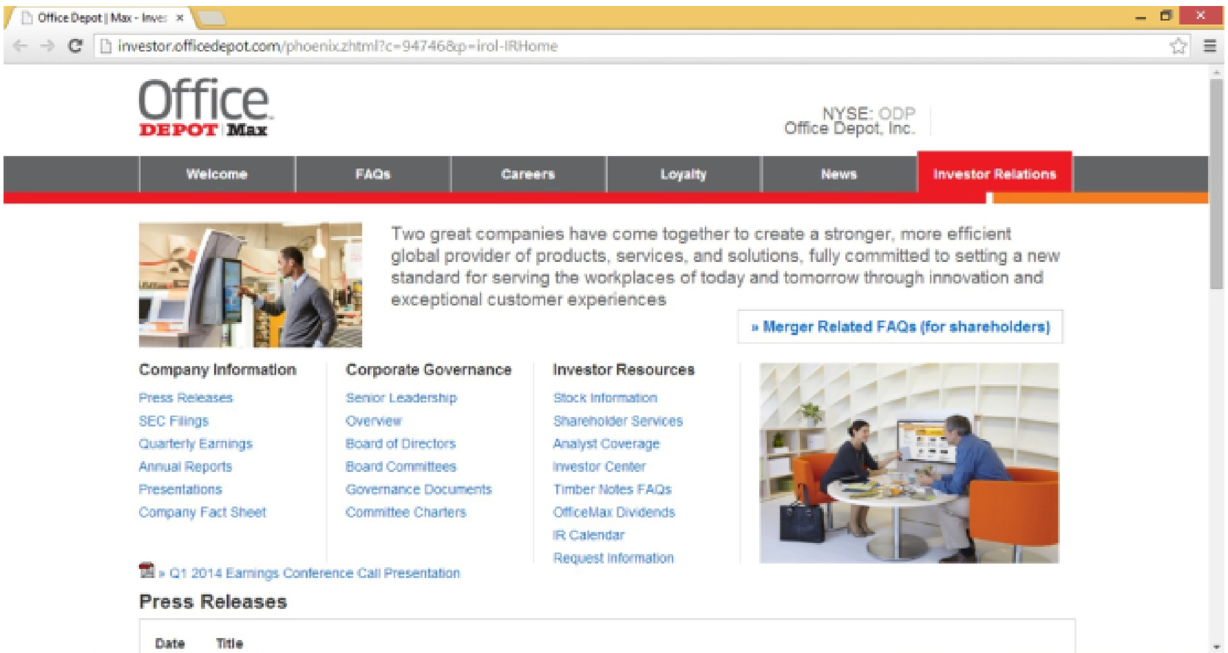

Exhibit 1.1 Office Depot Website—Investor Relations

To the left of this page under "Company Information," you can click the "Press Releases" link, where the press release can be found. You may have to adjust the drop-box located right under the "Keyword Search" box to select press releases from 2013, and then scroll down to find the exact February 20, 2013, press release entitled "OfficeMax and Office Depot Announce Merger of Equals to Create $18 Billion Global Office Solutions Company" (see Exhibit 1.2). We could have also gone to the Investor Relations section of OfficeMax to find a press release on the transaction.