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Summary of Program (2008-2010)

The objective of the Merger and Acquisition program is to make decisions that will improve the value of the largest US 300 companies\(^1\) by market cap in the SJ64 portfolio and other deals that are elevated through the Priority Company List Spreadsheet managed by Todd Mattley for Senior Management. Given the complexity and uncertainty surrounding deals, CalPERS has developed its program to incorporate a process that utilizes the knowledge from over 50 various studies in the market and experts in the field of merger and acquisitions. A great number of studies emphasize the failure of a majority of deals. As a result, Staff votes with a high level of scrutiny based on CalPERS’ portfolio holdings of each firm involved in the deal. Staff will also post all decisions of these deals in advance on CalPERS’ Shareowner Forum website in order to garner additional support from other like-minded shareowners and institutions.

Introduction to M&A Deal Assessment Reports

The overall goal of this report is to help Staff make an informative decision on a deal that will lead improved performance of CalPERS’ portfolio. “Depending on how success is defined – whether by shareholder value, customer satisfaction, employee retention, etc. – research indicates that the failure rate for mergers is between 50% and 80%. Regardless of the definition of success, the suggestion is that more than half do not live up to the expectations that were the rationale for the merger in the first place – among the issues that resulted in failure include, overpayment, inaccurate assessment of the expected synergies, and culture conflict.”\(^2\)

Proxy firms, such as Glass Lewis and Risk Metrics, vote for over 90%+ of deals. On paper, most deals drafted “appear reasonable” in terms of deal valuation and strategy to stakeholders. However, given the high failure rates and complexity of deal success, Staff has decided to narrow the gap between voting FOR 90%+ deals and deals that may fail by incorporating in to its M&A deal assessment the use of empirical and academic evidence of factors which signal potential long-term value destruction to CalPERS’ portfolio.

The following are examples of such factors reviewed in this report: 1) multiple event studies to assess likelihood of post deal failure and overpayment risk—“portfolio effect and price reaction”, 2) factors which are indicative of future value destruction – “deal characteristics”, 3) factors rated the number one cause for deal failures—“integration risk”, and 4) other factors that may signal post deal value destruction.

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\(^1\) Current limitation set by former Senior Management that could evolve to capture a greater number of companies in CalPERS portfolio.

\(^2\) The Projective Differential, Dr. Peter Raynolds, UCLA Graduate School Management
Deal Assessment
CalPERS decisions, when appropriate, are based on a deal assessment comprised of the following components:

1. **Portfolio Effect**: the absolute or net dollar change in holdings, depending on CalPERS’ ownership, of the target and acquiring firm from the “undisturbed price” through the date of the shareowner vote.

2. **Price Reactions**: the stock price movement of the target and acquiring firm from the “undisturbed price” through the first date of announcement and 20-days following the announcement vs. a peer group of the acquiring firm.

3. **Deal Valuation & Strategy**: the use of comparables, discounted cash flows, and cash flow return on investment. Also, a review of the motivation to ensure the deal makes strategic sense.

4. **Deal Characteristics**: successful and failure indicators of mergers and acquisitions as identified through empirical research

5. **Integration Risk**: indicators that increase the potential for post failure of a deal

6. **Conflicts of Interest**: compensation paid to individuals responsible for completing the deal or other identified self-interested motivations

7. **Governance Concerns**: value destroying indicators as identified through empirical research

8. **Legal Remedy/ Rights**: the right as a shareowner if the deal is unfairly valued

9. **Management’s Communication with Investors**: an assessment of Management’s response to concerns and questions of the deal
Ideas for Merger & Acquisition Program

1. Develop **Principles on “Best Practices”**
   a. Obtain feedback from proxy firms, investment bankers, attorneys, and then finalize a copy for Board approval to add to Global Principles
   b. Be proactive in the market and voting proxies in-line with new principles

2. Develop a **process to vote deals** in-line with CalPERS fund; file a Notice of Appraisal Rights when necessary. **Post decisions on the website**

3. Develop a **process to assess deal value creation/destruction** of Staff’s recommendation

4. Upload or reference M&A supporting research on our **website**

5. Campaign for M&A deals on the website and other resources
   a. Elevate an annual list of poor performing Mergers…. **“The Merger Madness” list** to set fire to the Board and managers to improve the success of the deal
   b. Monitor set financial targets and scrutinize targets not met
   c. Press release to elevate issues with companies
   d. Governance opportunity to improve
   e. Vote against board if deal fails and no governance changes have been made

6. Assess needs for additional student help on the program
   a. Research in the deal recommendation process
   b. Monitor process of deal to determine if shareowner value, profit, and synergy targets are met. If targets not met → raise issue of governance and target directors for poor oversight process…. Potentially vote against Directors through the Proxy Program.
Recommendations for Program

Ideas for Global Economic Principles

Eliminating Conflicts of Interest
- Reasonable payment to investment banker for recommendations
  o Full disclosure of a five year look back of business relations and fees charged
- Reasonable severance packages for management, including the required use of double triggers (vs. single)
- Conversion of unvested equity to new company and continuation of existing vesting cycles
- Opportunity for legal dispute
- Majority vote for mergers; except super voting requirements with business combination.
- Transaction cost of deal tied to performance of combined firm

Important Disclosure of Processes
- Disclose to shareowners the details of the deal at least 30- days in advance to allow for proper review
- Advisors opinion FOR the transaction and AGAINST
- Quantified benefits of the deal from the perspective of a shareowner owning stock in both firms
- Negotiation process
- Due diligence
- Anti-trust issues
- Anti-trust resolutions
- Financing
- Identification and skill-sets of an integration team
- Culture assessment
- Plan of integration
- Risks of integration
- Strategy
- Legal risks
- Regulatory risks
- Valuation assessment of deal
- Potential conflicts of interest
- Compensation structures tied to pre and post combined firm
- Post review process
- If available, examples of post reviews completed of prior integrations
  o Disclosure of performance metrics tied to assess success

KPMG Identifies Six Key Factors for Successful Mergers and Acquisitions; 83% of Deals Fail to Enhance Shareholder Value
The Effects of Mergers and Post-Merger Integration: A Review of Business Consulting Literature, FTC
www.ftc.gov/be/rt/businessreviewpaper.pdf

Important Disclosure of Valuations
- Fair value calculation of target
- Fair value calculation of acquirer
- Support for valuation model selected
- Support for peers selected
- Support for assumptions selected
- Support for time periods identified in valuation
- Support for meaningful metrics
- Pro-forma accretion/dilution model
- Stand alone valuation
- Combined valuation
- Cost of deal
- Cost as a percent of synergies
- Present value of synergies
- Dilution impact
- Cost of capital impact
- Support for growth targets
- Support for a “reasonable” premium that accounts for the value in synergy opportunities relative to other deals

Preliminary
CalPERS fiduciary duty is to analyze and execute its proxy vote on issues based on the likely net effect of the economic value of the plan’s investments. As described by the Department of Labor, issues may include “corporation’s policy regarding mergers and acquisitions, the extent of debt financing and capitalization, and the nature of long-term business plans.” CalPERS’ elevates the duty of the Board at a minimum:

D.1. Decisions should be made by the entire Board and in-line with long-term value of shareowners based on risk-adjusted relative long-term total stock returns.

D.3. Seek a majority vote to approve major corporate decisions concerning the sale or pledge of corporate assets that would have a material effect on shareowner value.

D.2. Provide legal remedy as an option for shareowners in a court of law where appropriate.

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3 Employee Benefits Security Administration, 29 CFR Part 2509; RIN 1210-AB28, Interpretive Bulletin Relating to Exercise of Shareholder Rights
4 Such a transaction will automatically be deemed to have a material effect if the value of the assets exceeds 10 percent of the assets of the company and its subsidiaries on a consolidated basis. Appendix A, “The Council of Institutional Investors Corporate Governance Policies.”
Specific important economic events include, but are not limited to the following:

- **Mergers & Reorganizations**
  - Acquire certain assets of another company
  - Approve acquisition OR issue shares in connection with acquisition
  - Approve the formation of a holding company
  - Approve a merger agreement
  - Approve plan of liquidation
  - Approve recapitalization
  - Approve reorganization/restructuring
  - Approve sale of company assets
  - Approve spin-off agreement

- **Capitalization**
  - Adopt/amend dividend reinvestment plan
  - Approve issuance of warrants/convertible debentures
  - Approve reverse stock split
  - Approve/amend conversion of securities
  - Authorize a new class of preferred stock
  - Authorize a share repurchase program
  - Eliminate class of common stock
  - Eliminate preemptive rights
  - Going dark transaction
  - Increase authorized common stock
How to Analyze the Deal Based on Ownership Levels

Scenario 1- Ownership Levels:
- Owner in both public Companies; or
- Owner in the public Target firm that is being offered a stock multiple in the public Acquiring company as part of the deal

Focus is on voting against any deals that may result in potential negative consequences to CalPERS holdings.

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<td>(In cases where CalPERS owns debt holdings in a target company that has a failing Altman Z-score (or definitive bankruptcy is near), Staff may weigh the vote recommendation on the portfolio effect to include the potential loss in CalPERS’ debt when appropriate).</td>
</tr>
<tr>
<td><strong>Price Reaction</strong></td>
</tr>
<tr>
<td>Immediate “thumbs down” beyond average or within 20-day window of company vs. peer is below -10%, higher probability of failure for acquirer in the future.</td>
</tr>
<tr>
<td><strong>Deal Valuation &amp; Strategy</strong></td>
</tr>
<tr>
<td>If any of the Proxy firms vote again the deal on the acquirer side. Proxy firm may vote down the deal on the target side for too low of an offer, however, if CalPERS owns a greater number of shares on the acquirer side, staff may not agree with proxy firms and should vote for the Target firm to be taken over at a smaller price to minimize the potential of overpayment and destruction of future value for the acquirer.</td>
</tr>
<tr>
<td>Ensure valuations calculated by Risk Metrics and Glass Lewis is fair. Utilizing both proxy firms is important because each firm takes a different approach in measuring valuation… which adds value to our process. The firms are well equipped with Staff that have M&amp;A experience from working at Investment Banks, as an M&amp;A lawyer, and as an analyst for several years.. also, education levels include CFA’s and MBA’s.</td>
</tr>
<tr>
<td>However, the proxy firms look at deals from the perspective of being either a shareowner of the Target or the Acquirer (100% owner in either company). CalPERS must take the information provided by the firms and apply it towards the thought process of owning both sides of the deal (if this is the case). This is where CalPERS may differ in its recommended vote from the proxy firms. If CalPERS owns more shares in the acquirer, we must be very cautious to minimize any overpayment which may unfavorably impact the stock performance of the combined firm.</td>
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If the offer price does not seem reasonable given Holt’s Model Value Chart and the expected transaction premium on the deal (research on Bloomberg).

If multiple, what is the historical trading multiple between the two companies?

**CAUTION! Short term traders!**  
Traders seek to ensure the deal closes because of their long/short strategy… not whether the deal makes sense. Traders may trigger an auction and then back the highest bid. Knowing that an overpayment to the target firm leads to a higher likelihood of value destruction of the post combined entity, CalPERS should be VERY cautious to not support any overpayment to the Target firm.

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<th>Deal Characteristic</th>
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<tr>
<td>2) MOE or firms are of equal size: twice as likely to fail</td>
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<td>3) High P/E multiple: Acquiring firm – more likely to underperform</td>
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Do not vote for deals with **HIGH** integration risk. Assess the following:

1) Measure Management’s skill: measure Management’s skill:  
a) operational and stock performance over their career/tenure at the company has underperformed  
b) does the management have the capabilities to reduce integration risk? What is the Altman Z/AGR Factor of the target firm?  
If it’s failing, this may increase the overall risk of the integrations success… could increase the risk of not achieving synergy targets… and if the Management team has overseen the company in to its problems… be sure that this Management team/ & Board does not lead the new company.  
c) Are there high withhold votes on the Board? CEO?  
d) Does the company have a history of material write downs of goodwill or asset impairment charges?

2) Planning: the company has NOT communicated its plan for the following:  
a) performed robust analysis of synergy and performance targets- confident about what is achievable before including them in the purchase price;  
b) Identified and investigated post deal issues prior to completion – these issues could be deal breakers;  
c) Used the regulatory period – start post deal management work prior to completion;  
d) Set up
a dedicated team to manage the post deal work; e) Obtained control over the finance and reporting systems as early as possible after close; f) Identified the cultural differences early and plan how to overcome them; g) Anticipated and planned for management and leadership issues early, then monitored them closely after completion; h) Balanced focus on delivering incremental value with the need to keep an eye on the day-to-day business performance; i) Planned to exceed the original synergy and performance improvement targets; and j) Tracked the value being delivered from the deal and honestly assessed the success or otherwise of the post-deal work.

3) Analysts ability to project company’s performance in the past to determine if analyst’s estimates are reasonable estimates for post deal. Historically, has the company met or exceeded analyst’s earnings expectations? Valuations?

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| Organization Culture “Check-up” | degree of shared vision  
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hopefulness/optimism regarding the organization's future  
values alignment  
executive<->employee alignment |

| Change Management | assess readiness for change  
determine the degree of "buy-in" for a particular plan  
uncover areas of resistance  
reveal silent allies  
pre/mid/post assessment/check-up |

| Mergers & Acquisitions Culture Assessment | Understanding the ways in which the cultures differ can lead to a more accurate assessment of whether they can be blended, and if so, what steps will need to be taken.  
Uncovering the areas/departments within organizations that will require more attention or provide unanticipated champions in the process |
of merging organizations with different cultures can help to target your efforts and increase the likelihood of success.

| **Conflicts of Interest** | Are contingent fees for the Investment Bank outliers to deal? Is this causing a biased in opinion? Or is the contingent fee priced to provide greater incentive to not “overprice” the deal?

Are Change in Control values causing a biased opinion for any part of the Management team? Is the Change in Control as a percent of the deal seem reasonable as compared to other company’s in the same industry? Is there any compensation tied to the success of the post merge deal?

How is the Board involved in the deal… and the new formed company? Does the Board have any biases? |

| **Governance Highlights** | *Poison Pill
*Classified Board
*Supermajority Voting Rights
*Poor pay-for-performance |

| **Staff’s meeting with Management comments** |  |
Scenario 2- Ownership Levels:

☑ Owner in the Target firm and the deal is an all cash offer

Focus is on voting against any deals that may result in potential negative consequences to CalPERS holdings.

<table>
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<td><strong>CAUTION! If buyer is a private equity fund!</strong></td>
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<td>The average gain for shareholders of the target when the acquirer is a public firm is 22.2%, and when it is a private equity fund it is only 20.47%. The study finds no evidence that target or deal characteristics can explain the differences in premiums between private and public bidders.</td>
</tr>
<tr>
<td><strong>Deal Characteristic</strong></td>
</tr>
<tr>
<td>1) Private equity purchase (\rightarrow) more likely to be bought at a low ball price</td>
</tr>
<tr>
<td>2) Auction process: only one offer on the table? (\rightarrow) may not be optimal price or direction</td>
</tr>
<tr>
<td>3) Investment banks fees outside the norm (\rightarrow) may not be a good deal</td>
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<td>4) Change-in-control fees outside the norm (\rightarrow) may not be a good deal</td>
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<td>5) Not a cash offer (\rightarrow) introduces integration risk</td>
</tr>
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<td><strong>Legal Remedy &amp; Rights</strong></td>
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<tr>
<td>If CalPERS does not believe we have been offered a fair value for our shares, vote AGAINST. Then, submit a written demand for appraisal rights to the Company before the vote is taken on the Merger Agreement. These two steps will enable CalPERS to take legal action against the deal. Touch-basis with CalPERS’ legal Staff to discuss necessary steps.</td>
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Scenario 3- Ownership Levels:
✓ Owner in the Acquiring firm

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2) Planning
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*Poor pay-for-performance
*Majority Vote rights |

| Staff’s meeting with Management comments | |

From the perspective of who owns the shares a factor that influences the determination of value is **Discounts for lack of liquidity.** The discount for lack of liquidity is closely related to the discount for lack of marketability. Lack of liquidity means that it may require additional time to sell the position, and the perceived cost of this delay is deducted from the value of the position. Lack of liquidity can arise due to either the nature of the position (e.g., non-publicly-traded shares) or the size of the position in relation to its normal trading volume. *(Level 2 Book 4: Equity Investments and Alternative Assets; Kaplan Schweser; September 2008 page 20)*
### How to Execute the Vote- More than One Payout Option

| More than one payout option? | Assuming the deal is approved and there are payout options (i.e. cash or cash/stock) a corporate action will be sent to CalPERS by our custodian. FYI… these corporate actions are not something we (Corp Gov) have been involved with in the decision making process. Generally, final decision will be made by the fund Portfolio Manager holding the position. I think Dennis had weighed in on a corporate action last year, but as I said this has generally been deferred to the traders. (per Todd Mattley) |

| Use the “Portfolio Effect” tab of the Workbook used to assess deals with “Multiple Medium of Exchange Scenarios” - #1 file |

---

### How to Monitor CalPERS’ Portfolio for Deal Value Creation (or) Destruction

**Category**

| Portfolio Effect- short term (isolate investor sentiment immediately) |

**If we own BOTH acquiring and target firm:**

Capture actual dollar “net benefits” based on the holdings in our portfolio. The value earned from the target firm + acquiring firm pre-deal announcement (undisturbed price) vs. post-deal for immediate value “net benefits” — + return to CalPERS portfolio.

For example:

**Cash deal —**

CalPERS owns

(per-announcement date/ undisturbed price)

1 share in Nordstroms for $5
1 share in Bebe for $20

Bebe offers $8 for Nordstrom
Nordrom stock drops to $18 (close)

Net Value of Position = $1
Vote FOR

(Apply same methodology to a stock multiple —)
this could be a bit more challenging because the stock price of the acquiring firm could be worth less by the time the deal closes if the forward looking prospects of the deal turn out to be less profitable than initially thought.)

*The focus is on the transactions that occur in the SJ64 portfolio. The team decided other portfolios are strategies driven by Managers that are given the opportunity to make their own M&A vote decision based on their investment strategy.*

**If we only own the Target firm:**
Capture the premium to report to the Board.

*The focus is on the transactions that occur in the SJ64 portfolio. The team decided other portfolios are strategies driven by Managers that are given the opportunity to make their own M&A vote decision based on their investment strategy.*

**If we own the Acquiring firm:**
If Staff also decides to track the returns of the post combined company, Staff may measure up to two years post integration vs. peers or perform a quality control review assessment to judge the effectiveness of the recommendation.

**CAUTION….** When studying the post effect of an acquisition from an academic perspective, the analyst must take precautions to avoid irrelevant noise in the assessment of the acquisition and its direct tie to performance. The academic must “isolate” the M&A deal in an attempt to control for other events that are known for impacting the stock performance of a company to determine if the abnormal return is the direct result of the deal under review. Examples of events that may cause noise are defined as “material” by insider trading: 1) dividend declaration or omission, 2) corporate reorganization or other takeovers, 3) acquisition or loss of a major contract, 4) major purchase or sale of company assets, 5) an event of default, 6) press coverage on company’s affairs positive or negative, 7) increase or decrease in earnings projections, 8) mineral find, regulation approvals of a product or issuance or denial of patents and other.

---

**Event Studies in Management Research: Theoretical and Empirical Issues, Academy of Management Journal; by Abagail McWilliams (page 634)**

**Selective Disclosure and Insider Trading, Release, Securities and Exchange Commission**

http://www.sec.gov/rules/final/33-7881.htm
Measure the success of the deal up to two years vs. peers (2-digit gics) and an index compared to one year prior to deal using TSR.

<table>
<thead>
<tr>
<th>Relative Size: describes the transaction value as a percentage of the acquirer's market capitalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Deals that comprised of less than 15% of the buyer’s capitalization tended to be considered a small deal and not included in the sample of companies used to identify the relationship that the initial 20-day window price reaction was indicative of future successful performance.</td>
</tr>
<tr>
<td>• The aggregation of financial data for business with differing financial structures, risk attributes, and indicators of performance obscures the characteristics of each segment. Reportable segments are defined by SFAS 131 as components of the enterprise that account for at least 10% of revenues, operating profits, or assets of all segments.</td>
</tr>
<tr>
<td>• 20% is considered “significant” in Inter-corporate Investment accounting.</td>
</tr>
<tr>
<td>• To concentrate on the mergers most likely to have a significant effect the bidding firm’s stock price, we require that the target be at least 10% of the bidder’s size. The main results hold for any cutoff between 5-25%.</td>
</tr>
</tbody>
</table>

Refer to the case study on CalPERS’ past deal votes to view the variety of deal sizes that are voted upon. (Legal size paper- Excel sheet and Regions Financial Corp.)

<table>
<thead>
<tr>
<th>Peer Selection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Which Mergers Destroy Value? Only Mega-Mergers; Dinara Bayazitova, Matthias Kahl and Rossen Valkanov; Oct. 23, 2009</td>
</tr>
<tr>
<td>MERGERS Why Most Big Deals Don’t Pay Off; A BusinessWeek analysis that shows 61% of buyers destroyed shareholder wealth; October 14, 2002</td>
</tr>
<tr>
<td>Financial Statement Analysis CFA Program Curriculum, Vol 2 pg 47</td>
</tr>
<tr>
<td>Financial Statement Analysis CFA Program Curriculum,</td>
</tr>
<tr>
<td>Merger Momentum and Investor Sentiment: the stock market reaction to merger announcements. Richard Rosen, page 9</td>
</tr>
</tbody>
</table>
### Who to Monitor - Ideas

<table>
<thead>
<tr>
<th>Category</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Largest Market cap in SJ64 Portfolio</td>
<td>Top 300 companies from website</td>
</tr>
<tr>
<td>Largest deals</td>
<td>Only track and measure the deals that contribute to at least 20% of the company’s assets – which means that CalPERS could eliminate resources spent on reviewing deals that may have only a minor impact on the business and reallocate a focus on deals that will have a greater impact on the operations of a business…..possibly expand its focus beyond the top 300 market cap companies and Focus List companies.</td>
</tr>
<tr>
<td>Corp Gov Program</td>
<td>Focus List companies (example: HRH)</td>
</tr>
<tr>
<td>Corp Gov Program</td>
<td>Ad Hoc from Internal Working Group</td>
</tr>
<tr>
<td>Corp Gov Program</td>
<td>Companies that the Focus List may be buying (but we only need the vote from the Target firm shareowners in which CalPERS owns shares) example LLY buys SGX Pharmaceuticals, Inc. (all cash deal)</td>
</tr>
</tbody>
</table>

### Which Products to Use

<table>
<thead>
<tr>
<th>Description and Contact Info</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>✔ Bloomberg</td>
<td>Use Bloomberg for M&amp;A information!! Product costs are already included in existing subscriptions 😊</td>
</tr>
</tbody>
</table>
| ✔ Factset MergerStat | Use the comparable multiples, price charts, corporate action info that are included in the current Factset subscription on Staff’s desktop 😊  
Other products: Merger products are thorough, however, Staff may not need all the information if takeover price is calculated by Glass Lewis and Risk Metrics $18k a year for one user ID ($1500 a month)  
Contact: John Leffler, 212-476-4398; jmleffler@factset.com |
<p>| ✔ Risk Metrics: Proxy Analysis and M&amp;A Edge | Fair Value, Investment Banking fees, and Change in Control assessment included in existing subscription. |</p>
<table>
<thead>
<tr>
<th>Service</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Glass Lewis: Proxy Analysis</strong></td>
<td>Fair Value, Investment Banking fees, and Change in Control included in existing subscription 😊&lt;br&gt; Contact: Warren Chen; <a href="mailto:wchen@glasslewis.com">wchen@glasslewis.com</a></td>
</tr>
<tr>
<td><strong>CSFB Holt-Online</strong></td>
<td>Use the Value Chart for a fair value assessment that is a free subscription 😊&lt;br&gt; Use the Value Chart to assess the best, warranted, and low price of stock only if the deviation of tracking the stock is 35 or less. This process would require Staff to add on an appropriate deal transaction premium.</td>
</tr>
<tr>
<td><strong>SEC Merger Filing</strong></td>
<td>Use the SEC public filings at no charge: Includes deal valuations from Investment Banking firms→ premium and multiple assessments → list of peers. Compensation matters, equity vesting, new bylaws etc, officers and directors of surviving entity. Post closing details such as headquarter location, charitable contributions, distribution channels, solicitation of other offers, ect…. (BUD preliminary merger proxy with InBev)</td>
</tr>
<tr>
<td><strong>Egan Jones</strong></td>
<td>Next time there is a deal in the pipeline, ask Sean Egan to complete a sample analysis based on CalPERS’ “Portfolio Effect” of the deal.&lt;br&gt; If the analysis proves useful, Staff may want to hire Egan Jones for their services on developing reports based on CalPERS’ Portfolio perspective.&lt;br&gt; Contact: Sean Egan, 610-642-2411; <a href="mailto:segan@eganjones.com">segan@eganjones.com</a></td>
</tr>
<tr>
<td><strong>Thomson Bank One</strong></td>
<td>Staff decided to not use product at this time.&lt;br&gt; Product is thorough, however, Staff may not need all the information if takeover price is calculated by Glass Lewis and Risk Metrics→&lt;br&gt; Option 1&lt;br&gt; ThomsonOne.com Foundational solution with the Deals Module for 2 users&lt;br&gt; $1,225 per month/ $613 price per user a month (minimum 2 id's) This application has some mobile capability and functionality included in this price.&lt;br&gt; Option 2</td>
</tr>
</tbody>
</table>
Thomson Banker which comes with numerous datasets and provides deep analytics as well as an excel add-in for 2 users $2,700 per month/ $1,350 price per user a month (minimum 2 id's) This application is for analysts to do top down and bottoms up review of industries and sectors as well as deep company analysis.

Option 3 - Legacy Product
SDC Platinum M&A (US & Non-US Targets Databases)
$2,000 per month for up $150,000 of total retail usage annually.
Or
SDC Platinum M&A (US & Non-US Targets Databases)
Unlimited usage at $3,000 per month

<table>
<thead>
<tr>
<th>✓ Thomson- One</th>
<th>CalPERS Operations organized contract…?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Always open to new ideas on products to use to improve the process of reviewing deals.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>What Paperwork to Print to Analyze Deal</strong></th>
<th><strong>Simple Snapshot Below</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bloomberg:</strong></td>
<td>Dependant on the need—may need a comparable analysis and other news on deal</td>
</tr>
<tr>
<td><strong>SEC filings:</strong></td>
<td>8k’s and updates- proxy 14 merger</td>
</tr>
<tr>
<td><strong>Factset:</strong></td>
<td>Quicklook, earning surprise history, M&amp;A news</td>
</tr>
<tr>
<td><strong>Proxy Advisor Reports:</strong></td>
<td>Risk Metrics, Glass Lewis and Edgar Jones (ask Edgar Jones to perform a “portfolio effect” analysis on CalPERS’… to determine the right decision for CalPERS.</td>
</tr>
<tr>
<td><strong>CSFB Holt-Online:</strong></td>
<td>Value Chart</td>
</tr>
<tr>
<td><strong>Thomson- One:</strong></td>
<td>Print analyst reports on the street for recommendation for and against deal. If possible, attempt to schedule an interview with a few analysts to discuss deal at hand and the industry aspect in favor or not.</td>
</tr>
<tr>
<td><strong>Press Releases:</strong></td>
<td>What are analysts and the company elevating in the press? Is it positive or negative?</td>
</tr>
</tbody>
</table>
### Roles of the Team

<table>
<thead>
<tr>
<th>Bridgette Butler</th>
<th>(Currently team is focused on transactions involving Merger, Spin-off, Divestiture or Recapitalizations.(^5) Staff relies on analysis of proxy firms to execute vote otherwise.)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Develops the Economic Program, the Economic Program Book, Deal Assessment Report and Procedures.</td>
</tr>
<tr>
<td></td>
<td>Responsible for training, organizing the educational aspect of the program, oversight of comment letters to influence regulation, and coordinating input from other units within the Investment Office.</td>
</tr>
<tr>
<td></td>
<td>Responsible for organizing alerts with Glass Lewis to keep the team up to speed on transactions in the pipeline.</td>
</tr>
<tr>
<td></td>
<td>Responsible for analyzing deals in the US for the top 300 companies by market cap in CalPERS’ portfolio. In addition to top 300, responsible for advising on transactions that take place in other programs such as the Focus List, the Financial Institution strategic initiative and other as requested by Management.</td>
</tr>
<tr>
<td></td>
<td>Responsible for sending the annual Due Diligence surveys to assess vendors and proxy firm’s analysis of transactions and to coordinate contracts where necessary.</td>
</tr>
<tr>
<td></td>
<td>Responsible for the follow thru with an Appraisal Process with legal if needed.</td>
</tr>
<tr>
<td></td>
<td>Responsible for creating and maintaining a page on the Corporate Governance website to educate and influence the market.</td>
</tr>
</tbody>
</table>

\(^5\) To date, the team has set an alert for these types of corporation actions that occur within CalPERS’ portfolio holdings. This alert can be modified to capture any type of deals.
<table>
<thead>
<tr>
<th>Name</th>
<th>Role and Responsibilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Celina Lu</td>
<td>Responsible for analyzing deals in the US for the top 300 companies by market cap in CalPERS’ portfolio. In addition to top 300, responsible for advising on transactions that take place in other programs such as the Focus List, the Financial Institution strategic initiative and other as requested by Management. Responsible for challenging and offering ideas to improve program.</td>
</tr>
<tr>
<td>Todd</td>
<td>Responsible for working with team to ensure Management knows vote is coming up and that analysis is completed and approval of report is completed to vote accordingly.</td>
</tr>
<tr>
<td>Bill</td>
<td>Final decision</td>
</tr>
<tr>
<td>Anne</td>
<td>Final decision</td>
</tr>
<tr>
<td>Other Investment Office Units in CalPERS</td>
<td>Hope one day to have point of interest contact responsible for giving feedback to the team from another unit’s perspective.</td>
</tr>
</tbody>
</table>
Support for CalPERS’ Active Involvement in M&A Deal Analysis

<table>
<thead>
<tr>
<th>Summary of Study</th>
<th>Title, Author, and Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>The results indicate that only major public pension funds are effective monitors. Pension funds reduce M&amp;A frequency. Presence of funds improves long-term M&amp;A performance.</td>
<td>Which Institutional Investors Monitor? Evidence from Acquisition Activity, draft June 2006; Lily Qiu</td>
</tr>
</tbody>
</table>

The document sets forth the views of the Department of Labor concerning the legal standards imposed by sections 402, 403, and 404 of Title I of the ERISA act with respect to the exercise of shareholder rights and written statements of investment policy, including proxy voting policies or guidelines. These guidelines affect fiduciaries of employee benefit plans, including trustees, investment managers and others responsible for the management of employee benefit plan assets.

The fiduciary obligation of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the economic value of the plan’s investment.

An investment policy that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is consistent with a fiduciary’s obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by plan alone or together with other shareholders, will enhance the economic value of the plan’s investment in the corporation, after taking into account the costs involved: such issues as the independence and expertise of candidates for the corporation’s board of directors…. policy regarding mergers and acquisitions, the nature of long-term business plans are reasonably likely to affect the economic value of the plan.

Dept. of Labor: Bulletin; Employee Benefits Security Administration

29 CFR Part 2509
RIN 1210-AB28
Page 1, 7, and 11-12
# Deal Characteristics: Successful & Failure Indicators

## Summary of Study

### What Makes Mergers Work Well?

Commonly reported items findings that apply to a wide range of circumstances based on the results of the surveys of corporate executives include:

1. Mergers that retain the main focus of the firm results in better outcomes;
2. Mergers of equal-sized firms work less often than others;
3. Early planning for the integration of the new physical and human assets improves the chances of success;
4. Fast-paced integration and early pursuit of available cost savings improves outcomes;
5. Managers must designate the merger integration leader and provide appropriate incentives;
6. Particularly in mergers involving technology and human capital, managers must retain the talent that resides in the acquired firm;
7. Customer and sales force attrition must be minimized.

### Seven Factors for Success-

Companies are twice as likely to succeed when they adopt the following seven practices:

1. early action
2. board of director involvement
3. pre-bid value assessment
4. formal transaction process plan
5. process manager involved throughout
6. process manager empowered with wide-ranging role
7. independent assessment of post-deal implementation

More U.S. companies (35 percent) are deriving value from mergers and acquisitions then their European counterparts (24 percent), because pre-bid assessment and issues were stressed more in the United States, according to the study, which used stock prices before and after the deals to analyze whether value was enhanced, destroyed or unchanged.

## Title, Author, and Year, page number

  - Page 8-9

  - Page 3
### Does it make Financial & Strategic Sense…

#### Motivations:

1. Undervalued
2. Diversification
3. Operating Synergy - cost and revenue  
   - Synergy is the primary motive in 1/3 takeovers.
   - Revenue driven synergies are less likely to achieve unprecedented “transformational” merger is subject to greater execution and integration risk → revenue synergies should be discounted
4. Financial: tax savings (loss to carry over), debt capacity (unable to borrow or only able to borrow at high rates), and cash slack (great projects but no funds or vice versa)
5. Management’s interest (ego/ power)

Revenue synergies as a primary motivator for an M&A deal lead to failure.

- “History shows that revenue synergies can be hard to capture, and that the market rarely gives credit for such synergies until they begin to be realized.” Page 19

### Mergers of Equals (MOE)

- “MOE merely defers judgment about who will rule, creating a real option in favor of the target and at the expense of the buyer, a rational deal for the buyer if it is confident it has the clout to win.” Page 13

Target shareholders capture less value from a MOE than they do in a traditional non-MOE merger. “Evidence suggests that CEOs {of target companies} trade power for premium by negotiating shared control in the merged firm in exchange for lower shareholder premiums.” Page 13

---

**Comments on Revenue Synergies:**


Same reference as above- {CSC Index Genesis 1997}

Caremark “Merger of Equals” with CVS; M&A Insight Analysis; Feb. 12th, 2006


Julie Wolf at the University of Pennsylvania
In 2004, Daimler Chrysler was formed to pay $300 million to settle a class-action suit that alleged that former Daimler CEO Jurgen Schrempp had misled target Chrysler shareholders by describing the Daimler-Chrysler deal as a merger of equals, when the merger was really designed as a takeover of Chrysler by Daimler. Page 13

- “True” MOE is shared economic ownership by the former shareholders. Take reasonable steps to preserve joint control of the combined company. Protect board members from BOTH interested parties with a supermajority board vote requirement is a reasonable defensible argument with an MOE.

“In an MOE deal, if both companies were trading in line with their peers prior to announcement, one could argue that both parties were fairly valued at that time, and therefore an “at market” deal is fair to both sides.”

With respect to the supermajority vote requirement to remove the CEO or chairman of the combined entity enables the parties to characterize the transaction as a “merger of equals” → this is not a governance issue but is a characterization of this type of deal.

Although some degree of skepticism is warranted when evaluating any so-called “merger of equals” and the slide in share price is definitely a cause for concern.

- Twice as likely to fail

Medium of Exchange

- When the medium of exchange is cash, public firm = higher likelihood of success
• Both target and acquiring firm experience a higher return with a cash vs. share offer. The results indicate a 5-day abnormal value change for acquiring firm of a public target is a loss of $100 billion. Remove all stock deals where the target is 10% of the size of acquirer or larger, the value change was a positive $60 billion.

Target is a non-public, significant and positive reaction regardless of medium of exchange.

• Acquirers do better when the medium of exchange is cash rather than stock.

Return to Acquiring company: Cash Offer > Combo > Stock offer

Deal financed with cash had a statistically significant and strong correlation with deal success. The average cash deal in the study showed a return of 15.1% after one year, and a stellar 27.5% after two years. Deals financed solely with stock were significant less successful. The average all-stock deal in the study returned negative 2.1% at 12 months and positive 3.6% at 24 months. Deals financed with a combo returned 3.9% after one year and 9.8% after two years.

• Companies that paid for their acquisitions solely with stock—65% of the cases—showed the worst results. After a year, they lagged behind their peers by 8%. By contrast, those paying entirely cash gained 0.3%.

“Do Acquisitions Drive Performance or Does Performance Drive Acquisitions?”; Michael Bradley and Anant Sundaram; Sept. 2004

“The Determinants of M&A Success; What Factors Contribute to Deal Success?” Transaction Services, KPMG (2007)

MERGERS Why Most Big Deals Don’t Pay Off; A BusinessWeek analysis that shows 61% of buyers destroyed shareholder wealth; October 14, 2002
<table>
<thead>
<tr>
<th>Public vs. Non-public target</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The results indicate a 5-day abnormal value change for acquiring firm of a public target is a loss of $100 billion, remove all stock deals where the target is 10% of the size of acquirer or larger, the value change was a positive $60 billion.</td>
</tr>
<tr>
<td>Target is a non-public, significant and positive reaction regardless of medium of exchange</td>
</tr>
<tr>
<td>Public target is large, acquirer’s price reaction is down</td>
</tr>
</tbody>
</table>

| “Do Acquisitions Drive Performance or Does Performance Drive Acquisitions?”; Michael Bradley and Anant Sundaram (Sept. 2004) |

| • When distinguishing value-creating deals, analysts must examine the operational strengths possessed by the acquirer and the target to discern the likelihood that post-merger synergies will be achieved. |

| Corporate Finance, CFA Vol 3; 2008, page 290 |

<table>
<thead>
<tr>
<th>Target vs. Acquirer’s Gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Target shareholders reap 30% premiums over the stock’s pre-announcement market price, and the acquirer’s stock price falls, on average, between 1 and 3%.</td>
</tr>
</tbody>
</table>

| Corporate Finance, CFA Vol 3; 2008, page 289-290 |

<table>
<thead>
<tr>
<th>Bids – obtained in an Auction</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Winner’s curse ⇒ if many bids are received in the auction, the acquirer may pay too high of a premium b/c of multiple bidders. “deal frenzy”</td>
</tr>
<tr>
<td>Acquirer stock returns are negatively related to the number of bidders</td>
</tr>
</tbody>
</table>

| Corporate Finance, CFA Vol 3; 2008, page 290 |

| • Albertsons process before its deal with Supervalue. In total, 10 different potential financial buyers, eight potential strategic buyers in the grocery industry, and four potential strategic buyers in the retail pharmacy industry.  |
| Target firm obtains more than one bid to ensure fair value is |

| Supervalu Inc. / Albertson’s Inc. ISS Proxy Analysis for Albertsons; May 30th, 2006 |

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6 How do we measure this? How has management been able to run this business up until this point? Has the company been on target for earnings and prior strategic objectives in the past? How capable is management?
obtained for shareowners.

**Price Reaction**

- Investors’ initial reactions were good predictors of subsequent price action. Of the bidder’s stocks that traded down relative to their peers in the first week after their deals, 66% were still laggards a year later, by an average of 25%. The stocks that were up initially went on to score even bigger, turning a smallish 5.6% gain into a 31% leap a year later.

- Initial market reaction is an important barometer for the value investors place on the gains from merging as well as an indication of future returns. If the acquiring company’s stock price falls when the deal is announced, investors are sending a message that the merger benefits are doubtful or that the acquirer is paying too much.

  Acquirers earn negative returns on announcement when paying a high premium.

  Acquirers whose earnings and share prices grow at a rate above the industry average for three years before the acquisition earn statistically significant positive returns on announcement.

- Public target is large, acquirer’s price reaction is down

- Stock Markets initial “thumbs up” or “thumbs down” on a deal is often predictive of future value of the acquiring company. Deals that received immediate “thumbs down” – a negative return 10% worse than a peer index in an initial 20-day window – continue to under-perform the market the market index two years later.

  Acquirer compared to the performance of peers, found:

  1) Deals that received immediate “thumbs down” – a negative return 10% worse than a peer index in an initial 20-day window – continue to under-perform the market the market index two years later.

  2) In the 20-day window before and after deal announcement, 23% of acquirers beat their index by 10% or more, while 27% of companies under-performed by 10% or more. In 50% of the deals, the markets did not take a significant

**MERGERS Why Most Big Deals Don’t Pay Off; A BusinessWeek analysis that shows 61% of buyers destroyed shareholder wealth; October 14, 2002**

**Corporate Finance, CFA Vol 3; 2008, page 290**

“Bain & Company’s Analysis of 790 M&A Transactions Uncovers Stock Market’s Initial ‘Thumbs Up’ or ‘Thumbs Down’ on a Deal is Predictive of Future Value”

**Business Wire (July 13, 2004)**
3) Nearly half of the companies whose news was greeted favorably still were out-performing their relevant index at the end of that two-year time frame.

4) Excess returns are generally poor across all industries but technology companies suffered a median excess return of -40% over that two-year time frame, while utilities was the only sector whose sector generated positive returns at 12%.

- No correlation between the capital markets’ reaction to a deal and the deal’s impact on the acquirer’s EPS.

- Research from last year that basically confirms some older studies that show that the initial market reaction of an acquirer's stock is a reliable predictor of future share price and price performance. In other words, the persistent and significant negative market reaction is often harbinger of value destruction. The drop is defined as the unusual acquirer dip that you see. Something in the double digits probably qualifies. Study basically says that here, the efficient market theory seems to hold true, that the market itself will tell you a lot about whether a deal is a value maximizer or a value destroyer and the implication obviously for shareholders is then to pay close attention to what the market is saying.

- Firms that make these large dollar losses (defined by $1-billion in a buy-and-hold investment strategy) perform poorly afterwards. It is immediately clear that the years 1998 through 2001 are dramatically different from the years 1980 through 1997. From 1980 through 1997, acquiring-firm shareholders lose $32 billion when acquisition are announced, while acquiring-firm shareholders lose almost eight times more from 1998 through 2001.


Wealth Destruction on a Massive Scale? A Study of Acquiring-firm Returns in the Recent Merger Wave (Intro, page 5 and 21)
**Around one half of deals with positive initial reactions stayed positive one year later. In the mean time, about 66% of deals with initial negative stock reactions stayed unfavorable.**

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<table>
<thead>
<tr>
<th><strong>Investment Banker</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• The acquiring company should be involved as an “independent” financial adviser</td>
</tr>
<tr>
<td>• Opinion, Contingent, or Guaranteed fee sometimes undisclosed separately</td>
</tr>
<tr>
<td>• Example of Guaranteed fee undisclosed for Lincoln National Corp. buying Jefferson-Pilot Corp.</td>
</tr>
</tbody>
</table>

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<p>| <strong>Washington Mutual, Inc. / Providian Financial Corp. ISS Proxy Analysis for Providian Financial Corp; Special Meeting dated August 31st, 2005</strong> |
| <strong>ISS Proxy Analysis for Mellon Financial Corp; Special Meeting dated May 24, 2007</strong> |
| <strong>Glass Lewis &amp; Co. Proxy Paper for Unocal Corp; August 10th, 2005</strong> |
| <strong>Lincoln National Corp. / Jefferson-Pilot Corp. ISS</strong> |</p>
<table>
<thead>
<tr>
<th>Change in Control</th>
<th>Fairness Opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Contingent fees provide less incentive to “overprice” the deal.</td>
<td>• Fairness Opinion should not be relied on by shareholders in determining whether or not to vote for or against the deal, for two reasons: 1) opinions are basically insurance policies written by investment banks for boards of directors, not the shareholders; and 2) they are fraught with potential conflict of interest, which is what the NASD is looking into.</td>
</tr>
<tr>
<td></td>
<td>UnitedHealth Group Inc. / PacifiCare Health Systems, Inc.; Glass Lewis &amp; Co proxy analysis for PacifiCare Health Systems; November 17th, 2005</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Board of Directors Expertise &amp; Ties to Investment Bank</th>
<th>Management’s Capability, Knowledge, and Expertise</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Improving the odds of success on mergers</td>
</tr>
</tbody>
</table>

| • Calculate payout as a percent of deal premium paid to Target firm. PacifiCare was 11% of premium valued at $193 million. | • Mergers of equals (firms of equal size) seem to have a lower probability of succeeding than acquisitions of a smaller firm |
| | “Investment Valuation” Chapter |
by a much larger firm

Cost saving mergers, where the cost savings are concrete and immediate, seem to have a better chance of delivering on synergy than mergers based upon growth synergy.

Acquisition programs that focus on buying small private businesses for consolidations have had more success than acquisition programs that concentrate on acquiring publicly traded firms.

Hostile acquisitions seem to do better at delivering improved post-acquisition performance than friendly mergers.

**Small acquisitions**

- Less prone to “agency” problems, consume less free cash flow, not an effective means of building empires, and result in smaller CEO compensation increases. There are likely to be greater information asymmetries between the acquirer and financial market participants with smaller acquisitions.

Smaller firms are less likely to be represented by sophisticated investment banks and lawyers at the bargaining table. All of these factors should work to the advantage of relatively large acquirers. Post-acquisition is likely to be easier and faster with smaller targets. There are fewer people, fewer entrenched admin heritages, and fewer competing-sized systems and processes to integrate.

**P/E Ratio**

- The P/E ratio is statistically significant. Acquisitions made by acquirers who had low P/E ratios were significantly more successful than acquirers with high P/E ratios. Acquirers whose P/E ratios were in the lowest quartile experienced a return of 21.6% after the first year and 42.2% two year after the deal was announced. Acquirers whose P/E ratios were in the second lowest quartile had an average return of 9.9% one year after the deal was announced and 17% after two years. Company whose P/E ratios placed them in the highest quartile experienced a negative 1.7% return after one year and just a .8% return after two years.

Also, statistically significant is the P/E ratio of the target firm. Acquirers who were able to purchase companies with below average P/E ratios had significantly higher returns. Acquirers whose targets were in the lowest quartile saw an average return of 14.8% after one year and a 34.4% stock price increase after two years. Acquirers who purchased...
companies in the second lowest quartile saw returns of 14.5% after one year and 24.9% after two years. Conversely, acquirers who purchased targets with P/E ratios in the highest quartile saw returns of negative 4.2% after one year and a positive 5.5% after two years.

**Size of the Acquirer**
- Statistically significant factor is the size of the acquirer. The smaller the acquirer, the more successful the deal. After one year, the deals completed by smaller acquirers had a normalized return of 6.2% and after two years, 15.8%. Deals by larger acquirers were not as successful. On average, after one year, acquirers returned a negative 3.5%, and after two years, they had a negative return of 7.7%. The average market cap in the study was $7 billion (US companies).

---

**Deal Experience**
- Too many deals lessen success. Acquirers who engaged in one or two deals in the prior year saw an average increase in stock price of 7.7% after one year and 18.3% after two years; companies that had completed 10 or more acquisitions in a year had an overall negative return of 7.2% after one year and a negative 8.3% return after two years.

---

**Deal Rationale**
- Some deal rationales are more successful than others as measured by TSR. Acquirers frequently make public statements that explain the rationale for their investments. Results over the first 12 months were similar to two years after the deal.

<table>
<thead>
<tr>
<th>1 year/ 2 year</th>
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<tbody>
<tr>
<td>Financial strength: 6.7%/ 16.8%</td>
</tr>
<tr>
<td>Distribution: 5.7% / 17.8%</td>
</tr>
<tr>
<td>Earnings accretion: 5.4%</td>
</tr>
<tr>
<td>Market penetration, product: 5.3%</td>
</tr>
<tr>
<td>Cost savings: 4.0%</td>
</tr>
<tr>
<td>Earnings diversification: 3.8%</td>
</tr>
<tr>
<td>Market penetration, geographic: 3.8%</td>
</tr>
<tr>
<td>Geographic diversification: 3.2%</td>
</tr>
<tr>
<td>Product expansion: 2.3%</td>
</tr>
<tr>
<td><strong>Revenue increase</strong>: -1.3%</td>
</tr>
<tr>
<td>IP/Technology: -5.5%/ 1.7%</td>
</tr>
<tr>
<td>Vertical integration: -9.5%/-20.5%</td>
</tr>
</tbody>
</table>

Factors not statistically significant to deal success (as

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“The Determinants of M&A Success: What Factors Contribute to Deal Success?”
Transaction Services. KPMG (2007)
measured by how the acquirer's stock would perform after 12 and 24 months):  

EBITDA/sales margins of acquirer and the target  

Geographic location: whether the acquirer or target were located in the same country or in different countries or regions.

**Post Integration**

- There was a strong correlation between companies that enhanced value and those that met or exceeded their synergy and performance improvement targets.

Nearly two thirds of acquirers failed to realize their synergy target, however on average 43% of the synergy target was included in the purchase price.

Companies found they did not start post-deal planning early enough. Top three actions companies would adopt on their next deal, earlier planning was the most commonly quoted. The advantages of early planning: 1) limit risk of losing customers, 2) bring forward synergy delivery, and 3) avoid a communication vacuum, where rumors and misinformation prevail.

Although a difference in organizational culture was the second biggest post deal challenge, 80% of companies were not well prepared to handle this. The top three post deal challenges cited by respondents were: 1) complex integration of two businesses, 2) Dealing with different organizational cultures, and 3) Difficulty in integrating IT and reporting systems.

It took an average nine months for companies to feel they had control of the significant issues facing the business post deal. Three quarters of the companies who succeeded in taking control of the business within their anticipated timeframe prioritized two types of activity as important in the first month: 1) Gaining sufficient understanding of and confidence in the finances and reporting systems to be able to actively manage the business and meet reporting deadlines both internally and externally; 2) Understanding and overcoming the cultural differences between the two companies.

Survey shows that buyers are having to pay for expected benefits in order to be competitive in the M&A market. Given the trend for competitive auctions, companies may need to take more seriously the ‘in-deal’ synergy analysis in

**Source?**

order to reduce the risk of paying for an unrealistic target in the price.

Potential remedies in the pre-deal and in the post-deal space:
1) perform robust analysis of synergy and performance targets. Be confident about what is achievable before including them in the purchase price;
2) Identify and investigate post deal issues prior to completion – these issues could be deal breakers;
3) Use the regulatory period – start post deal management work prior to completion;
4) Set up a dedicated team to manage the post deal work;
5) Obtain control over the finance and reporting systems as early as possible after close;
6) Identify the cultural differences early and plan how to overcome them;
7) Anticipate and plan for management and leadership issues early, then monitor them closely after completion;
8) Balance focus on delivering incremental value with the need to keep an eye on the day-to-day business performance;
9) Plan to exceed the original synergy and performance improvement targets; and
10) Track the value being delivered from the deal and honestly assess the success or otherwise of the post-deal work.

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### Assessing Culture

#### Jog Your Right Brain ~ The Projective Differential

#### Organization Culture "Check-up"

Most people *implicitly* understand that an organization's culture affects how work gets done, and how people within the organization relate to the organization, their work, and each other. For things to work smoothly, it's important that people have a shared understanding of the organization and where they're going.

Do different departments have a shared understanding of the purpose and direction of the organization?

Are management and employees on the same page in terms of how they see the organization and their perceptions of its potential?
Do managers see employees as employees see themselves? And vice versa?

How strongly tied to the organization and its mission are your employees?

The PD can be used to assess the "health" of an organization in terms of:

- degree of **shared vision**
- commitment
- hopefulness/optimism regarding the organization's future
- values alignment
- executive<->employee alignment

---

**Change Management**

For a change project to be truly successful, you need to have buy-in from the people making the change. How do you know if you've really captured the hearts and minds of those who will determine success or failure? How do you know if everyone understands the project, the process, and the goals in the same way?

You can ask. Perhaps you hold "town hall" meetings to communicate the changes and gauge the level of understanding and buy-in. But people don't always do what they say they'll do, they don't always say what they mean, and sometimes they don't even know what they really feel.

The Projective Differential gets below the surface, to uncover the deeper, **implicit attitudes** and perceptions that affect people's behavior. By understanding what's going on below the surface, you can take better predict where you're going to have problems with people, and know where you may have silent allies. Knowing how people are seeing things at a deeper level, you can make adjustments and take action **before** those unconscious attitudes start creating problems.

The PD can be used to improve planning and implementation of change projects ranging from small-scale departmental reorganizations to the merging of two large organizations with distinct cultures.

- assess readiness for change
- determine the degree of "buy-in" for a particular plan
- uncover areas of resistance
reveal silent allies
pre/mid/post assessment/check-up

Mergers & Acquisitions Culture Assessment

Depending on how success is defined – whether by shareholder value, customer satisfaction, employee retention, etc. – research indicates that the failure rate for mergers is between 50% and 80%. Regardless of the definition of success, the suggestion is that more than half do not live up to the expectations that were the rationale for the merger in the first place.

There are several reasons for failed mergers, among them overpayment, inaccurate assessment of the expected synergies, and cultural conflict.

The projective differential can be used to help assess the people and culture related issues at any point in the process:

Understanding the ways in which the cultures differ can lead to a more accurate assessment of whether they can be blended, and if so, what steps will need to be taken.

Uncovering the areas/departments within organizations that will require more attention or provide unanticipated champions in the process of merging organizations with different cultures can help to target your efforts and increase the likelihood of success.

Mergers, Acquisitions, Joint Ventures, and Internal Integrations:
http://www.metrus.com/issues/mergers.html

- Culture integration/measurement
- Talent assessment
- Speed of integration
- Strategy integration
- Customer service and systems integration
- Supply chain synergy

KEY ISSUES TODAY

Most M&As fall far short of their expected returns due to shortfalls in five critical ingredients. The number one factor cited by numerous press accounts has been incompatible cultures. The others include inadequate talent audit, lack of an integrated go-forward strategy, failure to analyze, understand, and address customer and market issues, and lack of cost savings expected from process integration, eliminated positions, and economies of scale.
Beyond M&A failures, many of these same factors contribute to gaps in internal restructurings as well. Many fail for political and cultural reasons; others fail because of redundant activities and overlapping or ineffective processes that chase customers away rather than enhance their loyalty; and still other restructuring efforts are victims of weak strategy implementation.

A Successful Approach to Merger and Acquisition Integration

**Process**

- Pre-planning
- Due Diligence
- Develop preliminary strategy and scorecard for integration
- Structural and financial evaluation and recommendations
- Human and market evaluation and recommendations
- Comprehensive and operating plans for new organization
- Integration Implementation

**Outcomes**

- Who to target
- Decide to merge / integrate
- Key success criteria
- Scorecard for success; 100-day plan
- Evaluation / tracking of milestones

**THE SOLUTION**

**Stage 1: Preplanning for a merger, acquisition, or other structural integration.**

The key is more effectively identifying target M&A candidates that will fit on multiple important dimensions of success, not only financial ones. Metrus has worked with clients on target profiles that include financial, market, customer, product, technology, and culture. Again, the culture fit is the most neglected of these areas. For example, Metrus used a cultural profiling technique with a well known health-care company that had experienced numerous failed acquisitions, enabling it to reject likely failures and realistically estimate the speed of integration of successful candidates.

**Stage 2: Capturing information**

During due diligence, many organizations gather far too little information regarding culture, leadership, organizational capabilities, and customers. Surprisingly, there typically exists a plethora of information available about the human capital, hidden cultural black holes,
management talent, leadership strength and philosophy, customer focus, and values that goes well beyond the financial and market data that is being analyzed. This information provides the foundation on which the closely studied financial information must be built. Lack of key leadership skills, loss of talent, or a major culture misfit can derail the financial benefits originally projected.

**Stage 3: Evaluation and 100-Day plan.**

The first 100 days after the close of a deal or the announcement of an internal restructuring are crucial. New information is being discovered and conflict over assumptions, resources, style, and roles is frequent. Process integration needs to begin, and customers must be protected. Metrus has a proprietary process for working with senior management during this crucial period. Metrus specializes in the development of an integration strategy - which should be started before the 100-day period - and the development of an integration scorecard that measures all of the important elements that must be tackled during this period, with clear success targets, accountabilities, and monitoring. It is also important during this period to quickly assess the cultures of the different organizations to develop a plan for leveraging the commonalities of the different cultures, and actively anticipating and managing the differences that will lead to conflict.

This period is also one of the highest risk periods to customers. Many will have negative experiences due to systems’ conversions, changes in client relationships due to downsizing or location changes, a lack of clear customer policies across the organizations and many more reasons. Service recovery, communication of policies, and setting correct expectations will be paramount for success. Metrus’ process includes a special focus on customers and other key stakeholders that can have a dramatic impact on the success of the new strategy. **Stage 4: Integration implementation.**

The last stage can also create problems. For those who have missed targets in earlier stages, there may be a chaotic state, with people trying to manage hundreds of initiatives, tripping over each other in a frenzy of activity. For those who are on target, there may be a lull during which momentum is lost. Some of the hard decisions have been made and plans executed. However, the customer, process and culture integration is rarely complete at this point.

Clear strategic metrics, such as customer loyalty, employee commitment, core process cycle times and so forth are critical to ensure that the limited resources of the organization are focusing on the really important activities - activities that produce value in the new context. Ongoing monitoring of these metrics, and integration tracking are essential to efficiently and effectively complete the integration with the expected value.

For example, Metrus has worked with a worldwide pharmaceutical in an ongoing tracking process to provide biweekly feedback on integration process effectiveness, specific business issues, and reactions to integration decisions. This information enabled them to make quick course corrections. Rumors were dispelled, critical information was directed to areas in need, policies were communicated where there had been none or confusion, and process integration was accelerated in key areas.

**BENEFITS**

The benefits of this new approach are substantial, and include:

- Greatly enhanced speed of integration, which translates into significant financial impact. Metrus has had integrations that have been successfully completed in as short as 60 days!
- Fewer employee and customer defections and less dissatisfaction
- Creates a positive mind-set from the start - organizational walls don’t get built and a strong buy-in to the integration process is developed
- Skills that are needed to complete the integration successfully are identified and focused
• The installation of an early warning system of information that can be used to avert disasters, make course corrections, and predict important results
• A common mind-set is created among members of the new leadership team
• An excellent base is forged for clear, concise communications with impact
• Enhanced ability to walk away from deals with a high likelihood of failure
• Information is put in the hands of the new owners to monitor progress toward implementation and to assess the validity of the business strategy, test the health and capabilities of their new venture, uncover hidden blind spots, and identify inherited cultural baggage

**INFORMATION**

The following articles are available at our Recommended Reading page:

• *Ten Myths of Managing a Merger*
• *Organizational Change: Lessons from a Turnaround*
• *Creating a Measurement-Managed Organization*
• *Organizational Change Starts With a Strategic Focus*

To download these articles, [click here](#).

**DIAGNOSTICS**

Metrus Group offers a complete diagnostic that includes two sets of assessments that can be used separately or in concert:

1. A full internal self-assessment survey that can be administered to key stakeholders to determine the effectiveness of your ongoing or most recent integration. This survey comes with interpretation of the results and recommendations for improvement. Click here for more information.

2. An on-site audit of your planned, current, or past M&A or other integration efforts. This audit can be completed in three weeks. It includes a review of your current process, feedback from key stakeholders including members of the leadership team, integration team players, and customers of the process (internal and external), comparisons to best practices, and recommendations for improvement.

**TRAINING**

Metrus offers custom training for internal members of your M&A, joint venture, or integration teams based on specific needs.

**CONSULTATION**

Metrus offers a range of consulting services and tools that support M&A efforts, which include:

• Target company profiling
• Cultural assessment of target or acquired companies
• Leadership assessment
• Strategy review
• Integration scorecards
• Integration tracking
• Customer satisfaction and retention
• Key employee commitment and retention
• Investment scorecards for managing newly acquired businesses
• Turnaround strategy and scorecards
• Financial valuation of proposed or new mergers
Who is Currently Voting Deals Now and What is There Method??

Greater detail provided in the section: Risk Metrics & Glass Lewis Deal Process Comparison

<table>
<thead>
<tr>
<th>Glass Lewis</th>
<th>Risk Metrics</th>
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<tbody>
<tr>
<td>Relies on the Fairness Opinion and Comparables Method to assess value of deal</td>
<td>Relies on Discounted Cash Flow basis to value deal, and assesses Change in Control and Investment Banking Fees.</td>
</tr>
</tbody>
</table>

U.S. Voting Manual for ISS → Mergers and Corp Restructures

While the fairness opinion may provide an initial starting point for assessing valuation reasonableness, ISS places emphasis on the offer premium, market reaction, and strategic rational.

How often do proxy firms vote AGAINST deals?

GL and Risk Metrics vote the same 90%+ of the time together AND vote FOR 90%+ deals

Benefit of using different proxy firms

GL and Risk Metrics use opposing methods covering different basis → a very thorough approach, but still come up with the same recommendation in most deals.
### Assessing Managements Operational Strengths to Understand Risk of Integration & Execution?

<table>
<thead>
<tr>
<th>Summary of Study</th>
<th>Title, Author, and Year</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operating Inefficiency: SG&amp;A over Sales</strong></td>
<td>Risk Metrics M&amp;A Edge Reports</td>
</tr>
<tr>
<td><strong>Historical impairments of Goodwill with the current Management team? Same Board members?</strong></td>
<td>“Investment Valuation” Aswath Damodaran Chapter 25</td>
</tr>
<tr>
<td>- The potential to reduce the dreaded goodwill amortization with a one-time charge is appealing for many firms and studies find that firms try to take maximum advantage of this option. Lev (1998) documented this tendency and also noted that firms that qualify for this provision tend to pay significantly larger premiums on acquisitions than firms that do not.</td>
<td></td>
</tr>
<tr>
<td><strong>High accrual of Inventories</strong></td>
<td>“HOLT Signal Flag: Rising Accruals” Credit Suisse HOLT. Ron Graziano (July 11th, 2008)</td>
</tr>
<tr>
<td>- Inventory growth that outstrips COGS can be a warning signal of a slowdown in sales or impairments to inventory. Inventory build also can be a sign of growth… important to differentiate between the quality of earnings risks vs. quality of investment opportunities. Certain companies with high levels of inventory accruals or business models with long cash conversion cycles will be at risk to experience further share price underperformance.</td>
<td></td>
</tr>
<tr>
<td>Cash Conversion Days: AR Outstanding + Inventory Days Outstanding – AP Days Outstanding</td>
<td>(Avg for the S&amp;P 1500 is 68 days). Worry when company’s CC is above average and increasing. A weak consumer and rising cost of credit will put additional strain on companies that have long cash conversion cycles, higher levels of debt and not a lot of cash.</td>
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<tr>
<td><strong>AGR Score/ Altman Z</strong></td>
<td><strong>Audit Integrity and Predicting Financial Distress of Companies: Revisiting the Z-Score and Zeta Models, Edward I. Altman, July 2000</strong></td>
</tr>
<tr>
<td>• Aggressive accounting measurements and increased likelihood of bankruptcy</td>
<td></td>
</tr>
<tr>
<td><strong>How have past M&amp;A deals been integrated in to the company? Stock performance since?</strong></td>
<td></td>
</tr>
<tr>
<td>I sent an e-mail on 8/18/2008 to Board Analyst and Governance Metrics International: Do you have any ratings for the following:</td>
<td></td>
</tr>
<tr>
<td>- Corporation’s ability to make good/bad strategic decisions?</td>
<td></td>
</tr>
<tr>
<td>- Management team that poorly runs the overall operations of its business?</td>
<td></td>
</tr>
<tr>
<td>- Management teams ability to &quot;integrate&quot; companies they merge with..... in terms of ability to meet cost cutting, synergy, and stock performance goals they set out to hit once the merge or acquisition has closed?</td>
<td></td>
</tr>
<tr>
<td>Neither Board Analyst or GMI created any type of rating to capture this issue. Board Analyst historically had a “Strategy” rating, but decided to delete this given its complexity.</td>
<td></td>
</tr>
<tr>
<td><strong>Under- funded pension</strong></td>
<td><strong>Alcatel SA/ Lucent Technologies, Inc. ISS M&amp;A Insight Note: Alcatel and Lucent/”Hedgies Thwarted” (Sept. 7th, 2006)</strong></td>
</tr>
<tr>
<td>• Lucent’s pension credit substantially effects the firm’s relative contributions to the income statement of the combined company. Lucent shareowners are projected to hold approx. 39% of the equity stake of the combined company which generally falls within the range of observed contribution of the company on a reported earnings and pension-adjusted earnings basis.</td>
<td></td>
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<tr>
<td></td>
<td><strong>Intercorporate</strong></td>
</tr>
</tbody>
</table>
Mergers that were done to expand revenue were likely to fail. Deals undertaken to pioneer new territory, incurred high execution risk. On the other hand, consolidations to achieve scale or scope synergies across or within markets were likely to work. In all deals, cultural clashes had the potential to be a serious problem, and firms that avoided those problems had greater success. Inexperience also seemed to hinder deal value-enhancement, as the returns relative to peers were higher for those deals done by experienced acquirers.

### Earnings prior to Merge

**Albertson’s (T) and Supervalue (A) deal**

- ABS’s EPS excluding extraordinary items had been decreasing for the past three years.
- ABS has struggled to create new growth and had projected a substantial decline in its free cash flows through 2010.
- Supervalue’s stock has declined in the months following the transaction. Company announced news of poor operating performance and S&P and Moody’s Investor Services put Supervlaue’s bonds on negative credit watch in March. The company’s debt was cut to below investment grade by Moody’s in April upon worries of increased leverage originated in the merger.
- Shares increased by 54%
- Cost of CIC = $63 million, synergy by the third full year was expected to be $150 million to $175 million.
- Higher leverage and integration challenges.

### Management

- Deals that do not meet expectations culminate with

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{CSC Index Genesis 1997, now Cap Genimi/Ernst & Young}
removal of the CEO within 2 years in 42% of the cases.

- A Watson and Wyatt survey of 1,000 companies revealed that more than two-thirds of companies failed to reach their profit goals following a merger, and only 46% met their cost-cutting goals.

- An A.T. Kearney study demonstrated that 58% of mergers failing to achieve their stated goals, and only 42% of global mergers managing to outperform their competitors after two years.

- Although many of the merging or acquiring companies state the importance of retaining and acquiring key talent, 47% of senior management in the acquired firm leave within the first year and companies experience on average a 50% drop off in productivity in the first 6-8 months of the integration. {Raymond Noe, “Mergers and Acquisitions” MHR 860, Jan. 17, 2002, Ohio State Univeristy Fisher College of Business}

- Poor communication at all levels is a principle reason why mergers fail.

- Lack in Human Resource involvement can have a detrimental impact on the merger{Raymond Noe, “Mergers and Acquisitions” MHR 860, Jan. 17, 2002, Ohio State Univeristy Fisher College of Business}* Lack of proper employee training for the merging company. If legal and financial experts are driving the strategic work behind the integration, then a number of important considerations critical for the financial success of the merger, such as the productivity of the new employees, many be overlooked unless human resources and corporate communications staff members provide their input. Survey reveals that 81% of HR directors believe that “most HR professionals do not have sufficient technical knowledge of M&A and other corporate growth activities to support acquisition strategy development.”

- According to a survey involving 88 senior HR executive of companies that have recently experienced a merger or acquisition, less than 33% of respondents reported that training in M&A communications was provided to top

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“Why Do Mergers Fail? What Can Be Done to Improve Their Changes of Success?” Key Strategy (Jan. 2003)
management, and training was provided to the CEO, middle managers, or frontline supervisors in just one out of five companies.

- According to a Wall Street Journal article, an estimated 50-75% of managers in companies that have merged plan to leave within three years. Yet the decision to merge or acquire is often based on the desire to gain a talented workforce, and new knowledge and expertise. (Suhkyung Yoon, “People Problems’ Hinder Post-Merger Success”, Far Eastern Economic Review, November 15th, 2001)

- Loss of customers, corporate culture clashes, power struggles (no such thing as really “sharing power” → MOE’s), and inadequate planning, lead to merger failures.

- A joint study by PA Consulting Group and the University of Edinburgh Management School found that companies that had planned the merger in great detail achieved short-term share price returns that were 4.5% higher than companies that had not carried out adequate planning. Companies that had created an integration and communications plan before the merger deal was finalized improve their share price return by a further 2.3%. Also, when the acquiring firm is aware that cultural differences exist, the merged company produces considerably higher shareholder value than those where the acquiring company believes there are no such differences- a cultural audit is a useful way of obtaining useful information about the two companies’ differing cultures and helps to evaluate differences and similarities in work standards and practices. (M&A Study Overturns Wisdom on Why Mergers Succeed or Fail – Research from PA Consulting Measures the Cost to Shareholders,” PA Consulting Press Release, 12 June 2000)

- Identify cultural differences between the two merging firms ahead of time.

- This may mean loss of turf, assumed career path, or the proud identify of the old company. Winners tend to feel a certain smugness and superiority that their company was able to vanquish the target firm. Losers resent their status as underdog in the acquiring firm. More often, the prevailing culture gradually becomes that of the acquiring company. In some cases preserving the separate culture of the target is the wisest path. Many fear that their track record may be disregarded and that they will have to prove themselves anew… nearly 50% of executives in a
Wall Street Journal poll were seeking other jobs within a year after a merger. Another 25% planned to leave within three years... implementing a merger is extraordinarily complex.

- In a recent survey that my firm conducted of senior executives in Fortune-500 companies, fewer than 50% of the respondents report that their organizations’ major change initiatives were successful (defined by meeting the objectives of the company’s senior management). Primary barrier to success, the survey found, was employee resistance to doing things in new ways.

- To create value, you have to think about balancing the need to work together interdependently with the need to preserve the culture of the organization. “Absorption” is what most people think of when they think about acquisitions—that is, Company A buys Company B, and Company B essentially goes away. That result is entirely appropriate where you have a high need to work together and a low need to preserve the acquiree’s culture. In contrast, if you have an initial low need for strategic interdependence, but you have a high need for autonomy, you’re going to want to preserve the culture and manage the acquisition different as a result. Unfortunately, a lot of people don’t pay any attention to those differences; but to create value, you have to consider the consequence of your integration actions. .. first thing we see are accountants, that sends some pretty strong messages about what you think about us... but if the first person we see is the executive vice president in charge of our area or the president that comes in with a strategic speech, we’re going to think a little differently and behave differently, too.”

- The average cost of replacing an employee is roughly $15,000; loaded costs, including lost productivity, quality, and team disruption often double that number. In a firm with 5,000 employees and a 10% turnover rate, shareholders may be swallowing over $15 million a year in unnecessary costs.”

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*Human Resource Involvement in the Merger Process*

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>Asia-Pacific</th>
<th>Brazil</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Planning</td>
<td>16%</td>
<td>19%</td>
<td>8%</td>
</tr>
<tr>
<td>Investigative</td>
<td>41%</td>
<td>21%</td>
<td>12%</td>
</tr>
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<td>---------------</td>
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<tr>
<td>Negotiation</td>
<td>16%</td>
<td>16%</td>
<td>24%</td>
</tr>
<tr>
<td>Integration</td>
<td>27%</td>
<td>44%</td>
<td>56%</td>
</tr>
</tbody>
</table>

**Assessing Analysts Ability to Predict Earnings of Post Combined Performance of Companies?**

<table>
<thead>
<tr>
<th>Summary of Study</th>
<th>Title, Author, and Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>In-line with actual vs. mean industry analysts earning expectations? Or Company’s targeted revenue/earnings estimates?</td>
<td>- “Some investors are troubled Alcatel may have overpaid for Lucent in light of its second quarter earnings announcement. Lucent missed consensus revenue estimates by 4%. Also Alcatel reported lower than expected earnings and continued to face margin pressure.”</td>
</tr>
<tr>
<td>Caution not to overestimate synergies</td>
<td>Alcatel SA/ Lucent Technologies, Inc. ISS M&amp;A Insight Note: Alcatel and Lucent/”Hedgies Thwarted” (Sept. 7th, 2006)</td>
</tr>
<tr>
<td>Caution not to underestimate execution risk</td>
<td>Alcatel SA/ Lucent Technologies, Inc. ISS M&amp;A Insight Note: Alcatel and Lucent/”Hedgies Thwarted” (Sept. 7th, 2006)</td>
</tr>
</tbody>
</table>
# Motivations for Merger or Acquisition?

## Summary of Study

<table>
<thead>
<tr>
<th>Motivations</th>
<th>Title, Author, and Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Counter increased buyer power</td>
<td>Alcatel SA/ Lucent Technologies, Inc. ISS M&amp;A Insight Note: Alcatel and Lucent/”Hedgies Thwarted” (Sept. 7(^{th}), 2006)</td>
</tr>
<tr>
<td>• Counter slowing market growth</td>
<td>Alcatel SA/ Lucent Technologies, Inc. ISS M&amp;A Insight Note: Alcatel and Lucent/”Hedgies Thwarted” (Sept. 7(^{th}), 2006)</td>
</tr>
<tr>
<td>• Significant consolidation in the industry and now left with substantially fewer competitors</td>
<td>Alcatel SA/ Lucent Technologies, Inc. ISS M&amp;A Insight Note: Alcatel and Lucent/”Hedgies Thwarted” (Sept. 7(^{th}), 2006)</td>
</tr>
<tr>
<td>• Eliminating competition through mergers and acquisitions is tempting but risky because any resulting increase in profits will attract new competitors. For example, national book retailers consolidated a previously fragmented industry and reduced distribution costs, only to attract new competition from online companies like Amazon.com that enjoy even lower costs because they don’t require brick and mortar locations. Specialty coffee companies who acquired smaller firms to defend high margins attracted more broad-based competition on both sides, from global competitors such as McDonald’s to local competitors such as the corner delicatessen.</td>
<td>(Level 2 Book 4: Equity Investments and Alternative Assets; Kaplan Schweser; September 2008 page 102)</td>
</tr>
<tr>
<td>• Doubling of asset size for financial firms lead to 20% reduction in unit cost of servicing accounts. For industrial firms, savings of 10-15% in materials and components are common as a result of scale gains.</td>
<td>“The Effects of Mergers and Post-Merger Integration: A Review of Business Consulting Literature” Federal</td>
</tr>
</tbody>
</table>
Results from a 1980-1997 sample of Fortune 500 takeovers indicated that post-merger firm performance improved in some important dimensions (e.g. costs per unit revenue) relative to 2-digit industry benchmarks.

The CFA Institute cites the following ten motivations behind mergers:

- **Synergy** – Companies seek to add value by taking advantage of revenue synergies and economies of scale. A company has incentive to participate in M&A activity if the opportunity exists to create an entity that is “greater than the sum of its parts.”

- **Growth** – Corporate managers have incentive to use M&A activity to grow their company externally. M&A activity is viewed as a safer and quicker alternative to organic growth (growth through internal investments).

- **Increasing Market Power** – Horizontal and vertical integration potentially bolsters a company’s ability to market prices. Horizontal integration increases market share, which potentially leads to greater pricing flexibility. Vertical integration may create competitive advantages that can be leveraged to influence industry output and prices.

- **Acquiring Unique Capabilities and Resources** – Companies often seek to solidify areas of strength, address areas of weakness, or acquire additional capabilities through M&A activity.

- **Diversification** – A company may seek to mitigate cash flow variability by acquiring companies in many different industries. This strategy negatively affects shareholders who can diversify more efficiently through the capital markets.

- **Bootstrapping Earnings** – If the P/E ratio of an acquiring company is higher than the P/E ratio of the target company, a merger can create the illusion of added value. Therefore, the acquiring company may be able to

---

**References**

*Trade Commission, Paul Pautler; Draft (Jan. 21”, 2003)*

*Boston Consulting Group 2000, 2001-internal research*


*“Corporate Finance: CFA Program Curriculum, Volume 3” CFA Institute. Pages 241-247. 2009*
temporarily boost its stock price through the acquisition. The market usually adjusts to this “bootstrapping effect” rather quickly.

- Managers’ Personal Incentives – Managerialism theory suggests that an executive’s compensation and prestige is positively correlated with the size of the company for which she works. This correlation gives members of the managerial team incentive to grow their company through merger activity.

- Tax Considerations – A profitable company has incentive to decrease tax liabilities through M&A activity. If the target company has a substantial tax losses, the acquiring company can use these losses to offset its tax liability.

- Unlocking Hidden Value – An underperforming company may represent an attractive acquisition if it can be acquired at a discount. The acquirer seeks to unlock “hidden value through reorganization, better management, or synergy.”

- Cross-Border Motivations – M&A activity represents an efficient way to achieve international business goals. According to the CFA Institute, potential benefits to an acquiring company include: exploiting market imperfections, overcoming adverse government policy, technology transfer, product differentiation, and following clients.

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**Tracking Deal Value Creation or Destruction of Recommendation?? Challenges?? Over What Time Period??**

<table>
<thead>
<tr>
<th>Summary of Study</th>
<th>Title, Author, and Year</th>
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<tbody>
<tr>
<td>“Acquisitions do not destroy value when pre-announcement run-up is taken in to account”</td>
<td>Bradley, Duke University</td>
</tr>
</tbody>
</table>

*Staff Comment on Challenges in holding the single recommendation decision accountable for post combined firm performance:*

Scenarios effecting CalPERS ability to track its decision made on an M&A recommendation:

- Corporate actions take place that may in aggregate accumulate to “transforming” the business since the
recommendation had been made: a) selling off assets less than 50%, b) buying assets with less than 20% of outstanding stock, or c) buying assets with cash.

- Each takeover that is voted on by shareowners may contribute only to an insignificant portion of the overall revenues and earnings of a company → thereby making your vote recommendation impact on stock performance minimal or irrelevant. (decision of M&A decision not significant enough to explain stock performance)

| Performance measurements – ROC, revenue and cost synergies, TSR one-year before vs. one-year after compared to peers |
| Hostile takeovers state 60% of takeovers were followed by significant divestures in while half or more of firm was divested to focus on company’s core assets. |
| Glass Lewis and Risk Metrics have not crafted a method that could help them assess the performance of their vote recommendation of a deal. Proxy firms state the matter is “Complex. Difficult to assess the impact of the performance of the deal. Example, decline in the post company may be based on a change in consumers cutting back spending → so many other factors that could be the cause of the deterioration of the post merge company.” “Difficult to exclude other activities, “causation” of other corporate events that may impact the performance of the company besides the deal after the fact.” |
| Measures success at creating value by comparing post-deal stock price performance of the combined firm to the performance of the relevant industry segment for a year after the deal was completed. |
| Compared TSR three months prior with total returns vs. two years after deal |
| Measured success – ROC vs. Cost of Capital |
| Three months prior merge vs. returns up to three years. Stipulations included: 150 deals involving $500 million or more, ½ reduced s/o value, and two year following merge vs. industry specific S&P indices. |

CFA

| In report |


PMI

McKinsey

Mercer Consulting
<table>
<thead>
<tr>
<th>Study $500 million or more, not be followed by another deal for the same buyer within a year (weeds out small deals or firms that make repeated purchases). Findings: 61% of deals reduced shareowner value → favorable initial market reaction on day one, later succeeded</th>
<th><strong>Boston Consulting Group</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Wharton School – Dept. of Finance (15 studies listed)</strong></td>
<td></td>
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<tr>
<td>Surveys show out of 1,000 companies, 43% of companies failed to meet their cost cutting goals.</td>
<td></td>
</tr>
<tr>
<td>Mechstroth questions the validity of academic research indicating below average financial performance among mergers. Such models, he states generally do not reflect the dynamic market forces faced by merging companies. Negative merger outcomes might reflect the best choice among several less-than-appealing possibilities confronting a company. Mechstroth also concludes that most mergers enhance economic efficiency by more efficiently distributing resources, even if they fail to achieve financial returns to shareholder when measured against stock market or industry average returns. As he put it “This finance’ test is very difficult to achieve simply due to the law of average.’ About 50% always are going to be below average and very few individual firms can beat the average consistently over the long term”</td>
<td><strong>Mechstroth (FTC)</strong></td>
</tr>
<tr>
<td>Proxy Advisory firms and Investments banks calculate the premium earned for Target firms based on the pre-announcement price – “undisturbed” price</td>
<td><strong>Glass Lewis, Risk Metrics, Goldman Sachs, Lehman Brothers, Morgan Stanley</strong></td>
</tr>
<tr>
<td>• The studies below concur that less than half fail to enhance shareowner value. “Success” is sometimes said to occur only if the deal results in share price appreciation beyond the average for all comparable firms. Thus, continued average growth is considered a failure. For certain studies presenting data in that way, mergers can be shown to “fail” as much as 75% of the time. However, the “no significant change” category is counted often drives the tone of the presentation.</td>
<td></td>
</tr>
<tr>
<td>• The 12 surveys or studies listed in Table 1 on “Selected Results from the Business Consulting Literature on Mergers and Post-Merger Integration,” contain results that do not go beyond measuring a company’s performance two years following the merge:</td>
<td></td>
</tr>
</tbody>
</table>
150 large, 1990-1995 deals. Share value 3 months before vs. three months after compared to S&P 500.

152 trans-Atlantic deals from 1994 to 1999 using 2-year post-deal comparison to industry-specific S&P stock price index. Also, Merger examined simple correlations of industry-adjusted post-deal stock price returns with stock price premiums paid, pre-deal performance of the acquirer, size of the target relative to the acquirer, and the strategic motive for the merger (e.g., expansion, consolidation, diversification) and found that none of those factors appeared correlated with the post-deal industry-adjusted stock price outcome.


115 large 1993-1996 deals; total shareholder returns 3 months before versus two years after the deal. No explicit non-merger comparison group- comparisons made to average or quartiles in the sample.

71 large deals from 1989 to 1993 compared to Peer group’s market value change from one year before to two years after the deals.

Short-term performance studies that look at stock returns before and after merger announcement dates conclude that targets gain approximately 30%, while acquirers lose stock value of between 1% and 3%. Some believe that high premiums received by target firms are the result of acquiring firms suffering from a “winner’s curse,” in which the competitive bidding process is won by the firm who overpays the most. Managers also may overestimate the synergies and expected benefits of the merger. This tendency is called managerial hubris.

Longer term performance studies of post-merger companies show that acquirers tend to underperform their peers. Average returns for acquirers three years after a merger are -4% with over 60% of acquiring firms lagging their peer group. Some believe that these results are due to a failure to capture promised synergies after a merger is completed.

Fama French
- The **Fama-French model** is a multifactor model that attempts to account for the higher returns generally associated with small-cap stocks.

- The "alpha" number that is shared with the Board is not significant for all but one deal AND the R squared are far too low to give us any comfort level the fama-french figure is accurately assessing the performance of Staff's deal recommendation.

- Ho definitely recommended we move away from Fama French and that it is not a good measurement for this type of program. Also, out of the 15+ studies I have read, this formula has not been used once in any academic studies.

### Different Benchmarks to Measure Performance

- Transactions measured against overall stock performance, industry average returns, pre-merger trends, or other. Whether a merger is considered a financial success can depend on the benchmark chosen. Sometimes success is only defined if the share price appreciation is BEYOND the average for all comparable firms. Sometimes the benchmark is the post-merger share price performance of other merging firms. Oftentimes the benchmark is whether the share price of the firm rose relative to an industry-specific average or an all industry average. In other instances, revenue growth relative to recent trends appears to be the benchmark. The best benchmark might consists of a financial performance index based on a set of matched firms in the same industry that did not go through a merger event. Unfortunately, the world seldom presents a natural experiment that well-designed.

### Lies, damned lies, and statistics

- Statistics on the consequences of mergers and acquisitions should be taken with a pinch of salt. The acquisition of KLM by Air France as an example. Imagine that their combined turnover and profits will remain on approximately the same level for the coming five to ten years. It would in that case be very tempting to label the acquisition as “failed.” Many analysts, however, expected the turnover and profits of KLM to decrease for that same period, if no acquisition had taken place. It does not really take rocket science to understand that this is quite relevant when valuing the success of a merger, does it? After all, many mergers and acquisitions take place when companies fail to achieve autonomous growth. It also regularly occurs that companies

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*Source: Level 2 Book 4: Equity Investments and Alternative Assets; Kaplan Schweser; September 2008 page 56*

*CalPERS’ M&A Vote Performance Excel Spreadsheet*


*“The Merits of Mergers” Lars Duursma; interface (Sept. 2004)*
are acquired, when disappointing results or growth expectations have caused their market value to drop a lot. Hence, is it enormously strange that their turnover and profits aren’t suddenly skyrocketing the years following the merger?

**Portfolio Effect ➔ Own Shares in Both Companies?**

<table>
<thead>
<tr>
<th>Summary of Study</th>
<th>Title, Author, and Year</th>
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<tbody>
<tr>
<td><strong>Portfolio Effect</strong> ➔ institutions that own shares in both companies should calculate the “net benefit” vs. relative. Depending on its relative dollar exposure, in theory an institutional shareholder may be likely to support a transaction even one that is poor deal for one side, provided the other side reaps a greater reward.</td>
<td>Risk Metrics M&amp;A Edge Note for Yahoo, “The Portfolio Effect,” (February 15th and Feb. 29th, 2008)</td>
</tr>
<tr>
<td>“Even if there were no synergies from a merger, managerial hubris would still lead to higher-than-market bids and a transfer of wealth from the acquiring company’s shareowners to the target’s shareholders.”</td>
<td>CFA Vol 3, page 290</td>
</tr>
<tr>
<td>“Target shareowners realize significant gains, while acquirer shareholders lose, slightly”</td>
<td>Professor of Investment Banking of Law at Duke University (Can’t find complete source)</td>
</tr>
<tr>
<td>PM with the highest # of shares in target firm will press for the highest buyout and vice versa. Vote down both deals if Acquirer is over paying for the Target (even if it looks good for the Target).</td>
<td>Risk Metrics M&amp;A Edge Note for Yahoo, “The Portfolio Effect,” (Feb. 29th, 2008)</td>
</tr>
<tr>
<td>More willing to go along with bad deal for target firm if other side reaps greater rewards. If you own both, very sensitive to overpayment.</td>
<td>Risk Metrics M&amp;A Edge Note for Yahoo, “The Portfolio Effect,” (Feb. 29th, 2008)</td>
</tr>
<tr>
<td>Studies in the academic genre based on stock market expectations show that mergers in general produce a small net abnormal stock value appreciation upon announcement of 0 to 1%, with virtually all of those gains going to the target shareholders.</td>
<td>“The Effects of Mergers and Post-Merger Integration: A Review of Business Consulting</td>
</tr>
<tr>
<td>Literature</td>
<td>Federal Trade Commission, Paul Pautler; Draft (Jan. 21st, 2003)</td>
</tr>
<tr>
<td>------------</td>
<td>---------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Acquirer’s gain</strong></td>
<td></td>
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<tr>
<td>• In the case of a public buyer of a public target, a fully-diversified shareholder cares about the COMBINED gains from the takeover, and not the division of the gains between the target and acquiring stockholders. However, when the target is non-public, the bidder’s shareholders care only about the bidder’s returns, since the target’s stock is not a part of their portfolio.</td>
<td>“Do Acquisitions Drive Performance or Does Performance Drive Acquisitions?” Michael Bradley and Anant Sundaram (Sept. 2004)</td>
</tr>
<tr>
<td>• The event study method is a powerful tool that can help researchers assess the financial impact of changes in corporate policy. Using this method, a researcher determines whether there is an “abnormal” stock price effect associated with an unanticipated event. An assumption with the event study is that a researcher has isolated the effect of an event from the effects of other events. Confounding events can include the declaration of dividends, announcement of an impending merger, announcement of a new product, announcement of unexpected earnings, declaration of dividends which may all have an impact on the share price during an event window. The longer the event window, the more difficult it is for researchers to claim that they have controlled for confounding effects. Management scholars do not appear to have been sensitive to this issue. The authors of many studies employing long windows have not stated whether they controlled for confounding effects.”</td>
<td>Academy of Management Journal 1997, Vol 40. No 3, 626-657</td>
</tr>
</tbody>
</table>
If Stock is the medium of exchange, what does the post company look like shared over more shares outstanding?

What percent of combined company is the Target vs. Acquiring companies contributing?

- Sales
- Ebitda
- Ebit
- Net income
- Shareowner equity (in terms of ownership structure based on shares divided now between both entities—if a stock multiple is included in the purchase price)
- Diluted shares outstanding incorporate convertible debt
- How do synergies improve the situation?
- Unlevered beta = beta/ (1-tax rate) (1- %debt/%equity) used to remove debt impact on each company separately…. So that the new debt structure can help calculate the new beta that is right for the combined company to appropriately discount by the right required rate of return (capm).

“Investment Valuation” Chapter 25 Aswath Damodaran
- Calculate the “Right” Premium of a Target Firm

### Summary of Study

<table>
<thead>
<tr>
<th>Fair Premium</th>
<th>Title, Author, and Year</th>
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<tbody>
<tr>
<td>Evaluating how the companies traded against their peer groups immediately prior to the announcement of a deal can illustrate whether the parties were under- or over-valued at the time, and therefore whether it's fair to apply industry average transaction multiples or premiums. Method of Comparables: using a price multiple to evaluate whether an asset is relatively fairly, under/over valued compared to a benchmark</td>
<td>Caremark “Merger of Equals” with CVS; M&amp;A Insight Analysis; Feb. 12th, 2006</td>
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<table>
<thead>
<tr>
<th>Implied Ratio for Price of T/ Price of A:</th>
<th></th>
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<tbody>
<tr>
<td>Proposed exchange ratio premium or discount to an implied exchange ratio vs. average prices over a 30- day period prior to the announcement of a selected group. A control premium should not be included if the deal is a pure MOE. Implied ratio calculated using the averages of the share price ratios provided by Datastream. Example: last price: lucent/alcatel 1 month: lucent/alcatel 3 month: lucent/alcatel 6 months, 12 months, highest over 12 months and lowest over 12 months</td>
<td>Caremark “Merger of Equals” with CVS; M&amp;A Insight Analysis; Feb. 12th, 2006</td>
</tr>
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</table>

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<thead>
<tr>
<th>Exchange Ratio Analysis for Price (or firm value) of T / an Earnings figure (such as EBITDA or Earnings) of T compared to the same for the A</th>
<th></th>
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<tbody>
<tr>
<td>Certain methods used by the advisor in this exchange ratio analysis are concerning. The advisors derived the proposed exchange ratio ranges using the derived high share prices of Alcatel against the derived low share prices of Lucent and the low shares prices of Alcatel against the derived high share prices of Lucent. The high-low, low-high method yields an artificially wide reference range. Using derived low</td>
<td>Alcatel SA/ Lucent Technologies, Inc. ISS M&amp;A Insight Note: Alcatel and Lucent/”Hedgies Thwarted” (Sept. 7th, 2006)</td>
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share prices of Alcatel against the derived low shares price of Lucent and vice versa is a more conservative method.

<table>
<thead>
<tr>
<th>Financial Industry</th>
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<tbody>
<tr>
<td>• Assess the multiple of Proposed Merger Price to Accounts Receivable in a comparables evaluation to High/Mean/Median/Low</td>
</tr>
<tr>
<td>• P/Tangible and P/Book Value were common multiples in assessing deals at Wachovia, Merrill Lynch, and National City.</td>
</tr>
<tr>
<td>Washington Mutual, Inc./Providian Financial Corp. ISS Proxy Analysis for Providian Financial Corp; Special Meeting (August 31st, 2005)</td>
</tr>
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<table>
<thead>
<tr>
<th>Health Care Industry</th>
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</thead>
<tbody>
<tr>
<td>• Assess the EV/ per medical member to Proposed Merger value/ per medical member</td>
</tr>
<tr>
<td>• Calculate the premium over market price to announcement: one day and 30-days</td>
</tr>
<tr>
<td>UnitedHealth Corp./PacifiCare Health Systems. Glass Lewis &amp; Co; PacifiCare Health Systems, Inc.; November 17th, 2005</td>
</tr>
</tbody>
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<table>
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<tr>
<th>Multiples</th>
</tr>
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<tbody>
<tr>
<td>• EV / EBITDA is recommended for comparables analysis. EBITDA measurement because it is before debt and equity holder distributions. Benefits of EBITDA: 1) valuation indicator for the overall company rather than the individual stock, 2) more appropriate than P/E for comparing companies with different financial leverage (debt), 3) controls for differences in depreciation and amortization across companies, and 4) positive when earnings may be negative.</td>
</tr>
<tr>
<td>• Compare the target’s equity value based on the transaction value by each of the actual net income for the most recently reported LTM and the projected net income for the next twelve months (NTM) based on I/B/E/S estimates.</td>
</tr>
<tr>
<td>CFA</td>
</tr>
<tr>
<td>UnitedHealth Corp./PacifiCare Health Systems. Glass Lewis &amp; Co;</td>
</tr>
</tbody>
</table>
- FCFF benefits: directly reflects the amount of required capital expenditures, and has a stronger link to valuation theory than EBITDA.

**Transaction Premiums**

- Identify a select group of comparable peers that were involved in an acquisition. Analyze the premiums paid relative to share price 30- days prior to deal announcement and 1-day.

**Board’ Reason for a Merge**

- Offer price represents approximately a 27% premium to the closing price for ABS, the trading day before the ABS issued a public announcement that it was considering its strategic alternatives.

**Private Acquirers**

- There is much debate in the press about whether shareholders of acquired firms are being exploited by private equity bidders with the help of the management of the acquired firm, which amounts to saying that the acquisition premiums paid by private equity firms are too low. Sample from 1990 to 2005, the average gain for target shareholders when the bidder is a public firm is 31.74% over the three days surrounding the announcement of the acquisition. This is 43% higher than the gain for shareholders when a private firm acquires their firm and 55% hire than the gain when a private equity fund is the acquirer. The average gain for shareholders of the target when the acquirer is a private firm is 22.2%, and when it is a private equity fund it is only 20.47%.

- However, if gains between acquisitions by private firms and by public firms falls as managerial ownership of the public bidder increases. A comparison of acquisitions by private firms to acquisitions by public firms in which managerial ownership exceeds 20%, the study finds there is no significant difference in shareholder gains between the two types of acquisitions.
The study finds no evidence that target or deal characteristics can explain the differences in premiums between private and public bidders.

**Terminal Value Estimation**

- A terminal value that is projected as of the end of the investment horizon should reflect the earnings growth that a firm can sustain over the long-run beyond that point in time. Analysts often use terminal price multiples like P/E, P/B, P/S, and P/CF to estimate terminal value. No matter which ratio is used, terminal value is calculated as the product of the price multiple (e.g., P/E ratio) and the fundamental variable (e.g., EPS).
- There are two methods of estimating the price multiple: based on fundamentals and based on comparables. The terminal price multiple based on fundamentals is the product of the justified price multiple and an estimate of the fundamental value. For example, the terminal value based on a justified P/E ratio is: terminal value in year \( n \) = (justified leading P/E ratio) \( \times \) (forecasted earnings in year \( n + 1 \)). Terminal value in year \( n \) = (justified trailing P/E ratio) \( \times \) (forecasted earnings in year \( n \)).
- The terminal price multiple based on comparables is calculated as the benchmark price multiple and an estimate of the fundamental value. For example, the terminal value based on a benchmark P/E is: terminal value in year \( n \) = (benchmark leading P/E ratio) \( \times \) (forecasted earnings in year \( n+1 \)). Terminal value in year \( n \) = (benchmark trailing P/E ratio) \( \times \) (forecasted earnings in year \( n \)).
- The strength of the comparables approach is that it uses market data exclusively. In contrast, the fundamentals approach requires estimates of the growth rate, required rate of return, and payout ratio. One weakness of the comparables approach is that a benchmark marred by mispricing will transfer that error to the estimated terminal value.

**Momentum Indicators**

- **Momentum Indicators** relate either the market price or a fundamental variable like EPS to the time series of historical or expected value. Common momentum indicators include earnings surprise, standardized unexpected earnings, and relative strength.
- **Unexpected earnings or earnings surprise** is the difference between reported earnings and expected earnings: earnings surprise = reported EPS – expected EPS
- This is usually scaled by a measure that expresses the variability of analysts’ EPS forecasts. The economic rationale for examining earnings surprises is that positive
surprises may lead to persistent positive abnormal returns.

- Similarly, the **standardized unexpected earnings** (SUE) measure is defined as:
  
  \[
  \text{standardized unexpected earnings (SUE)} = \frac{\text{earnings surprise}}{\text{Standardized deviation of earnings surprise}}
  \]

- A given size forecast error is more meaningful the smaller the size of the historical forecast errors.
Calculate the Gains of Target and Acquiring Firm

\[ V(AB) > V(A) + V(B) \] market values

AND per price per share \( (AB) > V(A) + V(B) \)

Acquirer Value\(^7\) = \( V(A) \)\(^8\) + \( V(B) \) + \{S – Cost\(^9\}\)

\[ \text{Acquirer gains} = \text{Synergies}^{10} - \text{Premium} \]

Target gains\(^{11}\) = \( P \) (price paid) – \( V \) (pre-merger value of the target company)

Stock Deal vs. Cash Deal → sharing the combined benefits amongst a great number of owners

Stock deal in an MOE: compare exchange ratio to the average ratio of companies to determine fair price (risk metrics – feb 12\(^{th}\), 2008)

$100 (T) prior to deal announcement

$800 (B) prior to deal announcement

$50 (S)

$20 (C)

10,000 shares outstanding (T) → .01 per share price

50,000 shares outstanding (B) → .016 per share price

---

\(^7\) Post merge

\(^8\) Pre merge of acquirer

\(^9\) Takeover premium paid in cash (add in Change in Control cost) → divide over new shares outstanding if the payment structure includes stock.

\(^{10}\) In a leveraged buyout, the cost of capital rate to discount cash flows should vary from year to year to reflect to pay down of the exceeded debt level that was initially took on to buyout the firm.

\(^{11}\) Control premium
Cash deal

$800 + 100 + 50 - 20$

After market cap = $930 winning transaction/ 50k shares = .0186 per share price

CalPERS is exempt from capital gains tax from the Target perspective → we share profits with less shareowners from the perception of the acquiring company → only concern is with the equity acceleration piece if excessive in comparison to value of deal (add this to the cost part of deal).

Stock deal

$1,250 shares + 50,000 = 51,250 new share count$

$930 winning transaction/ 51.2k shares = .01815$ (less per share price value than if cash paid up front)
## Shareowners Rights in Delaware Court

<table>
<thead>
<tr>
<th>Summary of Study</th>
<th>Title, Author, and Year</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Opposing a transaction or not voting</strong></td>
<td><strong>Washington Mutual, Inc./Providian Financial Corp. ISS Proxy Analysis for Providian Financial Corp; Special Meeting (August 31(^{st}), 2005)</strong></td>
</tr>
<tr>
<td>• Provides the option to the shareowner to seek appraisal rights in Delaware Court after the closing. The investor sends a notice to the company of their intent to exercise appraisal rights. Even if deal is approved, the investor has a 60-day option to have the Court to decide on fair value in hopes to get a higher value from the Courts.</td>
<td></td>
</tr>
</tbody>
</table>

The Delaware Court recently told directors that they have little to fear from the Court. In the Disney case, the Court refused to review the Board’s actions with any great scrutiny and left that role to shareholders. The Court said, “The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court.”
Merging with a Foreign Entity

<table>
<thead>
<tr>
<th>Summary of Study</th>
<th>Title, Author, and Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Foreign acquisitions of US companies face a protracted approval process, such agreements will have incremental inherent risk associated with them. Thus, all things being equal, in cases where a transaction faces the extended CFIUS review, a higher valuation from the foreign entity would likely be warranted relative to an agreement with a U.S. based acquirer.</td>
<td>Chevron Texaco Corp. / Unocal Corp. Glass Lewis &amp; Co. Proxy Paper for Unocal Corp (August 10th, 2005)</td>
</tr>
</tbody>
</table>

Takeover Defenses

<table>
<thead>
<tr>
<th>Summary of Study</th>
<th>Title, Author, and Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>• While takeover defenses can place the board under a spotlight, the board has to balance the goal of protecting or maximizing shareholder value with prudent and proportional use of these defenses. Oracle’s bid for Peoplesoft raised from $16 a share to $26 a share by the time Peoplesoft’s board agreed providing PeopleSoft’s shareowners with greater value.</td>
<td>M&amp;A New Trends and Deal Making. Institutional Shareholder Services. Moderator: Cheryl Gustitus. (March 22, 2005)</td>
</tr>
</tbody>
</table>
Thoughtful Academic Perspectives

“What Drives Merger Decision Making Behavior? Don’t Seek, Don’t Find, and Don’t Change Your Mind” Vicki Bogan and David Just; March 2008

“Mergers simply combine the rights to cash flow that are already held by diversified investors; investors should be indifferent between receiving future cash flow streams from two separate firms or from one merged firm formed by combining them. Nonetheless, several major, non-mutually exclusive reasons are typically offered to explain merger activity (Bower, 2001; Warshawsky, 1987): limit competition and/or gain market share; extend product line; expand geographically; wrest corporate control from entrenched, inefficient management in order to realize greater profitability; gain tax advantages; exploit inefficiencies in the financial markets that leave corporate equities undervalued relative to their intrinsic worth. Corporate merger usually have episodic occurrences across industries within the United States and around the world. Notwithstanding the previous theoretical explanations, the empirical evidence suggests on average that little to no short-term or medium-term benefits and limited long-term benefits are achieved from merging.”

The Merits of Mergers; Lars Duursma; interface Sept. 2004

“Statistics on the consequences of mergers and acquisitions should be taken with a pinch of salt. The acquisition of KLM by Air France as an example. Imagine that their combined turnover and profits will remain on approximately the same level for the coming five to ten years. It would in that case be very tempting to label the acquisition as “failed.” Many analysts, however, expected the turnover and profits of KLM to decrease for that same period, if no acquisition had taken place. It does not really take rocket science to understand that this is quite relevant when valuing the success of a merger, does it? After all, many mergers and acquisitions take place when companies fail to achieve autonomous growth. It also regularly occurs that companies are acquired, when disappointing results or growth expectations have caused their market value to drop a lot. Hence, is it enormously strange that their turnover and profits aren’t suddenly skyrocketing the years following the merger?”


“Mechstroth questions the validity of academic research indicating below average financial performance among mergers. Such models, he states generally do not reflect the dynamic market forces faced by merging companies. Negative merger outcomes might reflect the best choice among several less-than-appealing possibilities confronting a company. Mechstroth also concludes that most mergers enhance economic efficiency by more efficiently distributing resources, even if they fail to achieve financial returns to shareholder when measured against stock market or industry average returns. As he put it “This finance’ test is very difficult to achieve simply due to the law of average.’ About 50% always are going to be below average and very few individual firms can beat the average consistently over the long term”
# M&A Program Initial Brainstorm

<table>
<thead>
<tr>
<th>Initial objective</th>
<th>Accomplished</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Case study of past deals voted by Proxy Firms:</strong> regress Risk Metrics and Glass Lewis’s decisions to post company performance</td>
<td>Firms not able to provide me a list of decisions made; however, Risk Metrics and Glass Lewis provided statistics that demonstrated the proxy firms both voted FOR more than 90% of deals.</td>
</tr>
<tr>
<td>Utilize Academic Studies to capture signs of “successful and failure” indicators to predict post company performance…. and other important deal factors in terms of valuation, fairness opinion, calculating performance of a deal and other.</td>
<td>Located in the <strong>Mergers and Acquisition folder</strong>, Library, and quoted above in the findings.</td>
</tr>
</tbody>
</table>
| **Case study of past deals voted by CalPERS:** analyze companies historically by CalPERS → separate good vs. bad performers: Are there any distinguishing characteristics between either Group that could help be a predictive factor of post company performance? | Analysis located in the Excel Spreadsheet: **Performance and Characteristic Deal Program Analysis**  
**Findings:** (need to list)                                                                                           |
| What type of resources do organizations use to assess M&A deals? What other organizations could be used besides he general proxy firms? | Refer to Appendix: **Risk Metrics & Glass Lewis Deal Process Comparison**  
- Skill-sets of internal people  
- Research materials: read M&A Insight from Risk Metrics, a deal analysis from Risk Metrics and Glass Lewis deal analysis  
- Consultants  
- Performance → CFA calculated performance of Target based on day before deal announcement to close  
- How do other organizations measure the performance of their deal recommendation | Learn from studies
Glass Lewis Deal Process
Warren Chen – 12/18/2009
Answers from staff's annual due diligence questionnaire

Please describe the process for determining your final recommendation.
We analyze each transaction on a case by case basis, as each transaction is unique. We do, however, apply a general analysis framework, allowing us to form a foundation upon which to formulate our recommendation.

In analyzing these transactions, Glass Lewis believes investors should look for four hallmarks of a good transaction:
(i) an independent board of directors (or committee of the board) that recommends the transaction,
(ii) the process that was used to develop the transaction was one that was likely to yield the best deal;
(iii) a financial advisor who is independent and which has rendered a fairness opinion that is economically and financially sound; and
(iv) an appropriate price (i.e. premium). In short, we seek to determine whether a proposed transaction is fair overall to investors.

Each analyst is responsible for analyzing the assigned transaction. Depending on the complexity of the transaction, the analysis receives multiple layers of review before the report is published.

Who makes up your team? What are their credentials and training? International vs. Domestic
In order to provide a cohesive policy, the Glass Lewis M&A team is responsible for analyzing M&A related proposals across the globe.
The team members include:
Warren Chen – Managing Director, M&A Research
Career in finance for over 12 years
Former investment banker (UBS Investment Bank)
MBA – UC Berkeley
BS/MS – MIT
Jason McCandless – Senior M&A Research Analyst
BS - Finance
MBA - Finance
Mark Grothe – M&A Research Analyst
BS – Finance/Accounting
MS - Accounting
Katy Davis – M&A Research Analyst
BS – Mathematics
Previously proxy research analyst
Colin Ruegsegger – M&A Research Analyst
BS – Finance
Previously proxy research analyst
What external resources do you use when formulating your opinion and preparing your report?
FactSet, FactSet Mergerstat, Thomson Financial, Capital IQ, SNL, Nexis, various in house Excel templates.

What companies do you cover?
Glass Lewis’ coverage universe consists of approximately 16,000 companies across the globe.

How do you measure the performance of your deal recommendation?
In general, we solicit feedback from our clients on our reports.

How do you evaluate the Investment Bank’s “Fair Value”?
We believe each of the valuation techniques (and thus the result of each of the valuation analysis) provides a piece of information in forming a comprehensive view of the fair value range. With that said, we are critical of the assumptions used in each of the valuation analysis.

How do you evaluate investment banking fees? Does the magnitude of the respective fee(s) impact your final vote?
In general, while we are cognizant of the potential influence of the investment banking fee structure, evaluation of the fees is not a critical component of our analysis framework. We believe that ensuring the deal is reasonable and valuation is fair for all parties involved is the practical way to protect long term shareholder value.

How do you evaluate CIC payments?
We view CIC payments in conjunction with other transaction-triggered payments. In general, we expect the aggregate transaction-triggered payments should be in line with other similarly sized transactions.

How do you incorporate academic studies into your analysis?
Many, if not most, of academic studies are theoretical in nature. With that said, whenever possible, we analyze real world examples and case studies in order to keep abreast of current trends and practices.

What is your most heavily weighted valuation technique?
We believe each of the valuation techniques (and thus the result of each of the valuation analysis) provides a piece of information in forming a comprehensive view of the fair value range.

What is the most difficult valuation technique? What is the least valuable?
The most difficult one to get done correctly (i.e., produce meaningful results) is the DCF. The DCF is very sensitive to many variables and is highly dependent on management projections. This, in turn, makes DCF the least valuable in many situations.

What is your interaction with management and investors while evaluating deals?
Where appropriate we would have interaction with management and/or investors via our Proxy Talk platform.
How do you evaluate break-up fees?
   In general, we expect the magnitude of the break-up fee should be in line with other similarly sized transactions.

What are the most important multiples you analyze for these particular sectors: energy, materials, industrials, cons disc, cons staples, health care, financials, info tech, telecom and utilities?

Energy
   In most cases, price-earnings and enterprise value to EBITDA ratios are important valuation ratios across the industries. The use of EBITDA ratio eliminates the effect of high D&A for capital intensive industries. However, there are some industry specific metrics that are only applicable to companies in that particular industry. Financial sector, for instance, have their unique set of valuation ratios. For example, Price to Tangible book value is a commonly used valuation metric for banks.
## RiskMetrics Deal Process

**Jim Miller – 12/15/2009**

*Answers from staff’s annual due diligence questionnaire*

<table>
<thead>
<tr>
<th>Question(s)</th>
<th>Basic Proxy</th>
<th>M&amp;A Edge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Please describe the process for determining your final recommendation.</td>
<td>Varies on a case by case basis.</td>
<td>Varies on a case by case basis.</td>
</tr>
<tr>
<td>Who makes up your team? What are their credentials and training?</td>
<td>Various national and/or international degrees e.g., BA, BS, MBA, JD, etc.</td>
<td>CFA Charterholders that also hold various national and/or international degrees, e.g., BA, BS, MBA, JD, etc.</td>
</tr>
<tr>
<td>What external resources do you use when formulating your opinion and preparing your report?</td>
<td>Public filings e.g., SEC, Bloomberg, Thomson Reuters, Research Insight, etc.</td>
<td>Public filings e.g., SEC, Bloomberg, Thomson Reuters, Research Insight, etc.</td>
</tr>
<tr>
<td>What companies do you cover?</td>
<td>All industries.</td>
<td>All industries.</td>
</tr>
<tr>
<td>How do you measure the performance of your deal recommendation?</td>
<td>N/A</td>
<td>Monitor voting outcomes retroactively (ex post facto).</td>
</tr>
<tr>
<td>How do you evaluate “Fair Value”?</td>
<td>Situational dependent.</td>
<td>Situational dependent.</td>
</tr>
<tr>
<td>How do you evaluate investment banking fees? Does the magnitude of the respective fee(s) impact your final vote?</td>
<td>Situational dependent. Fees are one of many factors that are considered.</td>
<td>Situational dependent. Fees are one of many factors that are considered.</td>
</tr>
<tr>
<td>How do you evaluate CIC payments?</td>
<td>Situational dependent. CIC payments are one of many factors that are weighed.</td>
<td>Situational dependent. CIC payments are one of many factors that are weighed.</td>
</tr>
<tr>
<td>How do you incorporate academic studies into your analysis?</td>
<td>By reference or citation e.g., statistics related to private company discounts, average deal premiums, etc.</td>
<td>By reference or citation e.g., statistics related to private company discounts, average deal premiums, etc.</td>
</tr>
<tr>
<td>What is your most heavily weighted valuation technique?</td>
<td>Varies and is dependent on industry or company specific metrics that are used by analysts, industry experts and/or contained within fairness opinions.</td>
<td>Varies and is dependent on industry or company specific metrics that are used by analysts, industry experts and/or contained within fairness opinions.</td>
</tr>
<tr>
<td>What is the most difficult valuation technique? What is the least valuable?</td>
<td>Monte Carlo simulation may be considered challenging depending on one’s knowledge of statistics. Aged historic approaches may be problematic especially if they precede a systemic change in or macro shock to the economy e.g., credit crisis, etc.</td>
<td>Monte Carlo simulation may be considered challenging depending on one’s knowledge of statistics. Aged historic approaches may be problematic especially if they precede a systemic change in or macro shock to the economy e.g., credit crisis, etc.</td>
</tr>
<tr>
<td>Do you use FCFF or EBITDA in Comparable and DCF valuations?</td>
<td>It depends. Generally, we opine on what is contained in the valuation analysis in the proxy and do not perform our own analysis.</td>
<td>It depends. Forward and trailing EBITDA is generally used by analysts. FCFF (Free Cash Flow to the Firm aka FCF of Assets) can be more problematic for outside investors and analysts to use since it requires projections of...</td>
</tr>
<tr>
<td><strong>What is your interaction with management and investors while evaluating deals?</strong></td>
<td>Although we avail ourselves to management and investors and welcome such discourse, unless the deal is contentious, interaction seldom occurs.</td>
<td>Interaction is the norm rather than the exception.</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td><strong>How do you evaluate break-up fees?</strong></td>
<td>Analyzed relative to the size of the transaction.</td>
<td>Analyzed relative to the size of the transaction.</td>
</tr>
<tr>
<td><strong>How do you evaluate the impact of taxes on deals?</strong></td>
<td>It depends. Generally, we opine on those issues contained in the proxy and do not perform our own independent analysis.</td>
<td>It depends.</td>
</tr>
<tr>
<td><strong>What are the most important multiples you analyze for these particular sectors: energy, materials, industrials, cons disc, cons staples, health care, financials, info tech, telecom and utilities?</strong></td>
<td>It depends. Generally, we rely on those that the market considers relevant as described in the filings and fairness opinions.</td>
<td>It depends on the depth and granularity of issues that have been addressed by management, investors and analysts.</td>
</tr>
<tr>
<td><strong>Other Comments?</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Initial Questions which Guided Staff’s Call with Risk Metrics & Glass Lewis for the Deal Process Evaluation

Risk Metrics-

- Brief overview of how Risk Metrics and ISS work together to formulate the final recommendation on an M&A deal
- M&A Insight reports for Biomet, TXU, Clear Channel, Caremark - specific to company and general M&A questions to help me appreciate the full reports
- General M&A questions surrounding the resources Risk Metrics has allocated to the analysis of companies going through an M&A transaction - such as human capital (number of individuals, credentials, experience, and additional training if applicable), vendor resources and other on-line products used to capture deal information, and timelines of reports
- Coverage and ability to obtain approx 20 reports on past company M&A analysis..... I'm having trouble finding in the system (including the ISS recommendations)
- Your thoughts on measuring the performance = success, of M&A recommendations from the Target firm or Acquirer’s perspective, or combined position of an investor that owns shares in both companies... big picture ... not only how extensive of an analysis was done ... but how correct were we in making the "right" recommendation for investors to follow? How much time has been allocated to assess this "right" perspective?
- M&A Edge Analysis product (quickly take me through CSX Corp)? How this compares to M&A Insight?
- How much Risk Metric includes their clients in their discussions between Management of the M&A firm and (or) just to consult an investor such as myself on behalf of CalPERS?
- Ability to obtain past voting decisions on any recent M&A activity for a list of approx 100 larger cap companies?
- Do you have studies that you can share with me on M&A? ... I notice that you quote a few throughout the reports...

Glass Lewis

- Brief overview of how Glass Lewis's analysis is used to formulate the final recommendation on an M&A deal : 1) are certain factors weighted more heavily?  2) does Glass Lewis perform its own valuations? If so, how do you calculate the assumptions used... such as in the DCF model?
- General M&A questions surrounding the resources Glass Lewis has allocated to the analysis of companies going through an M&A transaction - such as human capital (number of individuals, credentials, experience, and additional training if applicable), vendor resources and other on-line products used to capture deal information, and timelines of reports
- Take me through the process using the proxy paper reports of Rite Aid and CVS.
- Coverage and ability to obtain approx 20 reports on past company M&A analysis..... I'm having trouble finding reports in the system
Your thoughts on measuring the performance = success, of M&A recommendations from the Target firm or Acquirer's perspective, or combined position of an investor that owns shares in both companies... big picture ... not only how extensive of an analysis was done ... but how correct were we in making the "right" recommendation for investors to follow? How much time has been allocated to assess this "right" perspective?

How much does Glass Lewis interact with Management, top shareowners, and other analysts in developing a recommendation? Are these sometimes vetted in the Proxy Talk Forum's?

Ability to obtain past voting decisions on any recent M&A activity for a list of approx 100 larger cap companies?

Do you have studies that you can share with me on M&A that Glass Lewis has relied upon in developing it's process?
### Product Comparison Analysis for M&A Research - “Wish List”

*(in progress of researching, calls and holding webcasts)*

<table>
<thead>
<tr>
<th>Assessment of Product</th>
<th>Factset Mergerstat &amp; Mergermetrics</th>
<th>Bloomberg</th>
<th>Thompson Bank One</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ability to analyze past deals on specific companies and within an aggregated specific industry</td>
<td>x</td>
<td>X</td>
<td>x</td>
</tr>
<tr>
<td>Peer selection</td>
<td>x</td>
<td>X</td>
<td>x</td>
</tr>
<tr>
<td>Multiples for comparable analysis for company vs. peers</td>
<td>x</td>
<td>X</td>
<td>x</td>
</tr>
</tbody>
</table>
| Historical transaction premiums for comparable analysis | X | Goes back 12 months
Includes deal multiples | X | x | Goes back 6 months
Includes deal multiples |
| Discounted cash flow basis |  | X | |
| External research from analysts opinion of deal |  | X (CN) | |
| Recent earning estimates and revenue revisions upwards or downwards for Target and Acquiring firm | x | X (EEB) | x |
| Management and Board turnover as a result of the deal |  | Captured in filing | |
| Motivation for deal (ie: revenue or cost synergies, diversification, undervalued target, financial- tax savings, debt capacity, cash slack) |  | Captured in News | Moe, equity carve-out, all different deal “types” not motivation → must review their news links |
| Investment banking fees involved in transaction: opinion, guaranteed, and contingent | x | x | x |
| Change in control details |  |  | |
and $$ value payout \rightarrow \text{ and as a percent of the deal}

<table>
<thead>
<tr>
<th>Details on deal description - company profiles and offer on the table</th>
<th>x</th>
<th>x</th>
<th>x</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charts to graph price reaction of target and acquiring firm, along with Price Charts of Company with an overlay of industry and peer comparisons</td>
<td>x</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Time line of Management’s action of the deal from the beginning of the announcement to date</td>
<td></td>
<td>X (fun price reaction chart with news-find short-cut)</td>
<td></td>
</tr>
<tr>
<td>Vertical or horizontal deal</td>
<td>x</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hostile, Friendly, or MOE</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Debt profile of Combined Company vs. Acquirer (investment grade?) compared to peers</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Calculate the implied ratio premium or discount of stock multiples… evaluating over the past one, three, six, 12 months, high and low over the past 12 months</td>
<td></td>
<td></td>
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<tr>
<td>If the sale was done in an auction? If so, number of bids involved?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ability to upload a portfolio of companies and set up an alert system for M&amp;A deals in the pipeline?</td>
<td>Included in Factset subscription</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ability to upload a portfolio of companies to set up an alert system with</td>
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</tbody>
</table>
the additional customized feature of the size of the Target firm (assets) as it relates to the Acquiring firm?

<table>
<thead>
<tr>
<th>Shareholder rights comparison</th>
</tr>
</thead>
<tbody>
<tr>
<td>Help with training or sales support during subscription</td>
</tr>
<tr>
<td>Who is your client base</td>
</tr>
<tr>
<td>Price of subscription for one person</td>
</tr>
<tr>
<td>Graphically pleasing</td>
</tr>
<tr>
<td>User friendly</td>
</tr>
</tbody>
</table>
Product Example (RiskMetrics M&A Edge Analysis)

RiskMetric’s Approach to Hostile Tender Offers

Discussion of approach used in M&A Analysis of Agrium (AGU) Tender Offer for CF Industries (CF)

Summary:

RiskMetric’s cites adequacy of valuation as its primary focus when evaluating bids. Additional determining factors include deal process, contract terms, and corporate governance impact. These factors become important when the “adequacy of valuation is a close call.”

Framework:

RiskMetric’s seeks to answer the following questions: Is the offer is reasonably certain? Is the value of the offer is reasonable? Has the target board has been provided with adequate time and leverage to maximize shareholder value? Has it made good use of this time?

1. Certainty of the Offer
   a. Factors considered include regulatory hurdles, the company’s toe hold, and the legitimacy of each successive bid.
   b. Example from report: “On Oct. 19, Agrium announce it reached an agreement with Terra to sell 50% of its Carseland nitrogen facility to Terra, conditioned upon the closing of Agrium’s proposed acquisition of CF. Agrium believes this agreement will address antitrust issues with the Canadian government, and the company has re-filed for HSR clearance with the FTC.”

2. Adequacy of the Offer
   a. RiskMetrics evaluates the adequacy of the offer by valuing the targets shares, using the following methods:
      i. M&A comps analysis
      ii. Trading comps analysis
      iii. Average one year target price (Street consensus via Thomson Reuters)
   b. RiskMetrics also examines potential synergies from the deal, the state of the entire industry (industry cycle), and the acquirer’s share price.
   c. Example from the report (acquirer’s share price): “We noted on Nov. 5, the day Agrium announced its “best and final” offer, Agrium shares rose 3.7% or about $2 while CF dropped 7.5%, as the market reassessed the probability of a completed Agrium-CF Transaction. As such, the current Agrium share price may be higher than if the market expected it to be successful in its pursuit of CF, and as such the current offer may be artificially inflated.”

3. Appropriateness of Target Board Response
   a. RiskMetrics summarizes the board’s response to the bid, seeking to evaluate whether the board is acting in the shareholder’s best interest.
      i. What can be inferred from the board’s actions?
         1. Is the board maximizing negotiating leverage or acting selfishly to stifle a potentially beneficial deal?
         2. Has the board worked to find a superior alternative or “convinced” its shareholders that the bid is not in their best interest?”
   b. Example from the report: “a majority of CF Shareholders sent a strong message to the CF board that the status quo should be abandoned for a new strategy. However, over the subsequent five months, it does not appear that the CF board has changed from its prerreferendum strategy in any meaningful way. CF continues to stonewall Agrium and pursue its acquisition of Terra (a transaction on which CF shareholders will have no say), despite Agrium bidding against itself for a third time.”
What is a Merger?

A merger occurs when two companies combine to form a single company. A merger is very similar to an acquisition or takeover, except that in the case of a merger existing stockholders of both companies involved retain a shared interest in the new corporation. By contrast, in an acquisition one company purchases a bulk of a second company's stock, creating an uneven balance of ownership in the new combined company.

The entire merger process is usually kept secret from the general public, and often from the majority of the employees at the involved companies. Since the majority of merger attempts do not succeed, and most are kept secret, it is difficult to estimate how many potential mergers occur in a given year. It is likely that the number is very high, however, given the amount of successful mergers and the desirability of mergers for many companies.

A merger may be sought for a number of reasons, some of which are beneficial to the shareholders, some of which are not. One use of the merger, for example, is to combine a very profitable company with a losing company in order to use the losses as a tax write-off to offset the profits, while expanding the corporation as a whole.

Increasing one's market share is another major use of the merger, particularly amongst large corporations. By merging with major competitors, a company can come to dominate the market they compete in, giving them a freer hand with regard to pricing and buyer incentives. This form of merger may cause problems when two dominating companies merge, as it may trigger litigation regarding monopoly laws.

Another type of popular merger brings together two companies that make different, but complementary, products. This may also involve purchasing a company which controls an asset your company utilizes somewhere in its supply chain. Major manufacturers buying out a warehousing chain in order to save on warehousing costs, as well as making a profit directly from the purchased business, is a good example of this. PayPal's merger with eBay is another good example, as it allowed eBay to avoid fees they had been paying, while tying two complementary products together.

A merger is usually handled by an investment banker, who aids in transferring ownership of the company through the strategic issuance and sale of stock. Some have alleged that this relationship causes some problems, as it provides an incentive for investment banks to push existing clients towards a merger even in cases where it may not be beneficial for the stockholders.

The merger process will no doubt change in the near future, as dynamic technologies allow for the development of a more streamlined marketplace which manages to protect the privacy of interested companies while linking up ideal candidates for a merger.

http://www.wisegeek.com/what-is-a-merger.htm
In Business, What is a Bear Hug?

In the business world, there are a number of methods of assuming control of a business. One method is popularly known as the bear hug. Essentially, the bear hug is a hostile takeover attempt that is done in such a ways that the board of directors of the company find it impossible to not accept the bid. Here is some information on the way that a bear hug may take place, and what can happen if a board attempts to block the move.

The basic strategy of the bear hug generally involves the attempted acquisition of a company that is currently not for sale. Investors take note of a company that is consistently performing well, and decide to take step to acquire that company. In many cases, an initial offer may have been rejected. This leads to the implementation of more aggressive methods that are designed to lead to the eventual acquisition of the company, whether the board of directors of the corporation like it or not.

In order to accomplish this type of hostile takeover, the bear hug requires the support of the shareholders in the company. Obtaining shareholder support usually involves convincing the shareholders that their investment will appreciate in value as a result of the acquisition. In some cases, a bear hug requires the acquisition of a controlling number of shares as a means of bringing pressure to sell on the board of directors. Once the investor or a group of investors holds the majority of shares, it becomes very hard indeed for the board to do anything but submit to the sale of the company.

Corporate raiders have long employed the strategy of the bear hug as a means of acquiring a company and then systematically dismantling the operation. By acquiring a company and selling off its assets, equipment, and property, the raider can often make an impressive profit from the venture. Acquiring a controlling interest in the company makes it possible for the raider to convince other shareholders that a failure to align with the sale could lead to the devaluation of their shares, meaning they ultimately lose money on the deal. This is usually enough to take care of any resistance on the part of the shareholders, and clear the way for the bear hug to finally come to pass.

While the bear hug is often successful, companies have managed to avoid this sort of situation. When it seems that a corporate raider is acquiring an inordinate amount of stock, steps can be taken to minimize the amount of influence that the raider may assert on the board and the other shareholders. In some countries, raiders have to file papers with the local government upon acquiring a certain percentage of available stocks. These papers outline the intent of the raider to acquire the company, and are made available to the current ownership. When steps are taken early in the process, it is possible to avoid a hostile takeover, and thus defuse the bear hug before it ever has a chance to damage the operations or reputation of the company.

In Business, what is a White Knight?

A white knight is a friendly savior in the business world who helps a company by purchasing it when it is either in the midst of an attempted hostile takeover, or when the business is either near bankruptcy or bankrupt due to unpaid debts. The term needs to be contrasted with black knight: a person, group or corporation that initiates a hostile takeover. Another related term is gray knight: a person, group or corporation that initiates a takeover, which is not what the business in trouble wants, but is perceived as a better alternative than being taken over by a black knight. The gray knight might take over the company with some concessions to retaining employees or staff, while the black knight ruthlessly replaces staff and management with its own people from its own corporation. A white knight, conversely, generally will try to maintain the same employees but funnel money into the company to help restore it.

As mentioned, the white knight can be a single person. Alternately, the white knight may be a group of investors, or a different company, all intent on either saving the business from bankruptcy, helping a company after bankruptcy, or preventing a hostile takeover. The related term white squire is used to describe people who purchase a minority interest in a company. They don't take over companies, but their interest may give them enough voting power, combined with other shareholders to prevent a hostile takeover.

The goal of the white knight is not entirely altruistic. Such knights may perceive profitability in acquiring or merging with a company. Few people spend millions or even billions of dollars simply to save a business without thought to the personal or corporate benefits they may reap. For instance, when United Paramount Theaters (UPT) purchased ABC in 1953, they acted as a white knight because ABC was nearly bankrupt. Yet they weren’t simply acting for ABC’s sake, they were hoping to acquire a company they could turn around to produce greater profits. The money UPT funneled into the network did ultimately produce a network that could fully compete with the more popular TV networks CBS and NBC.

A more recent white knight example is Bank of America’s 2008 acquisition of Countrywide Financial, a mortgage company. Initially the risk of acquiring the company is high, due to the significant fall in new mortgages and the subprime mortgage crisis. However, when the housing market turns, Bank of America has eliminated a competitor, which could prove greatly profitable.

Like any knight of old, the white knight acquires a company with money problems at some considerable hazard to self, investors or company. For Bank of America, acquiring Countrywide financial meant acquiring debt of about $100 billion US Dollars (USD), mostly in the form of mortgages. Bank of America is betting on its own financial strength, a way out of the subprime crisis provided by the government, and a future of being able to offer loans to more people when the housing market begins to scale upward.

http://www.wisegeek.com/in-business-what-is-a-white-knight.htm
What is a Blitzkrieg Tender Offer?

Often used as a term to describe a friendly takeover, the Blitzkrieg tender offer is characterized by an offer made to investors and owners of a company that is so attractive that there is no possible chance of the offer being rejected. While employing a term that dates back to World War II, the Blitzkrieg tender offer is not based in any type of wartime strategy, but instead refers to the speedy nature of the acceptance of the offer once the potential buyer or group of buyers presents it.

Unlike a hostile takeover, a Blitzkrieg tender offer does not include any attempt to secure controlling interest in a company without the knowledge of the current shareholders or owners. The strategy involves approaching the owners and shareholders directly, and submitting a compelling offer that will immediately pique the interest of all involved parties. Generally, takeovers of this type progress somewhat rapidly, with current owners and investors entering into dialogue with the potential buyers that tend to lead to offer acceptance in a short period of time.

Once the offer has been accepted, the progression of a Blitzkrieg tender offer can move along quickly. The owners and shareholders generally engage the services of legal counsel to finalize the terms of the sale and make sure all the supporting documents are in place. Inventory listings and other pertinent paperwork relating to the operation of the company is forwarded to the new owners, and announcements to the employees are made. In many cases, the new owners participate with the former owners to make the announcements to the employee base, as well as to the clients of the corporation. Often, press releases are drafted and forwarded to the appropriate outlets once the employees are informed of the change in ownership, and press conferences may be scheduled with industry media outlets.

In most cases, a Blitzkrieg tender offer is researched in detail before it is ever extended to the current owners and shareholders. This comprehensive research not only helps to increase the chances that the offer will be accepted, but also proves helpful in escalating the acquisition process once all parties agree on the terms.

http://www.wisegeek.com/what-is-a-blitzkrieg-tender-offer.htm
What is a Bust-Up Takeover?

A bust-up takeover is a situation in which some or all of the assets associated with a recently acquired company are sold in order to cover the costs that were incurred during the acquisition process. In some cases, the bust-up takeover will focus on a few key assets of the corporation in order to settle the indebtedness, while still maintaining the operations and functionality of the corporation. In other situations, the focus may be on completely dismantling the company, dispensing with all associated expenses, and dividing the profits among the investors who initiated the takeover.

When a leveraged buyout is the means of orchestrating a friendly takeover of a company, the investors usually do so with an eye to restructuring the corporation and continuing operations. If this is the goal, the group of investors will often focus their attention on target companies that have a number of assets that are not central to the core business model of the corporation. As part of the restructure, those peripheral assets can be placed on the market and sold as a means of quickly recouping the expenses incurred during the takeover. Thus, the newly restructured company begins a new life with little or no debt to carry, a viable if somewhat smaller financial portfolio, and a renewed focus on the core business.

In takeovers where the aim is to acquire the company and dismantle it completely, a target company is selected that has plenty of assets which can be sold off in lots or singly. Often, in this version of a bust-up takeover, the emphasis is on a quick sale of the assets so that expenses are repaid and the remaining profit can be distributed among the investors in the hostile takeover strategy. Sometimes there is not any real effort to find buyers who want to continue to operate the company in some fashion. Instead, the focus is on selling the assets to the highest bidder. The general concept of a bust-up takeover can be applied to both friendly acquisitions and to hostile takeover attempts. It is not unusual for at least a portion of the assets of a company to be sold by new owners as a means of recouping expenses. However, a bust-up takeover usually involves advance plans and intentions to sell off specific assets after the acquisition, rather than evaluating the feasibility of selling assets after actually taking control of the corporation.

http://www.wisegeek.com/what-is-a-bust-up-takeover.htm
What is a Targeted Repurchase?

Targeted repurchases are strategies that are sometimes utilized to derail a hostile takeover attempt and retain control of a corporation. The exact method of a targeted repurchase usually involves buying enough of the issued shares to regain controlling interest in the company and thus have enough shareholder votes to prevent the hostile acquisition from taking place. In most cases, the repurchase of outstanding shares is conducted by offering more than the current market price for each share of stock that is repurchased.

A targeted repurchase can involve working around the corporate raider to acquire as many outstanding shares as possible. This usually means offering stockholders more for each share than the raider is willing to offer. With luck, the company can buy up enough shares before the raider has acquired a controlling amount of stock and essentially stop the takeover attempt from proceeding any further.

At this point in the targeted repurchase, the company may approach the corporate raider and make an offer on all shares that the raider has acquired up to this point in time. If the price per share is attractive to the raider, he or she may choose to sell the shares to the issuing corporation and abandon the takeover attempt. When this takes place, the targeted repurchase can be considered a success.

However, if the raider is not happy with the price per share offered by the company, the situation may become a stalemate. When this type of situation occurs, the company may choose to combine the targeted repurchase efforts with another strategy, such as setting up a holding company that receives all acquired shares and begins the process of converting to an employee stock ownership plan. Under these conditions, the raider usually has to accept a fair market value price for the shares under his or her control, or they stand the risk of becoming worthless once the government approves the stock conversion plan.

Hostile takeovers are a fact of life in modern business today. Depending on the position of the company that comes under attack, a targeted repurchase may be a wise move. However, there are incidences where a targeted repurchase attempt may be futile, such as when the corporate raider is determined to acquire the company for dismantling, or when the company lacks the resources to raise enough capital to repurchase the shares.

http://www.wisegeek.com/what-is-a-targeted-repurchase.htm
What are Ultra Vires Activities?

Ultra vires activities are any type of business activity or action that is taken by a corporation, but is not sanctioned by the regulations outlined in the company charter. Depending on the circumstances, ultra vires activities can lead to legal action on the part of shareholders. At the same time, ultra vires activities can also be the cause for the initiation of lawsuits by third parties, such as consumers or other entities within the same industry.

Essentially, ultra vires activities would encompass any type of action that is considered outside the scope of the stated purpose and function for the corporation. All companies, as part of their Articles of Incorporation and other founding documents, address the issues of why the company exists and what type of business operation the corporation will undertake. When the company chooses to go outside these defined limits, this opens the door for both investors and others to take issue with the actions, even going so far as to file a lawsuit against the corporation.

Ultra vires activities are one of the most common reasons for shareholder lawsuits. When corporations choose to engage in actions that are outside the company charter, this can easily be seen as a threat to the integrity of the investment that shareholders have made in the company. If shareholders do feel that the action or actions will harm both the company and the investment over the long term, they may choose to band together into a shareholder lawsuit to force the company to cease and desist in the unauthorized activities.

At the same time, ultra vires activities may also result in legal issues from other quarters. Depending on how far the actions are outside the charters and other founding documents, third parties may choose to file suit against the corporation. This would be especially true if it was felt that the activities were taking the company into business sectors that were outside the industry where the main function of the company was found. Both consumers and other businesses that feel the ultra vires activities are inappropriate for some reason could choose to file a lawsuit.

http://www.wisegeek.com/what-are-ultra-vires-activities.htm

What is a Watch List?

One of the reasons that a company and its stock may be placed on a watch list is due to the existence of circumstances that make the corporation ripe for a takeover. Brokers who have clients that currently own stock in the corporation will want to monitor for any signs that corporate raiders are attempting to buy up available shares of the stock, or employ other means of getting control of the company, such as a buyout. Placing the company on the watch list for the brokerage helps to ensure that the broker can alert investors to relevant events as they happen, and possibly protect their clients from realizing a loss on the investment.

http://www.wisegeek.com/what-is-a-watch-list.htm
Worst Deals in History

- AOL/ Time Warner
- Boston Scientific/ Guidant

How Traders Impact M&A Deals

<table>
<thead>
<tr>
<th>Summary of Study</th>
<th>Title, Author, and Year</th>
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<tr>
<td>Short term traders impact on deals</td>
<td></td>
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<tr>
<td>▪ Traders vote FOR the Target company, shorts the acquirer, and seeks to capture the deal’s spread. Traders seek to ensure the deal closes, not whether the deal makes sense. Some traders seek simply to trigger an auction and then back the highest bid on the table, whether or not that makes sense in the long-term. (Omega Advisors and Perry Capital are identified as traders)</td>
<td>M&amp;A New Trends and Deal Making. Institutional Shareholder Services. Moderator: Cheryl Gustitus. (March 22, 2005)</td>
</tr>
<tr>
<td>▪ The MCI and Verizon deal… Omega publicly encouraged MCI to reconsider a higher bid. Long-term shareowners should scrutinize “who” is recommending the higher bid? Do they have the long-term shareowners at interest?</td>
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What are the requirements to see merger, spin-off, divestiture, or recapitalizations come to vote? What document contains these rules and where do we find it?

General

The stockholder vote requirements for a merger are governed by state law and the company’s charter (Certificate of Incorporation in Delaware or Articles of Incorporation in California) and bylaws. (Occasionally, the company’s charter will need to be amended in connection with the merger to change the flow of merger consideration or other reasons. In this situation, the stockholder approval to amend the Company’s charter is also relevant.) The stockholder vote requirements under Delaware law and California law for a merger are outlined below.

Delaware corporate law provides that a merger requires the approval of a majority of the outstanding stock entitled to vote. Companies cannot “contract out” of the Delaware law requirement. Generally, the necessary stockholder approval for a merger of a Delaware corporation will be (i) a majority of all shares on an as converted to common basis, (ii) any other approval required by the protective provisions in the Certificate of Incorporation, such as a separate series approval or super-majority approval, and (iii) any other approval requested by the acquiror in the merger, such as a super-majority approval in order to limit the number of stockholders that may exercise dissenters' rights.

California corporate law provides that a merger requires the approval of a majority of the outstanding shares of each class of the corporation. This means preferred stock as a class and common stock as a separate class. Companies cannot “contract out” of the California law requirement. Generally, the necessary shareholder approval for a merger of a California corporation will be (i) a majority of all common stock, (ii) a majority of all preferred stock on an as converted to common basis, (iii) any other approval required by the provisions in the Articles of Incorporation, such as a separate series approval or super-majority approval, and (iv) any other approval requested by the acquiror in the merger, such as a super-majority approval in order to limit the number of shareholders that may exercise dissenters' rights.

The fact that holders of common need to approve a merger of a California corporation is one reason why venture funds prefer Delaware. Venture funds don’t want common holders to have the ability to block a merger.

NYSE 312.03 Shareholder Approval

Shareholder approval is a prerequisite to issuing securities in the following situations:

(a) Shareholder approval is required for equity compensation plans. See Section 303A.08.

(b) Shareholder approval is required prior to the issuance of common stock, or of securities convertible into or exercisable for common stock, in any transaction or series of related transactions, to:
(1) A director, officer or substantial security holder of the company (each a "Related Party");

(2) A subsidiary, affiliate or other closely-related person of a Related Party; or

(3) Any company or entity in which a Related Party has a substantial direct or indirect interest; if the number of shares of common stock to be issued, or if the number of shares of common stock into which the securities may be convertible or exercisable, exceeds either one percent of the number of shares of common stock or one percent of the voting power outstanding before the issuance.

However, if the Related Party involved in the transaction is classified as such solely because such person is a substantial security holder, and if the issuance relates to a sale of stock for cash at a price at least as great as each of the book and market value of the issuer's common stock, then shareholder approval will not be required unless the number of shares of common stock to be issued, or unless the number of shares of common stock into which the securities may be convertible or exercisable, exceeds either five percent of the number of shares of common stock or five percent of the voting power outstanding before the issuance.

(c) Shareholder approval is required prior to the issuance of common stock, or of securities convertible into or exercisable for common stock, in any transaction or series of related transactions if:

(1) The common stock has, or will have upon issuance, voting power equal to or in excess of 20 percent of the voting power outstanding before the issuance of such stock or of securities convertible into or exercisable for common stock; or

(2) The number of shares of common stock to be issued is, or will be upon issuance, equal to or in excess of 20 percent of the number of shares of common stock outstanding before the issuance of the common stock or of securities convertible into or exercisable for common stock.

However, shareholder approval will not be required for any such issuance involving:

- any public offering for cash;
- any bona fide private financing, if such financing involves a sale of:
  - common stock, for cash, at a price at least as great as each of the book and market value of the issuer's common stock; or
  - securities convertible into or exercisable for common stock, for cash, if the conversion or exercise price is at least as great as each of the book and market value of the issuer's common stock.

(d) Shareholder approval is required prior to an issuance that will result in a change of control of the issuer.

(e) Sections 312.03 (b), (c) and (d) shall not apply to issuances by limited partnerships.
NASDAQ Rules regarding Shareholder Approval

The corporate governance rules for The NASDAQ Stock Market are set forth in the Listing Rule 5600 Series and the interpretative materials (e.g., IM 5605) associated with these rules. These rules include topics such as annual meetings, independent directors, audit committee composition, shareholder approval of certain transactions, and the voting rights policy.

Pursuant to Listing Rule 5635(a), shareholder approval is required if any director, officer or 5% or greater shareholder has a 5% or greater interest (or such persons collectively have a 10% or greater interest), directly or indirectly, in the company or assets to be acquired or in the consideration to be paid in the transaction(s) and the present or potential issuance of common stock, or securities convertible into or exercisable for common stock, could result in an increase in outstanding common stock or voting power of 5% or more.

In addition, shareholder approval is required for an acquisition of stock or assets of another company if the present or potential issuance of common stock or securities convertible into or exercisable for common stock, other than a public offering for cash, may exceed 20% of the voting power or the total shares outstanding on a pre-transaction basis.

Listing Rule 5635(a) describes when shareholder approval is required for a transaction involving the acquisition of stock or assets of another company. Among the factors considered in determining whether shareholder approval is required are the number of shares to be issued, including any shares issuable pursuant to an earn-out or similar provision, the voting power of any shares to be issued, and whether any director, officer or substantial shareholder has an interest in the company or assets to be acquired or the consideration to be paid in the transaction.

In addition, please note the following:

Even if shareholder approval is not required under Rule 5635(a), shareholder approval may still be required if the transaction will result in a change of control under Listing Rule 5635(b); and

There is no pricing test when determining if shareholder approval is required for securities issued in connection with an acquisition. Thus, shares issued in a private placement priced above both book and market value may require shareholder approval if the proceeds are used to fund an acquisition.

Additionally, Nasdaq rule 5635 sets forth the circumstances under which shareholder approval is required prior to an issuance of securities in connection with: (i) the acquisition of the stock or assets of another company; (ii) equity-based compensation of officers, directors, employees or consultants; (iii) a change of control; and (iv) private placements. General provisions relating to shareholder approval are set forth in Rule 5635(e), and the financial viability exception to the shareholder approval requirement is set forth in Rule 5635(f). Nasdaq-listed Companies and their representatives are encouraged to use the interpretative letter process described in Rule 5602.
5635 (b) Change of Control

Shareholder approval is required prior to the issuance of securities when the issuance or potential issuance will result in a change of control of the Company.

5635 (d) Private Placements

Shareholder approval is required prior to the issuance of securities in connection with a transaction other than a public offering involving:

(1) the sale, issuance or potential issuance by the Company of common stock (or securities convertible into or exercisable for common stock) at a price less than the greater of book or market value which together with sales by officers, directors or Substantial Shareholders of the Company equals 20% or more of common stock or 20% or more of the voting power outstanding before the issuance; or

(2) the sale, issuance or potential issuance by the Company of common stock (or securities convertible into or exercisable common stock) equal to 20% or more of the common stock or 20% or more of the voting power outstanding before the issuance for less than the greater of book or market value of the stock.

How do you track the filings within the countries?

The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. All companies, foreign and domestic, are required to file registration statements, periodic reports, and other forms electronically through EDGAR. Anyone can access and download this information for free. SEC.GOV website provides links to a complete list of filings available through EDGAR and instructions for searching the EDGAR database.

What organizations do you believe are most governance influential and regulatory influential in the country?

SEC

Though it is the primary overseer and regulator of the U.S. securities markets, the SEC works closely with many other institutions, including Congress, other federal departments and agencies, the self-regulatory organizations (e.g. the stock exchanges), state securities regulators, and various private sector organizations. In particular, the Chairman of the SEC, together with the Chairman of the Federal Reserve, the Secretary of the Treasury, and the Chairman of the Commodity Futures Trading Commission, serves as a member of the President's Working Group on Financial Markets.

Nasdaq

NASDAQ will provide non-binding guidance on corporate governance requirements for a company and/or its counsel over the telephone. If the caller is able to identify the
company, he or she should contact the Listing Qualifications analyst assigned to the company. If the call is on a no-names basis, he or she may contact any analyst within Listing Qualifications at +1 301 978 8008. A company may also call that number to determine the name and phone number of their Listing Qualifications analyst. While Staff will discuss such issues orally, any oral guidance is non-binding. For a definitive interpretation from NASDAQ, the company must provide details of the transaction and submit its request in writing. For more information on this process, please see the Interpretative Process.

To receive a definitive interpretation on a corporate governance issue regarding a particular transaction or issue, the company and/or its counsel should provide a written request for an interpretation to Listing Qualifications. The letter should be sent to the company's Listing Qualifications analyst at the following address:

The NASDAQ Stock Market LLC
Listing Qualifications
9600 Blackwell Road
Rockville, MD 20850

NYSE

Companies listed on the Exchange must comply with certain standards regarding corporate governance as codified in NYSE Listed Company Manual. The NYSE's role as regulator is fairly simple: watch out for unusual trading activity in the 2,700 listed stocks on the Big Board, make sure NYSE firms play by the rules and, most important, bring disciplinary actions against market wrongdoers

Who are you affiliated with in these countries?

While not directly affiliated with any the aforementioned organizations, ISS maintains open lines of communication with them.

What is the name of an analyst(s) from your firm that we could call if we had a question on a transaction?

Any member of the U.S. M&A Edge and Proxy Contest research team: James Miller CFA, CPA; Waheed Hassan CFA, Qin Tuminelli CFA, Etelvina Martinez

Do you believe your firm challenges the peers selected for comps from a growth, risk, and size to ensure subsets are feasible? How do you test this?

Yes, when evaluating proxy contests and contested mergers, every attempt is made to reconcile the peer group proposed by both parties, including those contained within the fairness opinion as to their relevance in order to settle of the best set of comps for the company.

Provide examples of analysis with each of the desired economic type topics above within each of the five countries
RiskMetrics’ Q&A – United Kingdom

What are the requirements to see merger, spin-off, divestiture, or recapitalizations come to vote? What document contains these rules and where do we find it?

Mergers (target) go to a vote as they alter the corporate structure; recaps and spin-offs alter the capital structure and need a shareholder vote. For asset sales or other transactions there’s a threshold of 25% of assets (some deals might be considered part of the same transaction and added). Rules contained in 2006 Companies Act and FSA Handbook (both available on the internet)

How do you track the filings within the countries?

http://www.investegate.co.uk

What organizations do you believe are most governance influential and regulatory influential in the country?

First the ABI (Association of British Insurer) and the FSA (market regulator). Then the NAPF (National Association of Pension Funds), the Cadbury Committee, Investment Management Association (IMA), Institutional Shareholder committee (formed by NAPF, ABI and IMA), The Takeover Panel (for tender offers)

Who are you affiliated with in these countries?

ISS entered the market through a partnership with the NAPF, and later took control of the company. ISS uses the NAPF corporate governance guidelines in its voting recommendations

What is the name of an analyst(s) from your firm that we could call if we had a question on a transaction?

Nelson Seraci (M&A Edge Europe), Ali Saribas and Mary Punch (London Office M&A Team)

Do you believe your firm challenges the peers selected for comps from a growth, risk, and size to ensure subsets are feasible? How do you test this?

Given local disclosure rules, companies don't publish fairness opinions and release as little information as possible. No information on peers is published.

Provide examples of analysis with each of the desired economic type topics above within each of the five countries.
RiskMetrics’ Q&A – Canada

What are the requirements to see merger, spin-off, divestiture, or recapitalizations come to vote? What document contains these rules and where do we find it?

In Canada, an offer to acquire voting or equity securities that, together with the acquirer's existing holdings, represents 20% or more of the outstanding securities is considered a take-over bid, which generally requires that the offer be made by circular to all holders of that class of security (partial bids on a pro-rata basis). Plans of arrangement and amalgamations require approval by two-thirds of votes cast. Plans of arrangement also require court approval. Related party transactions may require a formal valuation and are subject to the "majority of minority" approval. Toronto Stock Exchange requires TSX-listed issuers to obtain shareholder approval to issue securities exceeding 25% of outstanding securities for acquisitions.

Federal and provincial corporate and securities laws, and certain stock exchange rules govern M&A transactions (e.g. plans of arrangement, take-over bids, amalgamations, going private transactions, asset sales, share sales, restructurings). Competition Act and/or Investment Canada Act approval is required in certain circumstances. Certain industries also have foreign or other ownership restrictions.

While Canada has corporate laws in both federal and provincial levels, securities laws are enacted by each of the provinces (10) and territories (3) of Canada. Each provincial or territorial securities act creates and empowers a provincial or territorial securities commission to enforce such laws. Canada's provincial and territorial securities commissions have enacted a number of multilateral and national rules to try to harmonize the application of securities laws across the country. A multilateral rule governing take-over bids has been adopted by all provinces and territories except Ontario. Ontario’s Securities Act is harmonized with the multilateral rule.

Although a single federal regulatory body for the Canadian securities industry has yet to be created, progress towards this reality developed in June 2009 when the Minister of Finance announced the launch of the Canadian Securities Regulator Transition Office. The office’s mandate includes transitioning the country to a national regulator through the development of a Federal Securities Act (in collaboration with the Department of Finance), implementation of the G20 financial system recommendations and establishing a transition plan within a one year time frame. The Proposed Canadian Securities Act has been announced. A national regulator is expected to be in place by 2012.

Current regulatory responsibility is the jurisdiction of the provincial governments, most notably the Ontario Securities Commission (OSC), which has organized with other provincial securities regulators and formed the Canadian Securities Administrators (CSA). The CSA has outlined a set of recommended corporate governance guidelines under National Policy 58-201 Corporate Governance Guidelines and disclosure practices under National Instrument 58-101 Disclosure of Corporate Governance Practices. In September 2008, the CSA released its updated executive and director compensation
disclosure rules under 51-102F6 Statement of Executive Compensation. These requirements apply to all publicly-traded companies (including income trusts) with fiscal-year end dates on or after December 31, 2008.

How do you track the filings within the countries?

System for Electronic Document Analysis and Retrieval (SEDAR)

www.sedar.com is the official site that provides access to most public securities documents and information filed by public companies and investment funds with the Canadian Securities Administrators (CSA) in the SEDAR filing system.

The System for Electronic Disclosure by Insiders (SEDI) is Canada's on-line, browser-based service for the filing and viewing of insider reports as required by various provincial securities rules and regulations.

What organizations do you believe are most governance influential and regulatory influential in the country?

The Canadian Coalition for Good Governance (CCGG), a collective of 41 institutional investors that represents over $1.4 trillion in assets under management, has become a driving force for governance improvement in Canada. To date, the CCGG has addressed governance reform with its own version of best practices on director disclosure, compensation disclosure, and shareholder communication. In 2005 the CCGG took up the issue of accountability in director elections and promoted the introduction of a modified majority voting policy. The momentum of shareholder support for majority voting and director resignation policies in the United States helped highlight Canada’s existing plurality voting policy for directors, whereby directors require only one “For” vote to be elected. The CCGG has been largely responsible for persuading issuers to adopt modified majority voting policies.

Institutional investors are the country's largest group of shareholders, accounting for over 50 percent of the ownership of Canadian equities. Established in 1977, the Pension Investment Association of Canada has a mandate to promote sound investment practices and good governance for the benefit of pension plan sponsors and beneficiaries.

Who are you affiliated with in these countries?

ISS has a Toronto office with research analysts, including an M&A team, focusing on high profile shareholder meetings involving Canadian issuers.

What is the name of an analyst(s) from your firm that we could call if we had a question on a transaction?

For Canadian M&A transactions, please contact:

Victor Shengjun Li, CFA
Senior M&A Analyst
tel: +1 416.364.9000 x 3498
direct: +1 617.768.3498
Do you believe your firm challenges the peers selected for comps from a growth, risk, and size to ensure subsets are feasible? How do you test this?

We always try to use the most feasible peers in a contentious transaction. Starting from the peers used by issuers’ financial advisor (if any) and peers obtained from third party sources, we select the most relevant peers that we believe for comps. Unfortunately, we do not have a systematic way to this. It is case by case.

Provide examples of analysis with each of the desired economic type topics above within each of the five countries

Merger: Suncor & Petro-Canada (6/04/2009)
Spin-off: EnCana Corporation (11/25/2009)
Divestiture: MDS Inc. (10/4/2009)
Recapitalizations: Magna International (6/28/2010, meeting postponed per OSC ruling)

RiskMetrics’ Q&A – France

What are the requirements to see merger, spin-off, divestiture, or recapitalizations come to vote? What document contains these rules and where do we find it?

Mergers (target), spin-offs and recapitalizations need shareholder approval as they either imply issuing or cancelling capital; diversitures don't need shareholder approval. Rules are included in the 2006 Takeover Act (included in the Commercial Code) and the AMF General Regulations, available on their website

How do you track the filings within the countries?

Company websites

What organizations do you believe are most governance influential and regulatory influential in the country?

AMF (market regulator), AFG (association of institutional investors), MEDEF (Mouvement des Entreprises de France) and AFEP (Association Française des Entreprises Privées). One may add the retail shareholder associations like ADAM

Who are you affiliated with in these countries?

We have no affiliations

What is the name of an analyst(s) from your firm that we could call if we had a question on a transaction?

Nelson Seraci (M&A Edge Europe), Samy Saadallah (Paris office M&A team)
Do you believe your firm challenges the peers selected for comps from a growth, risk, and size to ensure subsets are feasible? How do you test this?

We haven’t found contentious deals set up as statutory mergers in France, so a peer group analysis was not done.

Provide examples of analysis with each of the desired economic type topics above within each of the five countries.

Veolia spin-off from GdF, GdF merger with Suez

**RiskMetrics’ Q&A – Japan**

What are the requirements to see merger, spin-off, divestiture, or recapitalizations come to vote? What document contains these rules and where do we find it?

Please refer to the text below, which is taken from the Japan section of our Global Voting Manual. Note that mergers and the formation of holding companies are Special Resolutions under the Japanese Company Law, and as such require the approval of two-thirds of votes cast. Companies are not permitted to vary the vote requirement. Recapitalizations usually require an amendment to articles, which is also a Special Resolution.

How do you track the filings within the countries?

ISS monitors not only shareholder meeting circulars, but transaction announcements which are released to the stock exchanges and also available on Bloomberg. We also read Japan’s major business newspaper every day.

What organizations do you believe are most governance influential and regulatory influential in the country?

The Financial Services Agency, Ministry of Justice and Ministry of Economy, Trade & Industry are the primary regulatory agencies in Japan; though the Fair Trade Commission is also relevant to M&A because of its role in antitrust enforcement. The Tokyo Stock Exchange is the dominant stock market, and sets certain rules on information disclosure etc., although it doesn’t go as far as the NYSE or NASDAQ with respect to requiring audit committees, defining director independence etc. The Pension Fund Association is the most influential organization on the investor side. The Japan Business Federation (Nippon Keidanren) is the most influential business organization, and tends to lead the forces of reaction against corporate governance reforms.

Who are you affiliated with in these countries?

ISS maintains open lines of communication and exchanges information with all of these organizations. When I was based in Japan, I was a member of the Tokyo Stock Exchange Advisory Committee. A former executive of the Pension Fund Association is currently an advisor to RiskMetrics in Japan.
What is the name of an analyst(s) from your firm that we could call if we had a question on a transaction?

Takeyuki Ishida is head of the Japanese governance research team, and should be the primary point of contact for Japan-related questions.

Do you believe your firm challenges the peers selected for comps from a growth, risk, and size to ensure subsets are feasible? How do you test this?

Peer group analysis is one of the most important aspects of our M&A analysis in the US. However, in Japan contested mergers and proxy fights are extremely rare, and companies seldom provide a peer group in connection with a transaction. Japanese companies never provide information on peers used for compensation benchmarking, because senior executives of listed companies are generally lifelong employees, and compensation is largely seniority-based.

Provide examples of analysis with each of the desired economic type topics above within each of the five countries.

In Japan there have not been significant recapitalizations since the bank capital injections a decade ago, and the capital injections into Mitsubishi Motors and Isuzu Motors shortly thereafter. There have been many significant M&A transactions, with good recent examples being the two casualty insurance mergers last December (Sompo Japan Insurance & Nipponkoa Insurance; and Mitsui Sumitomo Insurance Group Holdings, Aioi Insurance, & Nissay Dowa General Insurance). The most significant recent proxy contest was at Sapporo Holdings last month.

Mergers, Acquisitions, and Transfers of Business Operations

Merger and acquisition activity began to boom in Japan in the late 1990s, as the economic downturn spurred consolidation and spinoffs of noncore business units. Changes to the law allowing domestic companies to use stock swaps for mergers gave a further boost to merger activity. A new rule allowing a foreign company to acquire a Japanese company using shares of the acquirer's Japanese subsidiary took effect in 2007, after having been delayed due to fears of a wave of foreign takeovers of Japanese companies. Note that it is virtually impossible to use this “triangular merger” mechanism to carry out a hostile takeover, because it requires the cooperation of the target company’s board.

Even though many Japanese companies trade at prices below book value, hostile takeovers have been constrained by the cross-shareholding system, company-friendly institutional shareholders, and a cultural disdain for confrontation. However, friendly mergers or acquisitions are common. In the past, these usually took the form of mergers between two members of a keiretsu, absorption of wholly owned subsidiaries by their parents, or "creeping" mergers that begin as strategic alliances between companies in the same or complementary industries. Now, though, mergers of previously unrelated companies, or even companies in rival keiretsu groups, are no longer rare. Because special resolutions at a shareholder meeting, including proposals to amend articles, require a two-thirds majority vote, a stake of 33.4 percent is sometimes known as a "blocking stake" conferring passive control over a company. Strategic partners will
frequently limit their stake in a target company to this size, rather than making a more expensive bid for majority ownership. A bidder can acquire a stake of up to 66.6 percent without triggering an obligation to bid for all remaining shares.

Shareholders of an acquiring company are asked to vote on the terms of a merger or acquisition where the company or operations to be acquired have a book value greater than 20 percent of the acquiring company's net assets. Shareholders of the target company will always have a vote. The information presented to shareholders includes financing methods, new management structures, and time schedule. It is standard practice for merger ratios or acquisition costs to be determined with the assistance of third parties such as investment banks or accounting firms. Merger ratios are typically based on a blend of share prices, net asset values, and discounted cash flows. RMG evaluates mergers on a case-by-case basis and will oppose a deal if concerns exist regarding the fairness of the terms to ordinary shareholders.

The Corporate Law also requires that a company obtain shareholder approval for a spinoff or transfer of operations amounting to 20 percent or more of the company's total assets. Such approval is required even when the business operations in question are being transferred to a wholly owned subsidiary. However, the benefit to shareholders of this requirement is seriously compromised because companies are not required to disclose to shareholders the price to be obtained for the assets being sold. When a company seeks approval to transfer business operations to an independent company or to a joint venture, but does not inform shareholders of the consideration to be received or the way in which that amount is to be calculated, RMG recommends that shareholders oppose the transfer.
The Corporate Governance profile of an acquiring firm has a statistically significant influence on post merger operating performance. The following are examples of governance factors and their impact on operating performance (post merger). The information summarized below draws from U.K. deals during the period 1985-1994.

Sample:
- Both firms listed on London Stock Exchange for at least 5 years prior to merger; single entity listed 5 years after merger.
- The absence of antitakeover provisions in the U.K. provides the study with unmitigated economic incentives.
- Sample uses longer time frame to allow performance affects to “fully materialize.”
- Sample size consists of 81 mergers.

Factors Influencing Merger Operating Performance – Governance Profile

Board Composition and Profile:
- “Operating performance outcomes are also worse when the acquiring firm has greater excess cash in combination with fewer growth opportunities compared with the firm being acquired; when the size of the firm being acquired is large relative to the acquiring firm; and when the method of payment is common stock only” (1830).
- “Evidence suggests that the positive effects of increased ownership by officers and directors may be attenuated at high levels of ownerships” (1832). The ownership stake of the board of directors positively correlates with operating performance to a certain level. After which, these two variables become inversely correlated (1830).
- Inequality of stockholdings with respect to officers or directors may negatively impact results (1834). Equally dispersed” board ownership “aligns” shareowners interests with the interests of the board (1835). Relatively uniform distribution of officer and board ownership may mitigate the negative consequences of large aggregate ownership (1834).
- The size of the firm’s board negatively impacts post merger operating performance (1835).
- Studies do not support that board structure significantly impacts the acquirer’s returns (1835).
Outside Voting Block:
- “The results indicate that the presence of an outside voting block in the acquiring firm is associated with superior operating performance outcomes (1835). However, greater emphasis on and support of governance rules and regulations may lead to increased “costs” on the firm’s performance (1835).”

**Regulation in Foreign Countries – United Kingdom**

<table>
<thead>
<tr>
<th>Summary of Study</th>
<th>Title, Author, and Year</th>
</tr>
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<tbody>
<tr>
<td>The U.K. regulatory system ensures the shareholders will have more rights with regards to M&amp;A activity than shareholders of publically traded companies in the United States.</td>
<td>“The U.K. – A Hostile Paradise?” Nelson Seraci, M&amp;A Edge Research Team</td>
</tr>
<tr>
<td>- The U.K. requires target boards to remain neutral on any potential and active unsolicited offers. This regulatory requirement ensures that the shareholders will be given the chance to evaluate every bid.</td>
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<tr>
<td>- “There are no poison pills in the U.K.”</td>
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<tr>
<td>- Unlike in the U.S., U.K. companies are required by law to allow shareholders who rally at least 5% of the voting share capital to call extraordinary meetings. Additionally, shareholders have the right to put forward proposals to remove any (or all) of the directors during these meetings.</td>
<td></td>
</tr>
<tr>
<td>- The U.K. Takeover Panel sets a six month deadline for finalizing bids. Takeover Codes also prohibit contingency conditions, such as diligence and financing conditions. These regulations, as well as requirements regarding transparency of the shareholder base, ensure that the “bid process runs smoothly.”</td>
<td></td>
</tr>
</tbody>
</table>

How do the U.K.’s regulatory requirements impact shareholders interests?
- “Over the 10-year period ending in September 2008, 42 percent of announced unsolicited bids in the U.K. were consummated (40 out of 95), as compared with 33 percent in the U.S. (44 out of 134).”
- “The median one-day premium paid in completed hostile deals in the U.S. valued over $100 million during the same 10-year period [see above] was 38 percent versus 34 percent for hostile U.K. transactions.”
- Relative to the U.K., U.S. deals garner greater premiums for investors. However, hostile takeover bids also have a lower chance of approval. The costs and benefits of U.K.’s regulatory requirements must be weighed with...
these issues in mind, to evaluate the effectiveness of the U.K.’s regulatory requirements.

### Regulation in Foreign Countries – Sweden

“The Stockholm Stock Exchange has adopted new rules for the pricing of shares in takeover situations”, with the goal of facilitating equal treatment across all shareholders in takeovers. The rules were prepared by the NBK (the Swedish Industry and Commerce Stock Exchange Committee), which is a self-regulatory body.

**Issues:**
- Roughly half of the exchange’s listed companies have multiple share classes.
- Acquirers seek to acquire shares with greater voting rights by offering higher bids for these shares.

**Engagement:**
- A group of 24 domestic and international institutional investors, including CalPERS, have pushed the NBK to address the aforementioned issues.

**New Rules:**
- In general, the acquirer must offer all shareholders offered the same price and terms.
- The offer price may be different if economic differences exist between the different classes of shares “i.e., one class is entitled to a higher dividend.”
- The offer must be the same if one class is publically traded; however, may differ if there is a track record of differentiated share prices. The Swedish Financial Supervision Authority (FSA) has discretion in the latter case.
- “The FSA may also grant permission to offer a different price in special circumstances, when a different price would be in the interest of all shareholders.”

### Regulation in Foreign Countries – Canada

**Toronto Stock Exchange (TSX) – Regulation**

**New Rule (Effective November 24, 2009):**
- Shareholder approval is now required to issue

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“New Takeover Pricing Rules to Take Effect in Sweden” Risk and Governance Weekly

“Canada: New TSX Rule for Acquirers” M&A Edge Note
securities for an acquisition which exceed 25% of outstanding securities.

Current Regulation

- TSX has had the 25% dilution requirement since 2005; however, an exemption for the acquisition of public companies made it immaterial (new amendment eliminates exemption).
- “Effectively no requirement for security holder – regardless of dilution – in respect of acquisition of public companies.”

Key Statistic

- According to survey of 106 public company acquisitions, 43% involved over 25% dilution.

High-Profile Examples

- Goldcorp acquisition of Glamis diluted Goldcorp shares by 67%, without acquiring shareholder approval. Former CEO Rob McEwan took Goldcorp to court.
- HudBay Minerals’ announced an attempt to acquire Lundin Mining, which would have resulted in approximately 100% dilution without obtaining shareholder approval. Ontario Securities Commission ruled that they could not defer to the TSX rules, because of lack of reasoning behind the current regulations.

**Beginning Procedures to File an Appraisal**

Process to File?*

Suggested process to file an appraisal:

1. CalPERS Portfolio Manager would elect via SSB’s notification on CapTAIN to dissent action;
2. SSB- Security Entitlement Services- would withdraw the shares from DTC, hold them in Certificate Form (physical cert), complete the notice of appraisal rights, then send it to DTC;
3. DTC sends it to the company

Next Steps: Coordination of Team Necessary for Future Action?
1. Determine the loss threshold to identify a worthy case (is $2 million the right value- higher or lower?);
2. Educate, coordinate and communicate with portfolio managers, legal team, and the Corp Gov team to monitor securities that meet our desired loss threshold, become a takeover target with an offer price that is below fair value, and where CalPERS is not more heavily weighted in the acquiring company; and
3. Establish a process in place that helps to streamline communications and action with all participants necessary to pursue legal action when a BIG opportunity arises.

*State Street’s input – may need more clarity

**Appraisal Case Study**

*Harvard Law Blog*

**Delaware Provides Guidance Regarding Discounted Cash Flow Analysis**

Posted by John G. Finley, Simpson Thacher & Bartlett LLP, on Friday July 16, 2010 at 9:21am

Editor’s Note: John Finley is co-head of the Mergers and Acquisitions Group at Simpson Thacher & Bartlett LLP. This post is based on a Simpson Thacher memorandum.

Two recent opinions from the Delaware Court of Chancery, both authored by Vice Chancellor Leo E. Strine, Jr., provide important guidance for the preparation and use of a discounted cash flow (DCF) analysis in appraisal and other merger-related proceedings. [1]

*In Global GT LP v. Golden Telecom, Inc., C.A. No. 3698-VCS (Del. Ch. April 23, 2010)*, shareholders successfully challenged the pre-merger value of a Russian telecommunications company, Golden Telecom, Inc., in an appraisal proceeding. The valuation experts for both the shareholders and the company each primarily relied on the DCF method of valuation but arrived at meaningfully different results: $139 per share (shareholder valuation expert) versus $88 per share (company valuation expert). Vice Chancellor Strine ultimately arrived at an appraised value of approximately $125 per share (Golden was originally purchased at $105 per share) after making determinations with respect to the key differences between the experts’ competing DCF valuations. In particular, the Vice Chancellor made determinations with respect to the following key elements of the DCF:

- **Terminal Growth Rate** — Strine set the context for his review of the competing DCF analyses by observing that a fundamental component of any DCF analysis involves projecting future cash flow for a set period (e.g., five years) and, after that point, using a terminal value to predict a company’s cash flow into perpetuity. Significantly, he indicated that the applicable inflation rate is “the
floor for a terminal value estimate for a solidly profitable company that does not have an identifiable risk of insolvency.” In rejecting the company’s arguments, he stated that the assumption that the company would grow in perpetuity only at the rate of inflation was “unduly pessimistic” and further noted that the inflation rate was selected “with no rational basis.” Ultimately, Strine adopted a terminal growth rate that reflected the average of both the Russian GDP and inflation rate in order to account for the possibility that the target company’s growth rate could be close to or exceed the GDP growth rate for a period of time and then settle closer to the inflation rate as the Russian telecommunications market matured.

- **Equity Risk Premium** — In order to establish the cost of equity for purposes of discounting the appraised company’s future cash flows, Strine, as suggested by the shareholders’ expert, selected an equity risk premium (ERP) of 6.0% based on the supply side ERP published in the 2007 Ibbotson Yearbook. In contrast, the company’s expert contended that the historic ERP of 7.1% as published in the 2008 Ibbotson SBBI Valuation Yearbook (based on longterm historical data from 1926 through 2007) was appropriate. Although the historical ERP published in the Ibbotson SBBI Valuation Yearbook had previously been accepted by the Delaware Chancery Court, Strine ruled that the weight of published academic and professional opinion favors using the supply side ERP. The supply side rate uses the historical sample from 1926 but is also designed to take into account that the relationship between stocks and bonds observed in the past may not remain stable in the future.

- **Beta** — For purposes of establishing the discount rate, Strine selected a beta that gave 2/3 weight to the Bloomberg historic raw beta for the target company and 1/3 weight to the relevant industry’s beta. The Vice Chancellor fully accepted neither the company expert’s proposed reliance on historical beta alone nor the shareholder expert’s proposed reliance on the so-called predictive beta from the financial consultancy MSCI Barra. Strine crafted his balance between historic and industry beta to account for the fact that the target company operates in a riskier, emerging high-growth market. Yet, he tempered the number to account for evidence that Russia is normalizing and that the target is a stable company that could eventually achieve a beta closer to its more mature, NASDAQ-traded peers. Although the court predominantly relied upon historic beta in Global, Strine reserved judgment on the use of the more predictive Barra beta technique in future cases. Strine noted that, unlike the supply side ERP, the Barra beta’s reliability is not presently supported by the weight of any reliable professional or academic literature. He indicated “a more detailed and objective record of how the Barra beta works and why it is superior to other betas” would be required for the court to accept its application.

The *Global* opinion also provides additional guidance for litigating valuation in the appraisal context because the court did not defer to the merger price itself as an accurate indication of fair value. Although the merger price is a common factor in appraisal proceedings, the facts of the case suggested there was not a robust sale process. The court was also not influenced by the high percentage of stockholders that tendered their shares (or the low percentage of stockholders that brought a subsequent appraisal claim). Finally, the court took notice of the negative reaction by analysts and the market to the announced merger price in assessing the fair value of the target company.
In *Maric Capital Master Fund, Ltd. v. Plato Learning, Inc.*, C.A. No. 5402-VCS (Del. Ch. May 13, 2010), Vice Chancellor Strine temporarily enjoined a proposed merger because he concluded that the proxy statement was misleading with respect to its explanation of how a discount rate was selected. According to the proxy statement, the discount rate was based on the target company’s weighted average cost of capital (WACC). Strine found that, however, the investment bank chose the disclosed range of 23–27% because: (1) the WACC of comparable companies was around 25%; (2) the target company’s estimated WACC was about 23%; and (3) the investment bank thought it was appropriate to increase the upper end of the range since the target company was a micro-cap company with illiquid stock. As the court noted, the investment bank actually calculated two estimates of a WACC (one using a loose variation of the capital asset pricing model and one using a comparable company analysis) to generate discount rates of 22.6% and 22.5%. Accordingly, the “lofty” 23–27% range made the deal price appear more favorable to shareholders.

With respect to disclosure issues, Strine noted that the proxy statement omitted, for “some inexplicable reason,” the free cash flow estimates made by the target company’s management and provided to the investment bank. The court described a company’s own best estimate of expected future cash flows as “clearly material information,” while noting that Delaware courts have previously held staleness or other factors might render the information non-material in certain circumstances.

**Implications**

- Delaware courts can be expected to carefully examine whether valuation professionals used the most professionally accepted and credible practices when conducting financial analysis in connection with appraisals and other merger-related proceedings.

- While Vice Chancellor Strine did not explicitly state that the basis for the selection of the discount rate was material (or refer to any federal securities laws requirements in that regard), practitioners were, in the context of preparing a description of a financial analysis, reminded of the longstanding principle that once a proxy statement speaks to a subject, there is a duty to do so in a non-misleading fashion.

- Boilerplate descriptions are not sufficient when describing the DCF analysis but must be tailored to the actual analyses conducted and presented to a board or special committee.

- Where possible, growth rates should be industry and country specific. In the appraisal context, the assumption that a terminal growth rate will trail or match the rate of inflation may be subject to challenge.

- The actual merger price of a company may not always be an adequate indication of the fair value in the appraisal context, especially when a court questions whether a robust sale process took place.
Endnotes:

[1] The discounted cash flow analysis is a method used to value a company by calculating the present value of expected future cash flow. Generally, current forecasts are used to establish the cash flow for three to five years and a terminal growth rate (or terminal multiple) is used to predict the cash flow into perpetuity. The sum of the future cash flow of the current projections and the terminal value (i.e., value of all future cash flows beyond the date of projections) is then discounted to establish a present value for the cash flow. The discount rate, which is used to calculate the present value of cash flows, is typically based on the company’s estimated weighted average cost of capital (blend of cost of equity and after-tax cost of debt). The determination of the cost of equity is most typically focused upon the equity risk premium (the expected return above a risk-free return rate) and the beta (market risk as a function of the premium an investor should receive for the risk associated with investing in equities versus riskless assets).

Recapitalization

“Recapitalization can carry significant dilution for existing shareholders, which boards generally justify by emphasizing a credible and immediate threat – a liquidity crises which cannot be met through less expensive funding mechanisms, threatened by regulatory action in response to inadequate capital ratios or reserves, etc – to the ongoing health of the business. While the risk of rejecting these proposals may be high, so too is the risk from both the economic and governance terms of the proposal.”

1. Dilution to ownership: easy calculation of dilution to existing share owners as a result of new share ownership distributed.

2. Dilution on an EPS basis: more complex given a change in capital structure also impacts cost of debt and tax responsibility.

3. Improve Valuation of a Firm: complex given change in capital structure impacts the cost of capital and tax responsibility.

Questions for the Board

1. Motivation:
   a. Improve shareowner value?
   b. Emancipation from the government?
   c. New regulation – for example, meet your Tier 1 Common ratio?
   d. Meet your target capital structure ratio?
   e. Other competitors were paying off government-fear of competitive disadvantage?
   f. Recovery of market?

2. Process:
   a. What was your process to evaluate scenarios?

12 Proxy Governance, analysis of “Economically Vital” Proposals. Page 3
b. What risks are present now that were not before? How are you managing these risks? Did you assess other strategic alternatives?

3. **Independent Consultant:**
   a. Who consulted you on this?
   b. Fee structure?
   c. Boards involvement?

4. **Cost of Capital:**
   a. How was your cost of capital impacted?
   b. What was your cost of capital and what is it now? How did this impact valuation?
      i. Debt downgrade that raised your cost to borrow?
      ii. Increase systematic risk - cost of equity? (beta)
   c. If debt issued, how does the cost of preferred stock coupon differ from percentage paid on debt? What are your tax benefits? - Preferred not tax deductible
      i. Improve ROE? (improved earnings and smaller equity base)
      ii. Given the increased financed leverage, how does this impact financial risk?

5. **Capital Structure:**
   a. How much did you dilute shareowners? Number of shares? Less than 20% no shareowner vote required (only Citigroup and Bank of America had an active proxy with these types of proposals)
   b. Was the increase in capital structure dilutive or accretive to shareowners? By how many cents or dollars did you measure current years and performance?

6. **Earnings Multiple:**
   a. Did you expect to improve the earnings multiple your stock traded at? Did you succeed? Compared peers?
   b. Reduce your dividend payout?
   c. Increase required rate of return on equity?

**Brainstorm of other thoughts**
- No preferred share payment, increases earnings available to common shareowners.
  - Is this benefit a wash given the increase in shares outstanding? Accretive or dilutive to earnings?
- Does the agency cost (required rate of return) decrease with emancipation from government?
- Create pie charts of the capital structure to assess target optimal balance: Debt, Equity (Common/Preferred)
- Calculate percent charge coverage ratio? Cash flow percent? CF/debt? CF/cap ex?
**Trading GAP Risk Assessment**

Trading GAP Risk Assessment provides a conceptual framework for evaluating the risk of a potential deal by comparing the expected combined market value with the current combined market value. The calculation method for expected market cap of post combined firm was taught in Level II of the CFA Program curriculum. The assessment will be incorporated into our Portfolio Effect template workbook, and will be referenced in our M&A reports.

Goals of the Trading GAP Risk Assessment:
- Evaluate risk in order to assist in decision making process regarding M&A proxy voting.
- Accumulate GAP data on assessed deals in order to evaluate the effectiveness of the analysis and provide a historical perspective that will aid in future decisions.

Framework:
Compare current combined market cap value with expected combined market cap value with synergies.

Logic:
If the current combined portfolio value is below the undisturbed portfolio value and significantly below the expected combined portfolio value, then the acquisition is deemed “risky”. (Adjusted for size of stake by taking trading GAP risk as a percentage of undisturbed holdings value). If the current combined value is ABVOE the expected value of the deal, then the transaction may pose downside risk.
### Sample Gap Analysis - Pfizer and Wyeth

**TRADING GAP Risk Alert** = -$55 million (as of 7/6/09).

(The calculation method for expected market cap of post combined firm was taught in level II of the CFA program curriculum. The assessment will be incorporated into our Portfolio Effect template spreadsheets, and will be referenced in our M&A reports—unless teammates do not support)

#### Expected Post Combined Portfolio Effect of Synergies & Cost

<table>
<thead>
<tr>
<th></th>
<th>(Billions)</th>
<th>(Millions)</th>
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<tbody>
<tr>
<td><strong>Expected PV Synergies Per M&amp;A Proxy</strong>&lt;sup&gt;+&lt;/sup&gt;</td>
<td>$20.63</td>
<td></td>
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<tr>
<td><strong>Total dollar Cost (C) in Premium</strong></td>
<td>$16.30</td>
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<tr>
<td><strong>Undisturbed MarketCap of Target (MCₜ)</strong></td>
<td>$51.73</td>
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</tr>
<tr>
<td><strong>Undisturbed MarketCap of Acquirer (MCₐ)</strong></td>
<td>$117.70</td>
<td></td>
</tr>
<tr>
<td><strong>Expected MarketCap of Combined Firm (MCₜ + MCₐ + (S-C))</strong></td>
<td>$173.70</td>
<td></td>
</tr>
<tr>
<td><strong>Expected New Outstanding Shares (does not account for dilutive securities)</strong></td>
<td>$6.06</td>
<td></td>
</tr>
<tr>
<td><strong>Expected Post Combined Share Price</strong></td>
<td>$21.88</td>
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</tr>
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</table>

**CalPERS Post Share Holdings in Acquirer**  

<table>
<thead>
<tr>
<th></th>
<th>(Millions)</th>
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<tbody>
<tr>
<td><strong>Holdings Value</strong></td>
<td></td>
</tr>
<tr>
<td>Value based on M&amp;A Proxy Disclosure Estimates, Expected Combined Market Value of CalPERS' Holdings</td>
<td>$619.94</td>
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<tr>
<td>Undisturbed Combined Market Value of CalPERS' Holdings</td>
<td>$803.75</td>
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<tr>
<td>Current Combined Market Value of CalPERS Holdings (7/6/2009)</td>
<td>$564.75</td>
</tr>
<tr>
<td>Current Gain/Loss in Portfolio</td>
<td>$19.94</td>
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**TRADING GAP risk in Expected Combined Market Value vs. Current Combined Market Value**  

<table>
<thead>
<tr>
<th></th>
<th>(Millions)</th>
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<tbody>
<tr>
<td>Trading GAP risk as a percent of our undisturbed holdings value</td>
<td>9%</td>
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