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Making Acquisitions for Stock: How Sweet It Is

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Many of the largest and most widely publicized insurance acquisitions today are made with stock rather than cash or other considerations. Stock acquisitions offer some unique advantages and challenges for both the buyer and the seller in the transaction. Complex issues of measurement and market perception, as well as psychological ramifications for employees, customers and agents are raised in large stock transactions. The session will address these issues from the perspective of an active acquirer, a capital markets analyst, and a technical professional involved in dealing with these issues.

MR. CHARLES CARROLL: Our session is titled, “Making Acquisitions For Stock: How Sweet It Is.” To tell you the truth, I really don’t know if it’s all that sweet to make acquisitions for stock, but it isn’t too surprising that in a booming market you do find a lot of acquisitions made for stock these days. Actually, most deals are cash deals or they involve significant amounts of cash; however, many of the largest deals, or many of the deals that we read about in the *Wall Street Journal* are stock deals. It is also true that the prices paid in these large stock transactions tend to involve substantial premiums over book and market value. In order to understand the basic dynamics of the current mergers and acquisitions (M&A) market, it’s important to understand how stock deals work.

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All charts referred to in text can be found at the end of the manuscript.

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When we decided to run this panel on stock acquisitions in the spring of 1999, a number of big stock deals had just been announced, notably Aegon's acquisition of TransAmerica. That situation was part of the reason I thought this would be an interesting session. I didn't know back then that the Financial Accounting Standards Board would publish an exposure draft of a future pronouncement that will have a major impact on stock acquisitions and on the M&A market in general. We are going to discuss the implications of the exposure draft in this session.

I've set forth four goals for this session. There are four things I hope you will take away from this session:

1. an understanding of the advantages and disadvantages of stock as an acquisition currency
2. an understanding of how stock deals are analyzed from a financial point of view
3. an understanding of the key accounting implications of using stock
4. an understanding of the major exposure draft that the FASB has just released

To address these objectives, we have two very accomplished and expert speakers who have a deep background in this subject matter. The first speaker will be Scott Littlejohn. Scott is with Salomon Smith Barney. He joined their financial institutions group in 1992 as an associate working as a generalist across all industries. Since then, he has specialized in M&A for insurance companies. He was promoted to director at the end of 1998. Some of his deal experiences include the Provident Company's merger of equals with UNUM Corporation, the sale of CapMAC Holdings to MBIA, and ING's acquisition of The Equitable of Iowa Companies. Scott holds an MBA in finance with distinction from the Stern School of Business at New York University, and he holds an undergraduate degree from Lafayette College. He is also a CPA.

Our second speaker is Deborah Whitmore. Deborah is a partner in Ernst & Young. She previously worked at Equitable Life Assurance Society where she played a major role in the accounting aspects involved in the demutualization of the Equitable. She is also a CPA, a member of the American Institute of Certified Public Accountants, and a Fellow of the Life Management Institute. She also serves in many professional bodies, including advising AICPA committees and other professional rulemaking and standard-setting bodies. Scott will now discuss stock deals from an investment banking perspective.

MR. SCOTT LITTLEJOHN: I'm going to provide some background information on the M&A landscape at financial institutions, and then we'll talk in more detail about some of the mechanics involved in stock acquisitions. As Charles said, there are some pluses and minuses to using stock. When contemplating mergers and acquisitions, I think it's interesting to reflect on the impact that M&A has had on the global financial services landscape. The top 20 financial institutions in the world in 1990 are listed below.

- Industrial Bank of Japan
- Fuji Bank
- Sumitomo Bank
- Dai-ichi Kangyo Bank
- Mitsui Taiyo Bank
- Mitsubishi Bank
- Sanwa Bank
- Long-Term Credit Bank
- Nomura Securities
- Allianz Holding
- Tokai Bank
- Deutsche Bank
- Bank of Tokyo
- Assicurazioni Generali
- Nippon Credit Bank
- Mitsubishi Trust
- AIG
- Sumitomo Trust
- Tokio Marine & Fire
- Yasuda Trust

Remarkably, only four companies are not Japanese. Three of the companies are European. AIG is the only U.S. company.

Much has happened in the world since 1990 in terms of changes to local economies, currencies, and global stock markets. Many of these fundamental changes in the world have manifested themselves in the form of M&A activity as shown on Chart 1. This shows financial institution M&A activity from 1995 through year-to-date 1999. You can see the strong progression from 1996 to 1998. For each year there are two bars. The left-hand bar for each year shows the activity by type of business within financial institutions: asset management, depository, diversified and insurance. The bar on the right separates out the activity by region of the world. Insurance activity is represented by the pinkish color at the top of the left-hand bar. What you can see is that insurance has maintained a fairly constant percentage of total financial institutions activity

from 1996 onward, and if you annualize the data for 1999, it is pretty much on track in terms of total volume. The other interesting factor is reflected in the regional breakout. The blue is Europe, and if you look at year-to-date 1999, you can see that European activity for 1999 is a whopping 55% of total activity.

Chart 2 shows the top 20 financial institutions in the world ranked by market capitalization in 1999. Blue is the U.S., red is Japanese, and green is Europe. You can see it is dramatically different than in 1990. The top four are all U.S. institutions. Actually, 11 of the top 20 and six of the top ten are U.S. companies. Only three of the top ten are European, although they have pretty good representation in the top 20 (eight European companies are in the top 20). The one Japanese company is Bank Tokyo Mitsubishi.

Chart 3 provides a different perspective on global M&A activity. This is total M&A activity for all industries. Financial institution activity is represented in the green, and the takeaway from this chart is that financial institutions activity is about 30% of total global M&A activity in terms of all deals. What's more important is financial institutions activity is also about 30% in terms of deals over a billion dollars in transaction value.

The purpose of Table 1 is to show how M&A's have been used as a tool to implement strategic initiatives from revenue growth to geographic extension. These are some of the larger M&A deals in insurance that have happened over the last 12–18 months. Life insurance deals are shown at the top and property & casualty (P&C) are at the bottom. There have obviously been numerous, complex factors that have led to these transactions, but I will say that each one has helped both the acquirer and the target company implement strategic initiatives. Just for the record, we represented Provident, and I can certainly answer questions about that merger of equals. We represented American Bankers on the sell side of their transaction. We recently represented Royal in their acquisition of Orion and Markel in the Terra Nova deal.

TABLE 1
Recent Insurance Transactions

	\$ Billion
Life M&A Deals	
AIG / Sun America	17.7
Aegon / Transamerica	10.7
UNUM / Provident	5.3
Fortis / American Bankers	2.6
Metlife / General American	1.2
Allstate / American Heritage	1.1
Property / Casualty	
Berkshire Hathaway / Gen RE	22.3
RSA / Orion	1.4
Markel / Terra Nova	1.1
Allstate / CNA personal lines	1.2
Metlife / St. Paul personal lines	0.6
Trenwick / Chartwell	0.2

The multiples of price-to-book value for life insurance company deals have certainly been increasing over time. We can compare the purchase price to GAAP book value with the transaction value to statutory surplus for 1995–98. The purchase price to GAAP book value is as follows: 1995, 1.01x; 1996, 1.27x; 1997, 2.02x; and 1998, 1.87x. The transaction value to statutory surplus is: 1995, 1.61x; 1996, 2.60x, 1997, 2.79x, 1998, 3.66x. There is a progression from 1996 to 1998, although the price-to-book value ratio flattened out a little bit from 1997 to 1998. What I believe is more interesting is to see that buyers are clearly willing to pay for size.

We've separated out deals less than \$150 million, those between \$150 and \$700 million, and those over \$700 million. There is a progression in deal multiples as deal size increases. This doesn't mean that buyers are paying more money. They're paying more on a relative basis—relative to GAAP book value and relative to statutory surplus. It's not rocket science. People are willing to pay for scale, for market presence, and for economies of size. There's the interesting dynamic of scarcity, supply, and demand. With every year, there are fewer publicly traded life insurance companies with market values over \$700 million. American Heritage just went to Allstate. That was a deal with a purchase price just over one billion dollars. There are some

pretty significant mutuals that will demutualize soon, and that will change the demand/supply dynamic a little bit.

What's very pertinent to our discussion is the stock deals, defined as the deals where the consideration was 40% or more stock and the ratio of price-to-statutory book value. There's also the ratio of price-to-statutory book value for cash deals. You can see that the multiple of price-to-book value is about three times on average for stock deals and about two times for cash deals. The multiple to statutory earnings shows the much higher multiple. It's close to 25 times for stock deals versus about 16 times for cash deals. Why is this? Let's explore it a little bit. The short answer is the power of the currencies that are involved. What I hope to explain is a little bit more about the math involved and the way people look at their ability to pay. What can I afford if I'm going to go into this transaction and use my stock, and how's the market going to look at it?

Chart 4 illustrates some of the choices an acquirer has in selecting a form of consideration. If you're an acquirer and you're going to make an acquisition, you have two choices in terms of form of consideration. One is stock, and one is cash. To be clear, if you're providing cash as the consideration, it can be funded in many different ways, including doing a stock offering, doing a debt deal, or having excess cash on your balance sheet. The other two boxes in Chart 4 are much less common forms of consideration. One is called hybrid security, which is a preferred stock. You might give the target shareholders preferred stock. You may give them a convertible security. A facilitator is something like a warrant. Every once in a while, you'll see a warrant put in as part of the consideration. These facilitators are seen more often in Europe. There's a thing called a constant value receipt (CVR) that you can give a shareholder.

Table 2 lays out some of the issues with regards to using stock as consideration. One of the advantages of using stock is that the deal may qualify for pooling-of-interest accounting. If you use stock, you may be able to give the target shareholders an advantage in the form of a tax-free exchange. If certain conditions are met in dealing with continuity of interest, the deal might qualify as a tax-free exchange. In order to qualify as a tax-free exchange, 40% of the total consideration (the lawyers will tell you 50% is a little bit safer) must be in the form of stock. If

80% of the consideration was stock, taxes can be deferred only with respect to that 80%. The 20% that was received in the form of cash is immediately taxable, even in a tax-free exchange. It's just the stock component, because it's providing you this continuity of ownership that qualifies for tax-free exchange treatment. To the extent the acquirer's price/earnings ratio (P/E) exceeds the P/E paid in the deal, it will generally be accretive to earnings per share. When you issue stock, you're de-leveraging your balance sheet. Depending on how much debt the target has on its balance sheet and how much debt you're raising for this deal, stock deals will be de-leveraging to the balance sheet, and that could have a favorable credit rating impact.

TABLE 2
Stock Consideration Issues

Advantages	Disadvantages
<ul style="list-style-type: none"> • Allows for pooling-of-interests • Allows tax free exchange if stock makes up at least 40–50% of total consideration • Compelling purchasing power to the extent acquiror's P/E exceeds P/E paid • Deleveraging effect could have favorable credit rating impact • May be viewed as attractive investment 	<ul style="list-style-type: none"> • If electing pooling, limit certain strategic and capital transactions for two years post pooling • More dilutive to EPS than cash • Dilutive to EPS to the extent price paid exceeds acquiror P/E • High cost of capital vis-à-vis debt • Could lower pro forma ROE

The last advantage listed on Table 2 is kind of interesting. It says, “May be viewed as an attractive investment.” I guess if McDonald's was competing with Outback Steak House for an acquisition target, the target might think that McDonald's stock is more appealing than Outback Steak House's. An example close to home is Berkshire Hathaway's acquisition of Flight Safety a few years ago. If you've ever thought of an attractive currency, you've probably thought of Berkshire Hathaway stock. Warren Buffet thinks of it that way as well, to the point where he had the audacity, because it has really never been done before—to provide a discount for people taking Berkshire Hathaway stock as opposed to cash in the transaction. Those who chose stock received 50 cents less per share than those who took cash. To my knowledge, it has never been done before because the general view is that the seller will be indifferent unless there's a tax-free exchange involved. After all, you can always take the cash and buy the stock, but with Berkshire Hathaway, it's not so easy to buy it because, at the time, they only had Class A shares, which traded at about \$20,000 a share. You really didn't have the option of taking the stock unless you had other money you wanted to invest.

Let's discuss disadvantages. The first one is pooling specific. If you do elect pooling, then it's important to understand, as an acquirer, that it will preclude you from certain strategic initiatives you might otherwise want to do for the two-year period after the deal closes. Deborah can talk about that two-year period if she wants to. Sometimes you can push it a little bit, or you'll have investment bankers asking you to push it a little bit. For example, if you want to dispose of part of the newly acquired entity, you may not be able to do that without disqualifying the transaction as a pooling. Stock is more dilutive to earnings per share (EPS) than cash. To the extent your P/E is less than the P/E that you pay the target shareholders, it will be dilutive as well. Intrinsically, stock has a higher cost of capital. I don't know if people have ever fooled around with the capital asset pricing model, but if you've ever done that, you'll see that stock intrinsically costs shareholders more than cash, and it's an important consideration to think about. If you issue stock, you're enhancing your shareholders' equity, and you could be lowering your pro forma ROE. It's something we shouldn't lose sight of. Oftentimes, people just say the deal's accretive. Isn't that great? What about the ROE?

So, how much can I pay? What can I afford? The key constraints are: (1) EPS change, dilution or accretion, (2) impact on pro forma P/E, and (3) impact on leverage.

Leverage is going to be a function of the target's debt and how much debt the purchaser issues in the deal. I'm not going to cover that in this discussion. If you think about one and two, they're obviously linked. One is the pro forma EPS. Number 2 is really the P/E. What's really most important when you do a deal, if you're an acquirer, is how is the stock market going to react to the deal? What's my stock price going to be after the deal? Stock price is earnings per share times P/E. People often simplistically think of deals in terms of EPS change. If it's EPS accretive, and if the P/E is held constant, then your stock's going to benefit. You cannot always assume that your P/E is going to be held constant. Here's an extreme example that shows the fallacy of assuming a constant P/E. What if an Internet company that trades at 50 times earnings decides to buy a property/casualty company that trades at ten times earnings? For simplicity, let's assume they're both about the same size. You have 50, and you have ten. It's obviously going to be wildly accretive to earnings per share. Right? But what's the pro forma P/E? Well,

50 plus ten divided by two is 30. The math doesn't involve the emotion of an Internet company buying a property/casualty company. So, going from a 50 P/E to a 30 P/E, is a 40% reduction. Even though it's wildly accretive to EPS, the P/E is going to get cratered on this Internet company. And that's without considering the emotion of it, and that's why we always say M&A's not a science. It's an art. We'll talk a little bit more about what people think about pro forma P/E's, but I really want to drive home the math that's involved.

The basic equation for calculating EPS purchasing power or ability to pay, that is, the maximum amount the acquirer can afford to pay without the deal being dilutive to the acquirer's earnings per share, is shown below:

$$\text{EPS Purchasing Power} = \text{Acquiror P/E} \times \text{Target EPS}$$

As you can see in the equation, there are two components. There's EPS, and there's P/E. The EPS's ability to pay with no dilution to pro forma earnings per share is all P/E driven, regardless of size. You can be five times the size of me, but if I have the same P/E that you do, I can still pay the same price that you can pay for a particular target at the breakeven point, and only at the breakeven point. It's all driven by the acquirer's P/E multiplied by the target's earnings per share. That's the maximum price payable without any dilution in earnings per share.

Table 3 shows the basic assumptions for three hypothetical companies that we will use to illustrate the numerical relationships involved in acquisitions. There are two buyers, Buyer A and Buyer B. Buyer A is about three times the size of Buyer B, in terms of net income and in terms of the last column on Table 3, which is market value. Even though Buyer A is three times the size of Buyer B, they both have the same P/E or price-to-earnings multiple, which is 22 times. You can see that in the third column from the right. We're going to run numbers on both of them acquiring Target Company C. Target Company C has \$500 of net income, a P/E of 16, and a market value of \$8,000. In this example, we are assuming a 100% stock deal and pooling accounting. There's no goodwill involved. We're going to focus on ability to pay. What's the impact on pro forma earnings per share, and what's the impact on pro forma P/E? Put the two together, and see what the stock price does. Don't jump ahead.

TABLE 3
Assumptions for Example

Company	N/I	Shares O/S	EPS	P/E	Stock Price	Market Value
Buyer A	\$2,500	1,000	\$2.50	22x	\$55.00	\$55,000
Buyer B	800	1,000	0.80	22	17.60	17,600
Target C	500	1,000	0.50	16	8.00	8,000

Table 4 illustrates what happens if Company A acquires Company C, assuming the purchase price represents a range of premiums over the pre-deal market value of Company C. In Table 3, Target Company C trades at \$8 a share. I've shown different premiums to market from 10% to 50%. On the first line, you can see that the assumed premium to market is 10%, which translates to a price of \$8.80 per share. What's important is to translate the purchase price per share into the P/E paid, which is the third column. Target Company C earns about 50 cents a share. If I'm paying \$8.80 per share, that's an 18x P/E. That's how you derive the P/E paid. It's important to distinguish between the target's P/E relative to its trading price and earnings before the deal and the P/E paid; that is, the ratio of the price the acquirer pays to the target's earnings. We are referring to the P/E paid by the acquirer in Table 4. We see that the pro forma EPS for the combined entity is \$2.59. That's nine cents above Company A's pre-deal stand-alone EPS of \$2.50. Thus, we would say the deal is 3.45% accretive to earnings per share for Company A. It looks pretty good, right? Everyone would do this deal? If the deal is done at a P/E paid of 22—the same as Company A's pre-deal stand-alone P/E—it is breakeven on an earnings-per-share basis. You can see that the post-deal pro forma earnings per share is \$2.50, the same as company A's pre-deal earnings per share.

TABLE 4
Company A Acquires Company C: EPS Impact

Premium To Market	Price per Share	P/E Paid	Aggregate Value	PF EPS	Accretion/ (Dilution)
10%	\$ 8.80	18x	\$ 8,800	\$2.59	3.45%
20	9.60	19	9,600	2.55	2.37
30	10.40	21	10,400	2.52	0.92
40	11.20	22	11,200	2.50	-0-
50	12.00	24	12,000	2.46	(1.49)

Table 5 shows what happens if Company B, which is about a third the size of Company A makes the acquisition. If you drop down to the 40% premium to market, you can see at the 22 P/E that the deal is neither accretive, nor dilutive. The earnings per share is the same as Company B’s pre-deal earnings per share of 80 cents. At a 10% premium to market, with Company B making the acquisition, the deal is 8.3% accretive. Company B is a smaller company, yet it’s more accretive. The reason for that is fairly straightforward. Company B is starting from a smaller base. It’s just a matter of algebra. When you’re looking at percentage changes, the impact on the smaller company is going to be greater. When you’re in the land of accretion, that’s great, but when you’re in the land of dilution, it’s not so hot because if you look at the 50% premium-to-market scenario, the deal is 3.38% dilutive to Company B, whereas it’s only 1.49% dilutive to Company A.

**TABLE 5
Company B Acquires Company C: EPS Impact**

Premium To Market	Price per Share	P/E Paid	Aggregate Value	PF EPS	Accretion/ (Dilution)
10%	\$ 8.80	18x	\$ 8,800	\$0.87	8.33%
20	9.60	19	9,600	0.84	5.15
30	10.40	21	10,400	0.82	2.14
40	11.20	22	11,200	0.80	-0-
50	12.00	24	12,000	0.77	(3.38)

In Table 6, we’re going back to Company A buying Company C, and this gives you some more information that we’re going to want to look at in evaluating pro forma P/E. One important thing is target ownership, which is the third column. Remember that A is the bigger company. The Target Company C, Company A, gave them 100% stock as the purchase price, so now Company B’s shareholders own approximately 13.8% of Company B. Remember that Company A was worth \$55,000, and we paid \$8,800 in the 10% scenario. That translates into 13.8%, and the higher the purchase price, the more shares of stock they receive, and the more of Company A they own. If you follow that column down, you’ll see it progresses up to 17.9% ownership at a 50% premium.

TABLE 6
Company A Acquires Company C: Impact on P/E and Stock Price

Premium To Market	P/E Paid	Target Ownership	Target Earnings Contribution	Blended P/E	PF Stock Price	% Change	Breakeven P/E
10%	18x	13.79%	16.67%	21.0x	54	(1.25)%	21.3x
20	19	14.86	16.67	21.0	54	(2.48)	21.5
30	21	15.90	16.67	21.0	53	(3.67)	21.8
40	22	16.92	16.67	21.0	52	(4.83)	22.1
50	24	17.91	16.67	21.0	52	(5.97)	22.3

In the next column, the target earnings contribution is important as well. Target Earnings Contribution doesn't change with price. Company C earned \$500. That's how you get the 16.7% target earnings contribution, and what that's going to drive is P/E. P/E is a measure of valuation of earnings. It's the way the market values earnings. If, pro forma, this new Company A/C has 16.7% of its earnings coming from a company that traded at 16, what will its weighted average P/E be? I've calculated it for you so you have the answer. It's 21x. It takes the 16.7% that's coming from Company C, multiplies it by 16, which is Company C's P/E, and then takes 83.3% times 22 which is Acquirer Company A's P/E; that's how you get the 21. Finally, you take the blended P/E, you multiply it by the pro forma earnings per share, which was \$2.59, and you get a pro forma stock price of \$54. We are not even considering such questions as, what about the strategic fit? If that Internet company bought a property/casualty company, I can guarantee you the P/E would be less than that 30 that I talked about before. We're showing a pro forma stock price that's about 1% lower than where Target Company A trades before the deal. It's not looking like such a great deal anymore. That 3% accretive deal to earnings per share suddenly doesn't look so hot. Some people don't go any farther than the analysis shown on Table 4. They say, "It's an accretive deal. What more do you want to know?" Maybe you should continue to think through the impact on the P/E and not just the math.

The breakeven P/E, which is shown in the last column of Table 6, is another important number. The breakeven P/E takes the stock price today for the acquirer company, which is \$55, and divides it by the pro forma earnings per share which is \$2.59. That gives you the 21.3 breakeven P/E shown in the last column. The important comparison of the breakeven P/E is not to the 22 where they trade today. It's really to the blended P/E. The math tells me the blended P/E is 21.

You tell me the breakeven is 21.3. That means I must preface this deal on an expansion in my P/E of 0.3. I don't think it is too daunting. You don't like to preface deals on P/E expansion, but more and more these days people do because of the strategic nature of a lot of the deals. The required expansion in P/E in order not to have the stock price decline as a result of the deal goes up to 1.3. If you compare the breakeven P/E to the pro forma blended P/E at the 50% premium to market line, you'd find it is 22.3 versus 21.

How is Company B faring? Let's look at the results on Table 7. If we analyze the deal for company B as we did for Company A on Table 6, we see that ownership is 33% at a 10% premium because Company B is a much smaller company. What's going to happen intuitively with the blended P/E? Remember, Company B had the same P/E as Company A at 22, but the blended P/E, because it's picking up a lot more of the 16 P/E company, is going to be a lot lower. So, the blended P/E is 19.7 for Company B versus the 21 for Company A. You do the math to come up with a pro forma stock price. This was an 8% accretive deal based on the analysis on Table 5. Many would have said that's a slam dunk to Company B, but if you take the accretive earnings per share, it's 8% accretive. You multiply it by the pro forma blended P/E, and you get a stock price of 17. That's 3% less than the stock price today. It doesn't look like such a hot deal anymore, does it? The breakeven P/E is going to be commensurately higher than the breakeven P/E for Company A, which was the larger company. P/E is a driver to breakeven EPS, and it's important in terms of the whole equation here, but size does matter. P/E does matter.

TABLE 7
Company B Acquires Company C: Impact on P/E and Stock Price

Premium To Market	P/E Paid	Target Ownership	Target Earnings Contribution	Blended P/E	PF Stock Price	% Change	Breakeven P/E
10%	18x	33.3%	38.46%	19.7x	17	(3.03)%	20.3x
20	19	35.3	38.46	19.7	17	(5.88)	20.9
30	21	37.1	38.46	19.7	16	(8.57)	21.5
40	22	38.8	38.46	19.7	16	(11.11)	22.2
50	24	40.5	38.46	19.7	15	(13.51)	22.8

All of this is summarized on Table 8. The EPS accretion/dilution columns show much more dilution. When you get into the land of dilution that's when you certainly want to be the bigger company. You basically always want to be the larger company because, as we saw in the P/E

analysis, even when the deal is less accretive to Company A, they came off looking much better in terms of pro forma stock price. You can see that in the last two columns on Table 8 that show percentage change to the acquirer's stock price.

TABLE 8
Summary Page

Premium To Market	P/E Paid	EPS Accretion/ Dilution		Target Ownership		% Change in PF Stock	
		A/C	B/C	A/C	B/C	A/C	B/C
10%	18x	3.45%	8.33%	13.79%	33.33%	(1.25)%	(3.06)%
20	19	2.17	5.15	14.86	35.29	(2.48)	(5.88)
30	21	0.92	2.14	15.90	37.14	(3.67)	(8.57)
40	22	-0-	-0-	16.92	38.89	(4.83)	(11.11)
50	24	(1.49)	(3.38)	17.91	40.54	(5.97)	(13.51)

An equation for calculating purchasing power is shown below:

$$\text{PURPWR: } PP = (\text{TNI} + (\text{SYN} \times \text{OH} \times 0.65)) \times \text{APE/TSHR}$$

- PP – Pricing Power
- SYN – % Synergies
- OH – Pre-tax Overhead
- APE – Acquiror's P/E
- TSHR – Target Shares O/S
- TNI – Target Net Income

Purchasing power is defined as the maximum purchase price one can pay for a target without having any dilution in earnings per share. The formula takes into account cost savings or synergies because that's obviously very important in the real world when you do a deal. As I mentioned earlier, just like you hate to preface a deal on P/E expansion, you hate to preface a deal working from a financial point of view based on synergies. You might usually like it to work from a financial point of view before synergies or before required P/E expansion.

The formula for computing the percentage dilution in earnings per share due to a transaction is shown on the next page.

$$\text{DIL: \% DIL} = \frac{((\text{AEPS} - (\text{ANI} + \text{TNI} + (0.65 \times \text{SYN} \times \text{OH})) / (\text{ASH} + (\text{PP} \times \text{TSH}) / (\text{AEPS} \times \text{APE}))) / \text{AEPS}) \times 100$$

% DIL	– % Dilution
AEPS	– Acquiror EPS
TEPS	– Target EPS
TNI	– Target N/I
ANI	– Acquiror N/I
SYN	– % Cost Savings
APE	– Acquiror P/E
PP	– Price Paid
OH	– Target O/H
ASH	– Acquiror Diluted Shares O/S
TSH	– Target Diluted Shares O/S

What's nice about this formula is you can just input the data into your calculator, and then you can sensitize these different variables. This will enable you to answer such questions as, what if the target doesn't make what they say they're going to make, which is obviously a variable that you will focus on in M&A? What if I think I can do better than the expected earnings per share for the target company if I'm the acquirer?

There are some other issues in terms of structuring a stock deal. One is exchange ratio, or the ratio of the number of shares of the acquirer's stock that will be issued for each share of the target's stock. That's the most important. It's either fixed or it's floating. If it's a floating exchange ratio, that means that you're going to get a set dollar value for each share of target stock you own. I think that's the easiest to understand. It's a fixed price. Let's say I say to you, the target shareholders, I'm going to give you \$20 a share. So if I'm the acquirer, and my stock's at \$5 a share, I'll pay you four shares of my stock for each of your shares. What if at closing my stock is trading at \$10 a share? Then I'll only give you two shares. You'll still get your \$20 per share. That's what's meant by floating exchange ratio. On the other hand, the exchange ratio could just be set and fixed. Why would the exchange ratio be fixed at times and why would it be floating at times? Collars simply constrain or set a limit for the exchange ratio, whether it's fixed or floating. It'll only be fixed or floating plus/minus 10% or plus/minus one or two dollars. That's what a collar means. I have graphs that will make that clearer.

Election features is a pretty straightforward issue. That just means you have a choice of cash or stock. Oftentimes, there is a limit on how much cash or stock you can take. Usually the limit is on cash because if I want to do a tax-free deal, I'm going to make sure that the sellers, as a group, take 40–50% stock. In other words, you can only take so much cash. As the acquirer, I'll limit it so that I guarantee that the bucket of stock gets filled up to 40–50% so I can qualify for a tax-free exchange. Walk-aways are contract provisions that allow the seller or buyer to not go through with a deal if there is an adverse change in the trading value of the acquirer's stock between the time the deal is announced and closing. In other words, if the acquirer's stock price changes by a certain amount between the time of announcement and closing, the target shareholders will usually have the right to walk. A walk-away could also be for the benefit of the acquirer as well, and I guess now is as good a time as any.

Let's talk about the Cendant/American Bankers deal. This was a fixed exchange rate deal committed to, in a legal contract, a merger agreement. The provision was that Cendant would acquire American Bankers for a fixed-dollar price for each share of American Bankers stock. Moreover, a large percentage of the total purchase price was to be paid in Cendant stock. I've forgotten how much of the total purchase price was stock. It was a lot. There was over 50% stock.

Regardless of where Cendant's stock price was, it was guaranteeing a certain dollar price to the American Bankers' shareholders. What happened is, certain accounting irregularities were disclosed with regards to Cendant, and it's stock cratered. It went down over 50%. Think about it. In my example of the purchase of the company with the \$20 stock, the acquirer's \$5 stock went in the right direction from the acquirer's point of view. It went up. It was originally five, and I had to give you four shares; Then it went to 10, so I only had to give you two shares. In my example, what if my stock goes down to \$1 a share? I will suddenly have to crank out 20 shares, whereas I thought I only had to crank out four. At announcement, my stock was at five. When you issue more stock, it's more dilutive to earnings per share. You're giving away more ownership. You're giving away more shareholder value to the target shareholders.

Frankly, Cendant was between a rock and a hard place because it didn't negotiate a walk-away for the benefit of the acquirer. Unfortunately for Cendant, it couldn't afford to crank out all the stock it would have to crank out to pay the fixed price, so they had to pay a breakup fee to get out of this legal contract. A merger agreement is a serious thing. It's a legal contract. That's why you have walk-aways. They allow you, under the guidelines of the contract, to walk away without any repercussions. We can talk a lot more about walk-aways in the question-and-answer period because they certainly are interesting.

Table 9 attempts to answer the question, when do you use a fixed exchange ratio and when do you use a floating exchange ratio? To the extent the target shareholders' pro forma ownership is over 40%, you will see a fixed exchange ratio, and the reason for that is because that kind of deal where the target ends up owning over 40% of the whole company is viewed more as a merger.

TABLE 9
Exchange Ratio Generalizations

Target Company Pro Forma Ownership	Generalization
>40%	<ul style="list-style-type: none"> • Viewed more as a “merger” • Postannouncement target's stock/financial results have significant impact on acquiror's stock • Generally see more fixed exchange ratio transactions
<30%	<ul style="list-style-type: none"> • Viewed more as an “acquisition/takeover” • Price certainty usually rises to greater level of importance • Generally see more fixed price/floating exchange ratio transactions
30–40%	<ul style="list-style-type: none"> • Harder to generalize

After the announcement, the market will trade both companies as if they're one, assuming they expect a deal to go through. There's obviously always uncertainties with regards to regulatory approvals, antitrust, and just the deal falling apart. That's why you have that little arbitrage that people try to play. The market will trade both companies together. That means the target stock and the target's performance will impact the acquirer's stock almost as much as the acquirer's own results. If you're the acquirer, you say, “If you're going to impact me, why would I give you price certainty?” We're in this together, so let's fix the ratio between the two stocks so that we

do trade in tandem. By the way, if you do a merger of equals, which is close to 50/50, you always do a fixed exchange ratio. I mean there's just no debate about it. There has never been a merger of equals done where the exchange ratio is not fixed. That's why I feel pretty comfortable saying it is over 40%, although there will be exceptions. Generally, if it's over 40%, it's a fixed exchange ratio for the reasons I mentioned. Generally, if it's less than 30%, it's viewed more as a takeover. If you're the target company, and you're being bought out, whether it's for stock or not, your primary objective is price, right? You want to maximize the price, but you also want price certainty. You went and negotiated this price. The last thing in the world you want is for the acquirer's stock price to go down significantly, which would obviously diminish the value you receive if it's a fixed exchange ratio. To the extent it's less than 30%, you'll see a fixed price deal like the American Bankers deal, and the example of \$20 a share. That's what I'll give you, regardless of where my stock price is.

Chart 5 demonstrates, in graphic terms, the implications of fixed and floating exchange ratios. The red line represents the dollar value of the consideration received by the target shareholders, which is denominated on the right-hand vertical axis. Alternative I—Fixed Price—No Collar, is a constant amount of about \$73 a share. The x-axis represents the acquirer's stock price. For Alternative I, regardless of where that acquirer stock price is (from \$33.23 to \$43.23), you'll always get about \$73 a share, as shown by the flat red line. The dotted yellow line is the exchange ratio, which is simply how many shares of acquirer stock I get as a target shareholder for each share of target stock I own. The exchange rate changes as the acquirer's stock price changes. At announcement I assume it's about \$38.23. If the acquirer's stock price goes up, what happens? The acquirer issues fewer shares of stock to the target's shareholders. That's why you see the dotted yellow line sloping from left to right for Alternative I.

Alternative II shows what happens when you have a fixed exchange ratio. Some people say it's a floating exchange ratio for Alternative I, and I personally think that confuses things. I refer to Alternative I as fixed price and Alternative II as fixed exchange ratio. The dotted yellow line, the exchange ratio, is what stays constant in Alternative II. That's the number of shares of stock that you receive for each one share of target stock you own. So, if you look along the x-axis, which is

the acquirer stock price, to the extent that changes, the value or the red line will change, and it's all linear, and just inverse from Alternative I.

Alternative III is a fixed price deal with a collar. Again, it's a fixed price, floating exchange ratio within a collar. The red line stays constant. The collar here is \$34.23 to \$39.23 for the acquirer stock price. These amounts are between announcement and closing. You get a fixed price of \$73 a share, and the dotted yellow line obviously floats to maintain that value for you. Outside that collar, the dollar value of the consideration per share (represented by the red line) will change because the exchange ratio, shown by the dotted yellow line, stays fixed outside of the collar.

Alternative IV—Fixed Price with an Upside—is a deal where you have a target company and you say, “We know you want price certainty. Here's the fixed price.” If they have smart investment bankers on the other side, the target company is going to say, the market's going to like this deal. It makes sense strategically. It's going to reward the acquirer's shareholders with an increase in stock price after the announcement. Why can't we (the target) participate just a little bit? They want the best of both worlds. What you do is you give them a little bit of a ride, so to speak, in value. That's the red line. You can see they get that ride in value. Remember, the acquirer's stock price is \$38.23 at announcement. So, if the acquirer share price goes up a buck, you get that equity ride or that ride in value. After that, you get a fixed price. On the down side, if the acquirer's stock price craters, you don't get any diminution in value and that red line stays constant to the left.

MS. DEBORAH WHITMORE: Let's talk about the various accounting pronouncements regarding acquisitions. There is existing guidance for accounting for business combinations. There is Accounting Principles Board Opinion (APB) Number 16 with regard to intangibles and, APB 17. The FASB recently issued an exposure draft that would change the accounting for business combinations, as well as change the accounting for intangibles by superseding APB 17. I'll talk about the new proposal later, but first let's talk about what's out there today and what the existing guidance is.

APB 16 is relatively old literature. It was issued in 1970, and it's still the governing literature on accounting for business combinations. APB 16 lays out two basic accounting methodologies for combinations. The first alternative is purchase accounting, which is basically an acquisition of one company by another. Therefore, you fair value all the identifiable assets and liabilities that you're assuming. The second alternative is pooling of interest accounting, which is really the uniting of the ownership interest of two or more entities. It's an exchange of securities, and it's basically treated as if you simply combine the entities. There's no change in the carrying value of the target's assets and liabilities. The two methods of accounting are both acceptable, but they're not acceptable for the same transaction. A transaction that meets the criteria for pooling must be accounted for as a pooling, and if the transaction doesn't meet the pooling criteria, it must be accounted for as a purchase.

Contrary to the general impression that an all-stock deal is, by definition, to be treated as a pooling, an all-stock deal can also be a purchase. It's pretty simple; if the transaction meets the pooling criteria, it is a pooling, and if it doesn't meet the pooling criteria, it's a purchase. The issue, when you get into purchase accounting, tends to be, what's the value of the shares of stock that you're issuing? Typically, it's the fair value of stock that is actually issued in connection with the transaction. You'll occasionally also see considerations being given to things like the average of the value of the stock for a few days before and after the transaction. There's some consideration as to whether or not there are unusual transactions that are distorting the value, but the basic idea is to come up with a fair value.

Table 10 lays out in one place a comparison of pooling versus purchase. Let's walk through these columns. First, under the purchase column, a purchase is an acquisition of one company by another. You fair value all the identifiable assets and liabilities and record those at their fair value. To the extent that your purchase price is greater than that amount, there is goodwill that is recorded as an asset and is amortized over its useful life with an absolute limit on the amortization period of 40 years. In most life insurance company transactions in the last few years, the typical goodwill amortization period has been 30–40 years, assuming there was a fairly substantial block of life insurance. When companies had either entirely annuity business or

health business, amortization periods have tended to be shorter, in part because the SEC has been on a bit of a rampage about the amortization period of goodwill.

TABLE 10
Purchase vs. Pooling

	Purchase	Pooling
Balance sheet	Amounts recorded at fair value	Historical book values retained
Income statement	Reflects amortization of purchase adjustments	Not affected
Goodwill	Amortized over not more than 40 years	Not applicable
Historical financials	Acquired company included from date of purchase	All prior years restated on a pooled basis

The income statement, of course, just reflects this as a purchase. Income from the new acquisitions is accounted for based on the new market value cost basis, and it starts from the day of the acquisition. The historical financial statements of the acquiring company are completely unchanged. Contrast that with what happens when you do a pooling. Pooling is simply the put-together and the continuation of the two entities now going forward as one. There is no change in the accounting basis of any of the assets or the liabilities. The income is presented, in effect, as if the two companies have always been together. Obviously, there's no goodwill because you didn't revalue anything. Historical financial statements are restated as if the two combining companies had been one company since the earliest date that both companies existed.

I'm going to talk a bit about the criteria for determining whether a transaction qualifies for pooling accounting treatment. APB 16 sets forth 12 specific conditions that have to be met in order for a transaction to qualify as a pooling. One of the criterion that you tend to run into a little bit more frequently is that neither company could have been a subsidiary or a division for at least two years preceding the initiation of the transaction. It has to be a single transaction or completed under a planned transaction within one year. If you change any material aspect of the deal, that's a new transaction, and you've lost the ability to do a pooling. Scott, in his presentation, referred to the fact that you have a 90% rule. In order to qualify as a pooling, the shares of stock that are issued in the transaction must have the same basic features as the shares

of stock of the acquired company or the other merged partner. You must get at least 90% of that stock.

A number of things can taint stock, which puts it into this 10% corridor. Neither company could have been acquiring Treasury stock other than under some very limited circumstances, such as where the company has been acquiring Treasury stock based on well-established plans. For example, the company might have a long history of buying shares of stock just for the use of an employee benefit plan. The plan is very rigid. The stock purchases happened on the first of every month only. Nothing about the value of the stock will affect it. Sometimes companies have ongoing share repurchase programs. The shares acquired in such programs will be considered tainted shares, and, unless all tainted shares are less than 10%, you have blown pooling, and you're into purchase accounting. Another requirement for pooling is that you can't be planning on disposing of any significant pieces of the businesses that are being combined. A pooling situation is intended to be a put-together of existing companies with the intention of going forward as basically unchanged.

If you don't qualify for a pooling, you'll use purchase accounting. Purchase accounting guidance is contained in APB 16, which is obviously not specifically "on point" when it comes to insurance companies. There's very little guidance that is specific to insurance companies. There's any number of interpretations, though, that you need to be aware of as you're implementing it. There is also an Emerging Issues Task Force (EITF) interpretation that is specific to the life insurance industry. That is EITF 92-9, which deals with the present value of future profits or value of business acquired. There are also a number of EITFs that deal with such issues as exit costs and integration costs, notably, EITF 95-3 and EITF 94-3.

As far as existing FASB statements are concerned, the only one that's really relevant is *FAS 38*. *FAS 38* deals with preacquisition contingencies; that is, at the time I do the acquisition, I need some time to be able to identify the assets that I'm acquiring, the liabilities I'm assuming, and to assign values to those. You're given the opportunity to take a reasonable period of time after the transaction to get the information you need to be able to value those assets and liabilities. It can't be longer than you actually need to get the information, and it can never be more than one year.

The importance of this is that as those pre-acquisition contingencies are resolved (if they're not adjusted back into the purchase price), and if you're out of this allocation period, whatever happens goes through your income statement.

The SEC has issued a certain amount of guidance on purchase accounting, most notably the guidance on push-down accounting, which is contained in Accounting Bulletin 5J. Topic 5J, requires that if more than 95–97% of the registrant has been acquired in a transaction, purchase accounting must be pushed down to the financial statements of the registrant. The SEC encourages push down treatment if 90% or more of a company is acquired. They prohibit push-down treatment if less than 80% of a company is acquired. The Academy of Actuaries has published one piece of literature on purchase accounting, Interpretation 1D, which deals with some of the valuation issues that are associated with reserve valuation.

I'll try to run through some of the issues that you get into in purchase accounting. I alluded to the fact that there can always be the issue of what is the purchase price? The purchase price is what the acquirer paid for the target. The purchase price is easily defined when you pay cash because it's the amount of cash you pay. In addition, you're allowed to count certain direct out-of-pocket costs as part of the transaction cost and capitalize those into the purchase price. When you're using securities as the consideration to the seller, the purchase price is the fair value of the securities that are being issued. The second point is, now that you know how much you paid for the company, you have to allocate that cost to all the assets that can be identified as well as the liabilities. The allocation of the purchase price is based on the fair value of the assets and liabilities.

It's no real surprise that securities, such as bonds and stocks, are valued based on their market values. They either have quotes or you ask the investment bankers to give you estimates. You run the pricing model that you normally run. Investment real estate gets marked-to-market based on appraisals. You value the kinds of intangibles that you can identify. If you have leases, are they favorable or unfavorable leases? You need to revalue your debt. You revalue your liabilities. When you're through revaluing, you compare the net value of the revalued assets over the revalued liabilities to the purchase price. If the net value is less than the purchase price, you

have positive goodwill. If the net value is greater than the purchase price, you have negative goodwill. Goodwill is really the result of not being able to identify all the intangibles that you actually acquired as part of the transaction. Positive goodwill is amortized over a period not exceeding 40 years, at least under the current guidance.

I alluded to exit and integration costs, which you'll encounter frequently. The most relevant guidance appears in EITF 94-3 and EITF 95-3. Frankly, there are a lot of traps for the unwary right now in the exit and integration cost areas. The SEC is very focused on it. The SEC is asking very specific questions of registrants as to exactly what has been included in the category of exit and integration costs and how these costs meet the specific criteria of the two EITFs?

Sometimes an acquirer will identify assets that are part of the acquired entity that the acquirer decides not to keep going forward. As I mentioned before, selling a material asset that is part of one of the combining entities will cause a transaction to not qualify as a pooling. In the case of purchase accounting, there are a couple of EITFs that deal with how to allocate part of the purchase price to the asset being disposed of. One of these is EITF 87-11, according to which you should allocate based on what you expect to recover. The more interesting questions, of course, are what if you don't manage to sell it within one year or what if you change your mind? If you don't sell it within one year, there's an EITF that basically says you must stop accounting for the asset under the relatively favorable rules allowed under purchase accounting for assets that you plan to dispose of. From that point forward, any change in value for the asset will go through the income statement. If you decide you're not going to sell it, you basically do a calculation to determine where you would be financially if you had never intended to dispose of it. What would be the value of this particular segment of the business or these assets? You make a catch-up adjustment at that time.

Preacquisition contingencies, which I mentioned previously, are covered in *Financial Accounting Standard Number 38*.

Let's talk about why the FASB has undertaken a new project to reexamine the whole area of accounting for business combinations. Why did they ever start the project to change this

accounting? Sounds like there is plenty of guidance out there to guide people in this area of accounting. It just sounds like we have plenty because one of the things that the SEC started complaining about was that its staff was spending way too much time on pooling questions because pooling suddenly became popular again. Everybody wanted their deal to be a pooling. Investment bankers were getting a little more creative in how some transactions were structured. Pooling rules were getting stretched a little bit. The SEC staff was spending a lot of time on this. The FASB chimed in and said, it thought its staff was still spending way too much time on a piece of literature that has been around since 1970.

The FASB has been getting many complaints. It believes that the pooling rules have been stretched to accommodate transactions that they were never intended to fit. This is not the way it's written. I think both the SEC and the FASB really thought that pooling was supposed to be limited to something similar to what you probably have in some of the international concepts—a merger of equals. In fact, pooling accounting has been applied to many transactions that clearly are not the merger of equals.

The second objective of this project is what they refer to as international harmonization. Somewhere along the way, several years ago, everyone started saying, "Wouldn't it be nice if we started trying to get the U.S. accounting and the international accounting just a little bit more similar?" There are some international projects going on to reexamine the accounting for acquisitions. There currently are projects in the U.S., Canada, and the UK. New Zealand might not have an official project, but it has been participating in this, too. There could be changes pretty much everywhere as we move forward.

What are some of the conclusions the FASB has come to? This exposure draft has now been on the street for about a week. I have a caveat. I don't know the answers to all of the questions we have because, as I read the draft, I have a number of questions about how things would be implemented. Make a note. The deadline for comments is December 7, 1999. I suspect that they'll get a lot of comments. This is a very controversial project. It has been controversial since they kicked it off. It has got some conclusions on which I think people will have an interest in focusing and commenting. The one that you've heard is that all business combination

transactions will be accounted for as purchases. Pooling accounting has been eliminated. The FASB has concluded that there should be only one basis of accounting for these transactions. What would be most useful to the reader? The most useful information about a business combination is what did you pay, not what was the historical cost basis value of the target company prior to the acquisition. In effect, purchase accounting is much more consistent with the FASB's model and the FASB's views on fair-value accounting. We might be one more step down the path to fair-value accounting, but that's a different presentation.

One of the implications of the concept that every transaction must be a purchase, is that every transaction has to have an acquirer and an acquiree. In the case of some transactions that would be accounted for as poolings under current guidance, it can be difficult to tell who the purchaser is or who the acquiree is. According to the exposure draft, in order to determine who is the acquirer, you have to look at everything to do with the transaction. What is important is the reality, not just how things appear on the surface. The FASB would say that you put a lot of emphasis on the relative voting share interest that the stockholders are getting. You put a lot of emphasis on the board composition of the merged entity. Who wound up controlling the board and what happened in management? They believe that you can always tell who the buyer is.

What are some of the other conclusions that the FASB reached? First, they concluded that you should record all identifiable intangibles based on fair value. This isn't really a change because, as I told you before, APB 16 says exactly the same thing. They also concluded that goodwill includes intangibles that you can identify but that you can't actually measure. I don't think this is actually a change. This is really more of an articulation of what really exists today in practice. Most would answer the question, what's in the goodwill?, with this response: the excess purchase price was for assets that are not recorded on the balance sheet. This would include assets such as good agency staff, trained people, an infrastructure for processing new and existing business. All of these things exist, and they're very real. They have real value, but you just can't quite put a value on them. It's difficult to value the agency force. It's difficult to value the staff.

One conclusion that the FASB reached that is different, is that goodwill has to be amortized over no more than 20 years. They clarified some things about impairment. Current guidance in *FAS 121* would tell you that you have to evaluate the impairment of the assets. *FAS 121* basically

says you take goodwill and you allocate it down to the assets proportionately when you evaluate the assets themselves for impairment. If you have any goodwill left over after that, you look to APB 17. This process continues. However, the exposure draft goes beyond what *FAS 121* says. The exposures draft says that if certain factors are present at the time of the acquisition, you must do a review for impairment of goodwill within two years of the acquisition.

A factor that would be considered in determining whether a review of goodwill for impairment was necessary would include the fact that there was a significant premium paid over the market capitalization of the target. In this case, the market capitalization that would be used as the base to compare would be the market capitalization before anybody got wind of any negotiations or discussions that might lead to an acquisition.

Another factor would be if there was a clearly visible auction process or a bidding process. Yet another factor would be that the goodwill was significant relative to the value of the company or that the acquisition was primarily stock. All these are factors that the FASB believes could lead to the conclusion that the acquirer overpaid for the acquiree and that you could have some kind of goodwill impairment. The exposure draft doesn't change the normal rules of *FAS 121* with regard to goodwill impairment. It is still the case that when you've had events that have occurred (such as significant changes in stock prices, a deal that you expected to go through a certain way, or a product that didn't get approved) you still have to evaluate goodwill for recovery. All those rules stay in place.

The exposure draft also includes some new conclusions on negative goodwill. Under current guidance, you allocate negative goodwill to the noncurrent assets of the company proportionately. In the insurance industry that has meant that if you knew you were going to have negative goodwill, and you just allocated it to value of business acquired (VOBA). There was usually plenty of VOBA to absorb any negative goodwill and, you didn't see it allocated to other types of assets.

The new guidance is a bit more specific. First, you reduce any intangibles for which you don't have an observable market value. Then, if you still have negative goodwill, you proportionately reduce the combination of the nonfinancial assets and the identified intangibles that do have an

observable market price. I suspect this appears to be more of a change than it really is in practice. If, by chance, you have negative goodwill, once you go through the process of eliminating the intangibles and then eliminating the depreciable, noninvestment assets, anything left over would be an extraordinary gain. This, incidentally, is something that the FASB changed back and forth during the course of their consideration of this guidance.

The exposure draft also contains guidance on intangible assets. This guidance is applicable to all intangibles, not just intangibles that are acquired through a business combination transaction because you can acquire intangibles separately, one at a time, or you can acquire them in the aggregate or you can actually create them yourself. If you're creating them yourself, they're expensed. If you're acquiring them, the rule is you start off valuing them consistent with the fair value of what you've actually paid. The exposure draft discusses various categories of intangibles. One such category is intangibles that have specific identifiable cash flows associated with them. You have intangibles that have identifiable market value, and you have intangibles that don't really have identifiable market value. These intangibles are amortized over their useful economic life (with a limit of 20 years, unless you can demonstrate that, in fact, they have a life of more than 20 years). The concept seems to be that because these intangibles will have cash flows associated with them, you would expect to have the amortization consistent with these cash flows.

I said that there are ways of overcoming the presumption of a 20-year maximum period for amortization of goodwill due to intangibles. One instance could be where the intangible has clearly identifiable cash flows associated with it, and the right to those cash flows, either contractually or legally, is in excess of 20 years. There is also a new category created of nonamortizable intangibles. In order to overcome the presumption of a 20-year amortization period, nonamortizable intangibles must have an indefinite life, and they must have an observable market value. As you would suspect from the name, there's no amortization of nonamortizable intangible assets as long as they continue to have an indefinite life. However, you must review them for impairment by comparing them with the market value. If the market value of that intangible were to fall, you have permanent impairment, and you take a write-down.

The exposure draft specifies some changes in how we do financial reporting. The FASB concluded that, within the balance sheet, there should be a separate line item that is goodwill and, at a minimum, a separate line item for all the other intangibles. Within the income statement there will be a couple of new lines. First, there'll be a subtotal that would be presented before amortization and write-downs for impairments of goodwill. Goodwill impairments and amortization will be presented as a separate line item on the income statement on an after-tax basis. There will be a subtitle with a name, such as "income before goodwill amortization and impairments," and you would have "net income" presented afterwards. If you had either discontinued operations or accounting changes, this new caption would precede those captions, and you would have a caption such as "income before goodwill amortization and impairments and discontinued operations." In addition to doing all the normal earnings per share (EPS) calculations, the exposure draft would permit, but not require, that you do an EPS calculation of income before goodwill amortization and impairment.

The exposure draft proposes an effective date as of the issuance date for any transaction that's initiated after the date of the statement. Incidentally, the definition of the date of initiation is the same definition that appears in APB 16. Thus, a transaction is considered initiated when the parties are able to announce definitive terms. The intangibles and goodwill that exist as of that date continue forward under their existing accounting policies with one exception. The exception involves old ARB 43 goodwill that is not subject to amortization. Such goodwill is unusual. However, any such goodwill would be written off during the first reporting period after issuance of the financial statement as a change in accounting.

What's going on in the international arena? As I mentioned, the international accounting standards setting body is, in fact, in the process of reevaluating their Statement 22. There has been a discussion paper that was issued by the G4+1 that is under consideration. The international standards allow pooling, as well as purchase accounting. Pooling is limited, however, to transactions that are a true mergers of equals and transactions where you can't really identify the purchaser. Starting this July, there's a 20-year maximum limit on goodwill, and they made some changes in how they do negative goodwill.

Table 11 shows how certain large foreign insurance entities amortize goodwill. I managed to track down the 1998 annual reports for several foreign insurers that happen to have registration statements of some type in the U.S. The interest in this information was generated by the reports we have been reading in the financial press to the effect that the foreign issuers have an advantage over U.S. companies because they can treat acquisition goodwill differently.

TABLE 11
Selected Foreign Insurers

Aegon NV	Charged directly to equity
Allianz	Amortized over useful lives—maximum 20 years life and health; 10 years P&C
AXA	Stock transactions—charged to RE; other—30 years; negative goodwill—5 years
Generali	1998–30 years; prior to 1998–10 years
Zurich	Since 1995–20 years; prior—charged directly to equity

For instance, Aegon charges goodwill directly to equity in the year of the acquisition. Allianz discloses that it amortizes over the useful life, which is generally 20 years for the life and health acquisitions and ten years for property/casualty acquisitions.

AXA is a little more interesting in that they disclose that negative goodwill is first used to reduce the fair-value adjustment on real estate acquired during the acquisition and then amortized over five years. However, positive goodwill can be amortized over 30 years, if it was from a cash transaction. Where they issued stock (such as was the case in their acquisition of UAP a couple of years ago) and to the extent that there's goodwill equal to the amount of the value of the stock they issued, they charge it directly to retained earnings. Then, anything that's left would be amortize over 30 years.

Generali used ten years prior to 1998. Starting with their acquisition in 1998, they use 30 years. Zurich, since 1995, has used 20 years, and prior to that they charged it directly to equity.

MR. CARROLL: I have a quick question for Scott in terms of this foreign company phenomenon that people talk about so much. What's your view, as a practicing M&A specialist, on that question?

MR. LITTLEJOHN: I'd say, overall, that it's debatable that there is generally an advantage. Under current Dutch GAAP, you can deduct the goodwill immediately against your retained earnings, which is a big advantage. It's basically pooling of interest accounting. I just think that, despite all the talk about the accounting advantages, in the case of Aegon's purchase of Transamerica, it was a real strategic initiative. That's what motivated them to do what they did that Fortis and ING didn't do.

MR. MICHAEL C. EASTBURN: Are there any situations where you would want to try to purchase the target stock on the open market as opposed to making a tender offer?

MR. LITTLEJOHN: That's called a creeping acquisition, and there are rules against that. If you have a target company that didn't want to be acquired, or you just thought that that was a more economic way to buy the company, it would be somewhat of a loophole. Over a certain point, though, they're not going to allow you to do a creeping acquisition. Some people, such as Warren Buffet, have done a two-step acquisition. He'll go up to as much as he can in the open market. In his acquisition of Geico, he originally owned close to 50%, but then, over the years, it got diluted because he was issuing stock. It got down to 20%. He really controlled that company in a very economic fashion when he did not own 100%. Then he did the squeeze-in and bought the 100%. It's a good question because people do certainly think about that.

MS. WHITMORE: It's very easy to mess up a pooling if you start buying stock in the open market.

MR. BARRY L. SHEMIN: Scott, you mentioned how the blended P/E is the market's way of taking into account adjustments in the earnings per share that might result from a pooling combination. Consider a purchase combination for all stock. Obviously you get amortization of goodwill that's going to significantly affect the resulting company's earnings. Do you think there

might be a similar counterbalance that might actually start inflating P/E's, even if all-stock purchase transactions might be dilutive after the reduction of goodwill? Do you see what I'm trying to say? In other words, in these transactions, there's really no difference in what happened in terms of dollars, but the resulting earnings now would look much different under purchase.

MR. LITTLEJOHN: You're absolutely right. I think what you're going to want to do is what we've done. When there are earnings that are valued pro forma for the deal, we strip out the PGAAP adjustments, the goodwill amortization, and any other kind of PGAAP adjustment you have so that you're basically back to what we showed on the slide in terms of coming up with a blended P/E. That's the math of it.

FROM THE FLOOR: Even with a purchase?

MR. LITTLEJOHN: Yes, that's true even with a purchase. If you just look at it on the surface, you'd say the P/E expanded. Sometimes the market is not that sophisticated, particularly if you're doing a smaller deal. I wanted to mention ownership, even in this deal where we show, pro forma, the target was 30% of the total. Sometimes, because we know Company A, and it always traded around 22, we'll just slap a 22 on it. Then, if it's a purchase, going to your point, you might end up with P/E expansion because the market's just not that sophisticated sometimes.

MR. CARROLL: I had a question for Deborah. What effect would the exposure draft have on the mergers of mutual companies?

MS. WHITMORE: The concept of how to do purchase accounting when you merge mutuals will be interesting. The real question is about the purchase price, in terms of fair value in the assets and fair value of the liabilities. A mutual is like a stock company, so part of the equation is pretty easy to figure out. It's the other part that would be extremely difficult. It's an unanswered question. I think the FASB acknowledged that there is an issue when nonprofits are put together. They will presumably have to look at something and come up with some additional guidance for nonprofits, but nonprofits do not normally encompass mutual companies. There is no real answer to the question right now.

MR. CARROLL: Is it possible that the FASB could get comments on this and cut mutual mergers out of the picture? Do you think that's likely?

MS. WHITMORE: It's an interesting question. It's possible that they'll get comments on it, and it's possible that they'll react. The question has come up in some of the other forums. In Canada, pooling is limited to entities of common size, and I know that the question that has occasionally floated around is, What if you started putting together mutuals and they weren't really common sizes? What would you do then? How would you apply purchase accounting? I had a discussion about that with a Canadian colleague. They were asking me, how would you do it in the U.S.? My response was, if you Canadians know how to do it, why don't you tell me and then I'll figure out how we can do it. They didn't know how to do it either. I can't believe it's a question that hasn't been answered.

CHART 1
Transactions Volume by Region and Industry: 1995-99

Value of Transactions
 (\$ in Billions)

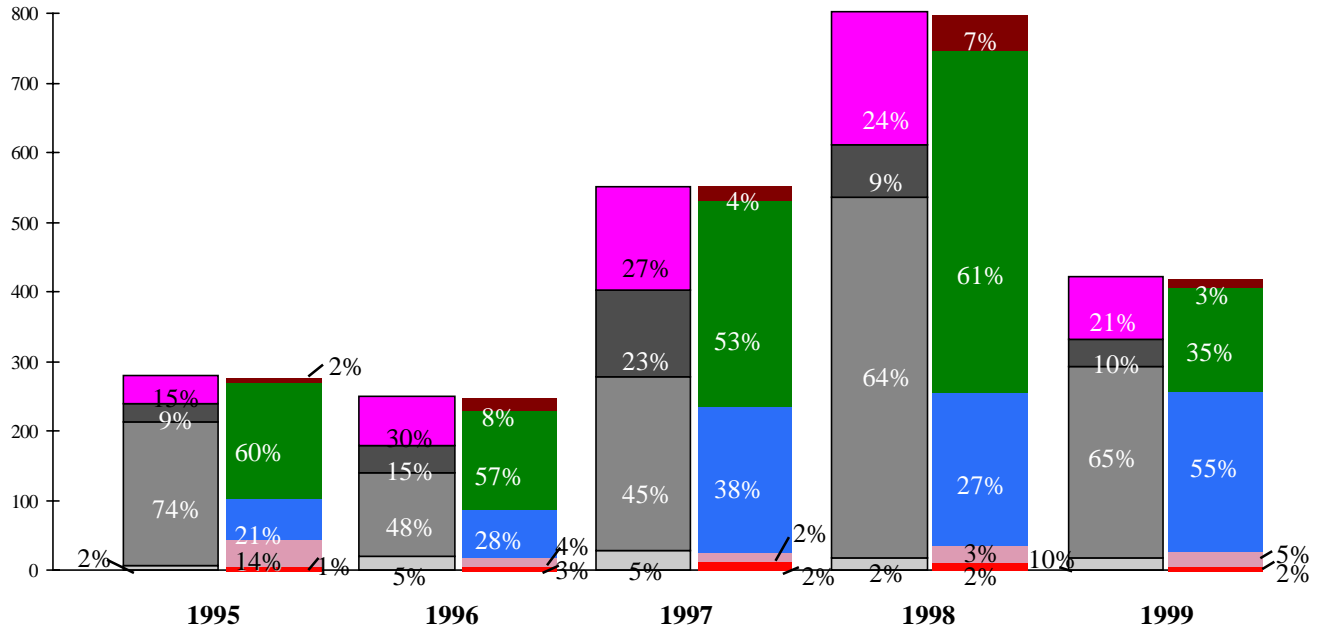


CHART 2
Top Financial Institutions Worldwide

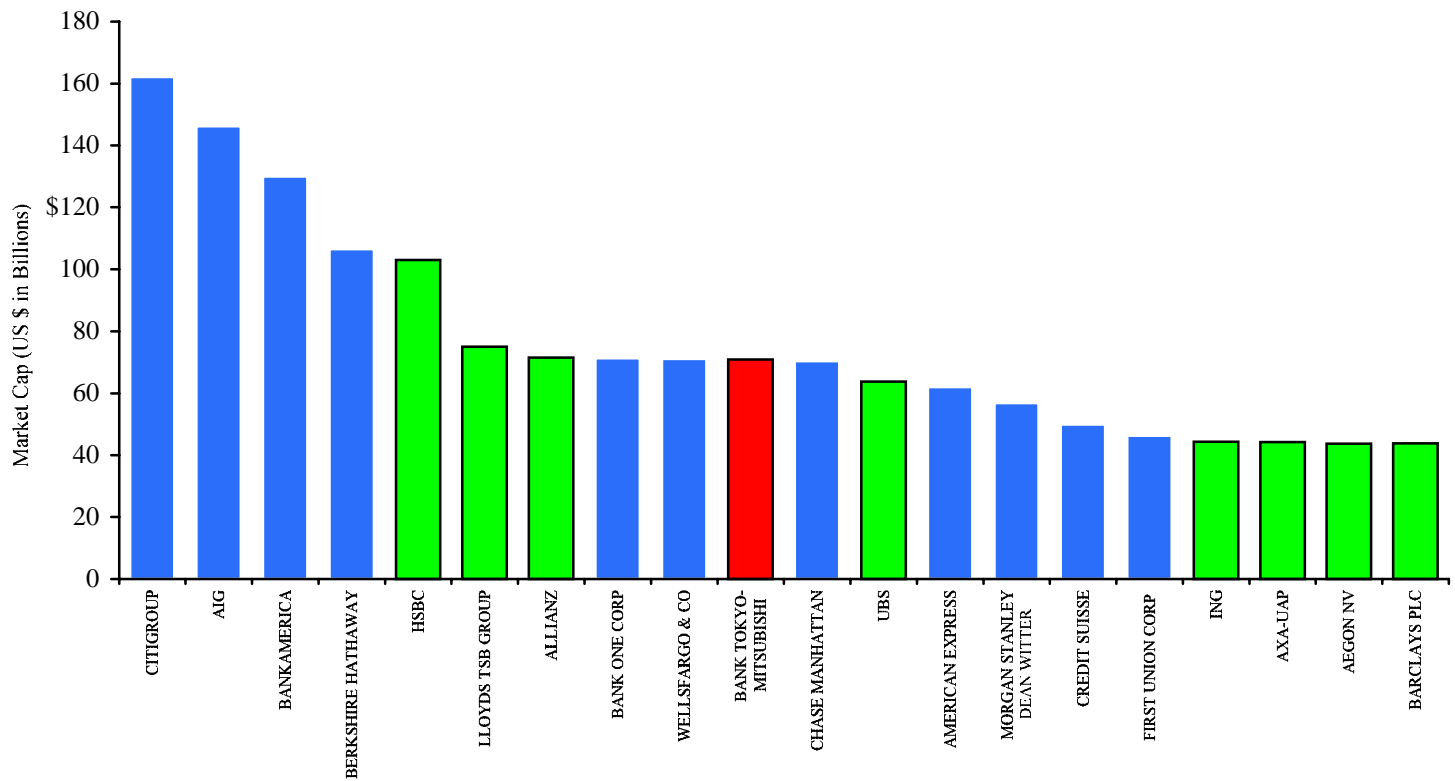


CHART 3
Global M&A Volume

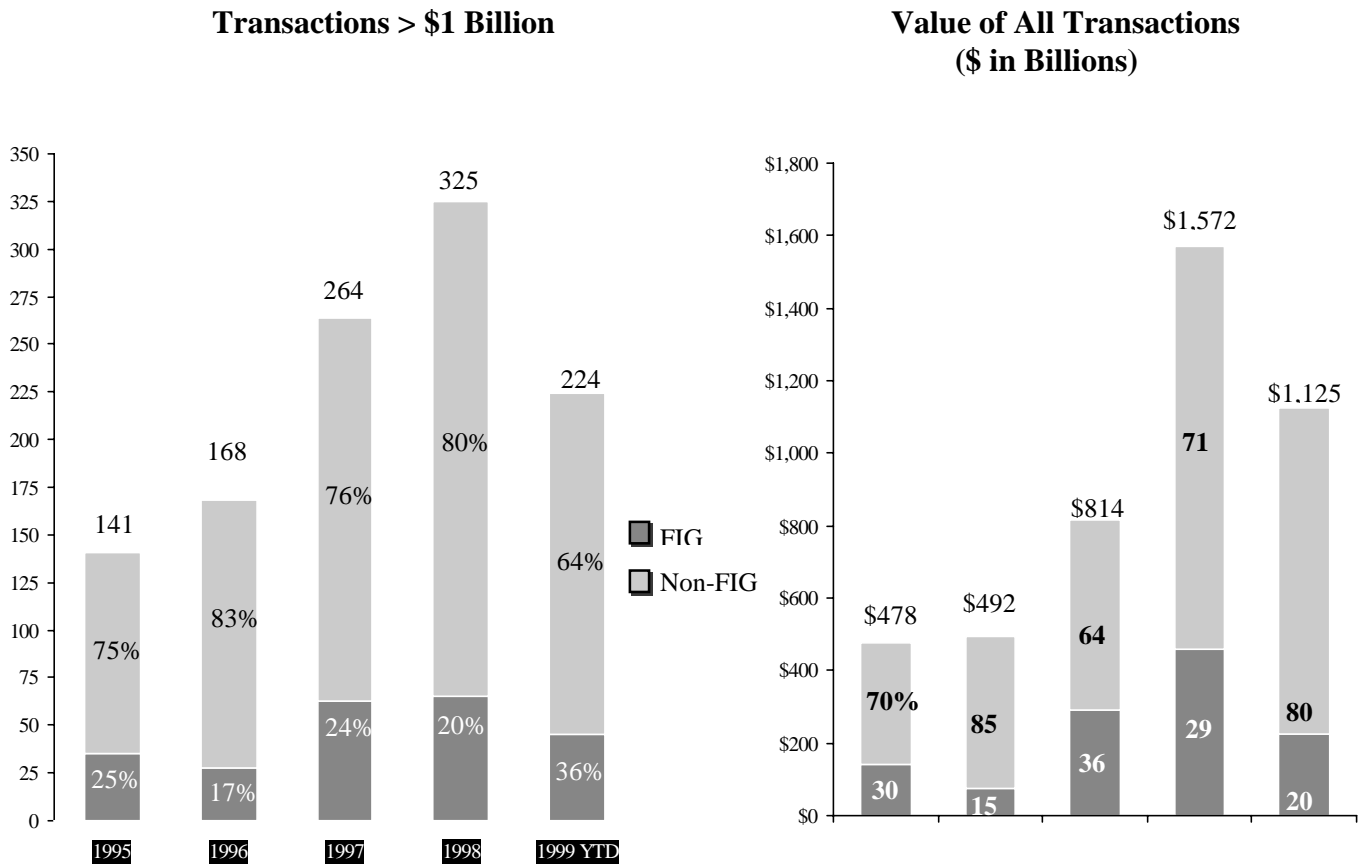


CHART 4
Choosing Your Form of Consideration

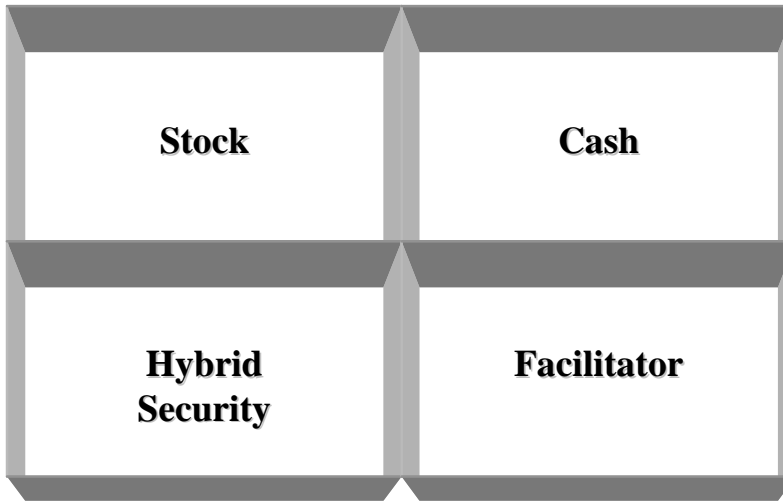


Chart 5
Exchange Ratio Economics

