

1 FEDERAL TRADE COMMISSION

2
3 A ROUNDTABLE SPONSORED BY THE BUREAU OF ECONOMICS
4 UNDERSTANDING MERGERS:
5 STRATEGY & PLANNING, IMPLEMENTATION AND OUTCOMES
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11 December 9 and 10, 2002
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26 FEDERAL TRADE COMMISSION
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48 transcript was edited by FTC staff to improve punctuation,
49 spelling and clarity. In addition each speaker was given
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P R O C E E D I N G S

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3 MR. SCHEFFMAN: Thank you all very much for
4 coming. I'm David Scheffman, Director of the Bureau of
5 Economics. I'm pleased to introduce Chairman Tim Muris.

6 CHAIRMAN MURIS: Welcome to our Roundtable on
7 Understanding Mergers, which is sponsored by the Bureau of
8 Economics. Throughout my career as a Commission official
9 and a law professor, I have thought that efficiencies ought
10 to be an important part of the Commission's agenda, and
11 that's what we're going to talk about today and tomorrow.

12 A main point I'm going to raise today is the fact
13 that, although efficiencies are an important part of our
14 agenda, we rarely have serious efficiencies presented to us.

15 Today, we'll have three panels. These panels will
16 discuss the rationales behind mergers, including important
17 questions about assessing the value a merger will create,
18 the likelihood that it will achieve that value, and how to
19 achieve a merger's objectives.

20 Tomorrow we'll have two panels. The first panel
21 will discuss the relationship between various costs and
22 business decision-making. The next panel will discuss what
23 the private sector perceives about the business planning
24 that merging parties may do without becoming illegal gun-
25 jumping, and we'll discuss the implications of our concerns
26 with gun-jumping.

27 Before we get to all that, I want to focus briefly

1 on my personal views of how the Commission should treat
2 efficiency claims. The government once treated efficiencies
3 as a reason to block a merger. Indeed, that position was
4 taken at the Commission as recently as 1974. We've, of
5 course, come a long way since then.

6 Modern merger analysis is much more sensible about
7 efficiencies. The 1997 revisions to the U.S. Department of
8 Justice and Federal Trade Commission Horizontal Merger
9 Guidelines elaborated on the importance of efficiencies and
10 offered some guidance on how to evaluate efficiencies.

11 Efficiency claims, however, have not flourished.
12 At least, in part, I believe this is because of a
13 misunderstanding of their role. Many apparently believe
14 that, practically speaking, efficiencies count only when the
15 merger is otherwise determined not to be anti-competitive.
16 Although I have written that the government has remained too
17 hostile to efficiency claims, especially in court, it is not
18 that hostile.

19 Efficiencies can matter, even when there is a
20 basis for concern. Of course, the more likely and
21 substantial are the likelihood of the anti-competitive
22 effects, the more likely and substantial must be
23 efficiencies to overcome the concerns about anti-competitive
24 effects.

25 A related misreading of the guidelines is to over-
26 emphasize the structural presumptions. The guidelines do
27 not state, and enforcement policy has never been over the

1 last 20 years, that a high HHI plus a significant delta is
2 dispositive evidence of anti-competitive effects. Instead,
3 a high HHI and significant delta in a properly defined
4 market, and the presence of barriers to entry, provide a
5 prima facie case. The prima facie case can be rebutted by
6 the absence of a viable, factually-supported theory of anti-
7 competitive effects.

8 Again, the strength of the affirmative case
9 matters. Thus, two-to-one or three-to-two mergers in well-
10 defined markets protected from entry are likely to pass the
11 anti-competitive test simply because of the very low number
12 of competitors.

13 In other circumstances, however, efficiencies can
14 be a significant component of the rebuttal of the prima
15 facie case. For example, in a four-to-three merger for
16 which the viability of an anti-competitive theory is
17 questionable, likely and sufficient efficiencies should lead
18 to a decision not to challenge the merger.

19 Last year, the Commission voted to close its
20 investigation of the proposed merger of the third- and
21 fourth-ranked drug wholesaling companies. In a public
22 statement, we concluded there was insufficient evidence to
23 support a theory of competitive harm, including a lack of
24 evidence that either of the merged firms had contributed
25 significantly to the ongoing trend of decreases in drug
26 wholesaling prices or that the resulting industry structure
27 likely would lead to price increases or prevent further

1 price reductions.

2 We also noted that the proposed transaction would
3 likely give the merged firm sufficient scale to allow it to
4 become more cost competitive with the two leading firms and
5 to invest in the value-added services consumers desire.

6 Further, we believed that the combined firm could
7 initiate these improvements more rapidly than either could
8 do individually and that this timing advantage would be
9 significant enough to constitute a cognizable, merger-
10 specific efficiency.

11 One source of confusion about the role of
12 efficiencies comes from the litigated cases. Generally, the
13 courts have placed more weight on structural presumptions
14 than do the Horizontal Merger Guidelines or actual
15 enforcement policy. For example, in *Cardinal Health*, the
16 Court appeared to have relied principally on the presumption
17 that increases in concentration would lead to higher prices.
18 There were also significant customer complaints, although
19 the Court did not appear to weigh those heavily. Despite
20 both acknowledging substantial efficiencies and recognizing
21 the lack of strong proof of price effects, the Court granted
22 the injunction the Commission sought.

23 When the government does lose in court, the reason
24 generally has been deficiencies in the evidence supporting
25 the government's allegations of market definition or of
26 entry barriers, rather than the viability of the theory of
27 anti-competitive effects.

1 An important decision that may be misunderstood is
2 the so-called Baby Foods case. The crucial issue in that
3 case was whether the merger was a three-to-two merger of
4 head-to-head competitors or a two-to-one merger of
5 competitors competing vigorously for shelf space, or
6 instead, was a transaction that would actually enhance
7 competition by combining two weak firms into one that could
8 at last challenge the dominance of Gerber.

9 If the evidence supported the three-to-two head-
10 to-head competitor characterization or the two-to-one
11 competitor for shelf space characterization, then the
12 structural presumptions rightfully would have trumped at the
13 preliminary injunction stage what was a solid and
14 substantial efficiency claim.

15 The parties lost, in part, because the District
16 Court ignored both antitrust economics and relevant
17 precedent, and did not even allow the substantial customer
18 testimony supporting the merger, let alone give that
19 testimony proper weight. Lacking such evidence, the D.C.
20 Circuit found that the record did not sufficiently rebut the
21 three-to-two or two-to-one structural presumptions on
22 appeal.

23 The misunderstanding of the role of efficiencies
24 in the Horizontal Merger Guidelines, in prosecutorial
25 decisions, and in court decisions has led some to advise
26 their clients not to make the effort necessary to put
27 forward their best efficiencies case.

1 On the Commission side, the dearth of sound,
2 factually-supported efficiency presentations leads us
3 usually to reject the efficiencies that are claimed. When
4 the parties present back-of-the-envelope calculations or
5 advance claims of efficiencies with insufficient support,
6 the staff will not accept them, and understandably so.
7 Although this may give the staff a reputation for not
8 welcoming efficiency arguments, the only deserved reputation
9 is one for rejecting poorly developed arguments.

10 The dilemma is obvious. Parties don't bother
11 giving us good material, and without good material, we don't
12 believe in efficiency arguments. It's the classic chicken
13 and egg problem. The antitrust bar should know, however,
14 that we take substantial, well-documented efficiencies
15 seriously, and we recognize that mergers can lead to a
16 variety of efficiencies beyond reductions in variable costs.

17 Counsel should also bear in mind that efficiencies
18 can be important in cases that result in consent decrees.
19 Presentations of credible efficiency claims can lead to a
20 settlement that preserves competition while allowing the
21 parties to achieve most, if not all, of the efficiencies
22 they believe will flow from the merger.

23 I want to encourage the presentation of solid,
24 credible evidence. I also want to reassure antitrust
25 counsel that such evidence will be taken seriously. That
26 requires some leap of faith from counsel, but the Commission
27 cannot move first in this area. We necessarily take the

1 arguments as presented to us, although we evaluate them
2 independently. We do not make them up for the parties. As
3 Commissioner Leary recently detailed, when the arguments
4 presented to us are strong, we will give them detailed
5 attention.

6 In sum, efficiencies should sometimes be an
7 important and substantial component of the party's
8 presentation to the Commission. We take such efficiencies
9 seriously. In turn, we expect that the parties will present
10 these claims with enough evidence to allow us to evaluate
11 their validity. I do not expect that substantial efficiency
12 studies will be presented in very many cases. I do hope
13 that they occur with more frequency than current practice.

14 Indeed, in four years as a Commission official,
15 counting my experience from the 1980s in the Bureau of
16 Competition, I've seen serious efficiency claims made only a
17 few times. I encourage the bar to do better. Solid
18 efficiency presentations will better enable the Commission
19 to identify and forego challenging those mergers with bona
20 fide efficiencies that benefit consumers.

21 We'll now move to what should be very interesting
22 and informative discussions by experts on mergers. Thank
23 you for coming.

24 MR. SCHEFFMAN: Again, I want to thank you for
25 coming. When Chairman Muris asked me to return to the
26 Commission a year and a half ago, I asked him what he wanted
27 to accomplish. Efficiencies were one of the primary focuses

1 on his agenda, and one of the reasons why he came back.
2 We've been doing a lot of work in the Bureau of Economics on
3 this and other related topics for the last year and a half.
4 Part of this work you'll see in Paul Pautler's paper on
5 merger outcomes literature that's available out front.

6 Over the next day and a half, we're going to hear
7 from an extraordinary group of people, professors and
8 researchers, consultants, business people, financial experts
9 and lawyers, who will be talking to us about what they know
10 from their research and expertise and experience about
11 various aspects of M&A, mergers and acquisitions. This
12 undoubtedly will be one of the most interesting conferences
13 on M&A that has ever been put together.

14 We're greatly indebted to the panelists who have
15 agreed to participate in this roundtable. If you look at
16 your program, you can see the very high opportunity cost
17 that's involved with the caliber of the people that we have
18 here. But what's interesting is that when we called and
19 invited people to participate, their uniform response was,
20 when and where. I believe that's testament to the
21 importance of the antitrust mission of the FTC and DOJ and
22 the respect our agencies have in the academic, consulting,
23 and business communities.

24 The audience is also extraordinary. There are
25 people here from the FTC and DOJ, from Commerce, from the
26 Fed, from other U.S. Government agencies, and from
27 competition enforcement agencies in Canada and Europe.

1 Now, this is an unusual roundtable for those of
2 you antitrusters, as most of you in the audience are. Its
3 topic is related to merger enforcement under the antitrust
4 laws, but the panelists today are not antitrust economists
5 or lawyers, save Mike Scherer. This was a conscious
6 decision, to have a panel of this type.

7 For many years before returning to the Commission,
8 I was a business school strategy professor and a business
9 consultant. From that experience, I've come to believe that
10 antitrust enforcers and economists and many private lawyers
11 do not sufficiently understand the business side of M&A, and
12 other business decisions, to be able to adequately and
13 appropriately deal with the potential benefits of mergers.

14 Thus, today, we're going to hear from people with
15 acknowledged expertise and experience with the business and
16 economic side of M&A, not the antitrust side. They are not
17 going to specifically address how we should analyze
18 efficiencies in our merger reviews. Rather, what we learn
19 in the next day and a half, along with a lot of other work
20 that's going on at the FTC and at DOJ, will greatly expand
21 our understanding of the business motivation and effects of
22 mergers, and therefore, should improve our ability to assess
23 efficiency claims.

24 I want to thank the Chairman for making this
25 possible. I want to thank Paul Pautler who did all the work
26 in setting this up, along with his assistants, his
27 secretary, Crystal Meadows, and Research Analyst Stefano

1 Sciolli.

2 So, we look forward to a very interesting day
3 and a half of discussions on aspects of mergers and
4 acquisitions.

5 MR. PAUTLER: We'll move on to Panel 1 now,
6 please. For the members of Panel 1, please come on up.

7

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**PANEL 1
RESEARCH ON MERGER OUTCOMES**

10 MR. PAUTLER: Before we get into the substance of
11 Panel 1, I just wanted to go over a few ground rules. When
12 you came into the room, you must have noticed all the stuff
13 we have outside on the tables. There are a lot of handouts
14 that give you the PowerPoint presentations that the
15 presenters are going to use today. Also, there are copies
16 of various books and articles by some of the people that
17 will be presenting. And as Dave mentioned, there are copies
18 of a couple of papers that I put together. I think there
19 are also copies of the agendas and biographies of all the
20 people that will be speaking so you know who's talking to
21 you.

22 For this first panel, each speaker will have about
23 15 minutes to make his or her presentation. Following the
24 presentations, there will probably be an opportunity for the
25 panel members to discuss among themselves differences of
26 opinion. Then there will be some questions from the
27 moderator. Finally, there will be an opportunity, I hope,

1 for questions from the audience.

2 When we get around to having questions from the
3 audience, in order to make the transcript work, we would
4 like to have each of the audience questioners wait until we
5 get a microphone to you so you can give your name and
6 affiliation clearly and then you can ask your question.
7 That will allow us to get a cleaner transcript.

8 So, to begin, we're going to hear from researchers
9 who have examined merger outcomes using several different
10 empirical techniques, and over very different time periods.
11 I think these presentations are going to serve as a
12 background for some of the more specific discussion that
13 will happen later in the day and they'll also help us
14 understand whether mergers have changed over time and
15 whether there's a consensus regarding how effective they've
16 actually been.

17 So, in order to get started, I'd like to give you
18 some background on each member of the panel first and then
19 we'll get started with Professor Scherer.

20 Our first presenter will be Professor Mike Scherer
21 who is Professor Emeritus at Harvard's Kennedy School of
22 Government. He's taught at several leading universities and
23 published numerous books on industrial organization and
24 technological change over the years. Perhaps his most
25 notable work, for our purposes today, is work that he did
26 with Dave Ravenscraft, *Mergers, Sell-Offs and Economic*
27 *Efficiency*.

1 Professor Scherer also happened to be the Director
2 of the FTC's Bureau of Economics from 1974 to 1976, and I'm
3 glad he could be here today.

4 The second speaker is going to be Robert McGuckin.
5 Bob is the Director of Economic Research at the Conference
6 Board. Prior to taking on that post, he was the Chief of
7 the Center for Economic Studies at the Census Bureau and
8 prior to that, he had a distinguished tenure at DOJ's
9 Antitrust Division for the Economic Analysis Group.

10 Our third speaker will be Susanne Trimbath who is
11 a researcher at the Milken Institute. Susanne has taught at
12 major universities and has been associated with several
13 private and public economic institutions that are involved
14 in capital development. Susanne recently published several
15 books. One of her most recent books involved mergers and is
16 entitled, Merger and Efficiency Changes Across Time. She'll
17 be discussing some of that work today.

18 Batting clean-up for us will be Steve Kaplan. He
19 is the Neubauer Professor of Entrepreneurship and Finance at
20 the University of Chicago. His research focuses on private
21 equity markets, corporate governments, mergers and
22 acquisitions, and corporate finance. He also is a Research
23 Associate at the National Bureau of Economic Research, and I
24 know that he did a book for them a couple of years ago on
25 case studies of mergers and acquisitions. That's part of
26 what we'll hear about today.

27 So, without further ado, I'd like to get started

1 with Mike Scherer.

2 MR. SCHERER: Thank you very much, Paul. Just a
3 prefatory note. It was interesting that Tim Muris set 1974
4 as the cut-off date for viewing efficiencies as something
5 that went against a merger. That's just when I happened to
6 join the Federal Trade Commission, and indeed, there may be
7 a slight connection, although the official change came only
8 10 years later.

9 We had a merger between two ball bearing
10 manufacturers, and because of my previous research, I knew
11 that this was an industry in which one could realize very
12 substantial efficiencies by combining operations. I had
13 studied a U.K. merger in ball bearings that led to
14 productivity growth of about 30 percent or so. I therefore
15 took a position as Director of the Bureau of Economics that
16 we will not support the complaint unless the respondents are
17 offered the opportunity to present an efficiencies defense.
18 That was 1975 or '76, I think. I left the Commission
19 shortly thereafter. I was told the defense went nowhere.
20 What happened, I don't know exactly.

21 In any event, I thank the FTC for an invitation
22 that provided the opportunity to visit an old friend. That
23 old friend is my book with David Ravenscraft, Mergers, Sell-
24 Offs and Economic Efficiency. As I reread it this past
25 week, I realized it's the best book I've written.

26 Why is it the best book I've written? Two reasons
27 -- well, maybe three reasons. Interesting subject. That's

1 minor. Very good co-author, David Ravenscraft. And very
2 importantly, we had access to the most magnificent database
3 that one would ever want to have on this subject, the
4 Federal Trade Commission's line of business database, to
5 which we linked 6,000 individual mergers and acquisitions.

6 Time is short, so let me briefly review our
7 findings. First, our study focused on mergers of the 1960s
8 and early 1970s. This was a period, because of antitrust
9 law, of mostly conglomerate merger activity. To be sure, 41
10 percent of the acquisitions in our sample were horizontal
11 acquisitions - but they were typically tiny, too small to
12 attract the attention of the antitrust authorities. So the
13 mergers were preponderantly conglomerate.

14 We found that on average mergers didn't work out
15 very well. One major reason for disappointment was that the
16 acquirer paid too much for its acquisition. And under
17 purchase accounting, this showed up strongly in our database
18 by very big negative coefficients on the profit measure for
19 mergers which were consummated under purchase accounting.

20 But, second, this was a period when pooling of
21 interest accounting was also used -- a method no longer
22 allowed. Under purchase accounting, you write up the value
23 of the assets you've acquired to reflect any premium you
24 have paid over the book value of the assets. That inflates
25 the assets denominator of most profit measures, and also, by
26 increasing depreciation charges, it reduces the indicated
27 numerator of profit measures. Neither of these two effects

1 happens under pooling of interests accounting, and so, we
2 had to do a different kind of analysis to deal with the
3 pooling mergers. What we found was that there was, in fact,
4 a small positive profitability coefficient, a couple of
5 percentage points relative to all other non-acquired lines,
6 for the pooling of interest mergers.

7 However, the pooling of interest acquisition
8 targets were extraordinarily profitable before they were
9 acquired. This is seen in Figure 7-1 on page 196 of my book
10 with David Ravenscraft. The adjusted line for the pooling
11 acquisitions adjusts for differences in macro-economic
12 conditions. What you see is that the smallest acquired
13 entities had returns on assets before merger on the order of
14 20 percent. After merger, on average, those lines had
15 returns on assets of about 12 or 13 percent.

16 So, what one sees is that there was an
17 extraordinarily sharp drop in profitability from pre-merger
18 versus post-merger. The smallest drop in profitability was
19 achieved for what we called mergers of equals. These were
20 for firms that differed from one another by no more than a
21 factor of two. They were almost always consummated through
22 an exchange of shares and, therefore, were accounted for
23 under pooling of interest. That was the only class of
24 merger which we found did not lead to a drop in
25 profitability relative to pre-merger conditions.

26 We found that the worst decreases in profitability
27 were for the pure conglomerate mergers, although we found a

1 decline in profitability also for related business mergers
2 and for horizontal mergers. Our sample of verticals was too
3 small to draw any conclusion.

4 The other striking thing about the merger wave of
5 the 1960s and 1970s was the very large number of
6 divestitures. Large numbers of mergers were undone
7 subsequently. Now I'm going to use some slides.

8 I believe this is the most striking finding of our
9 entire study. We were able to track the profitability of
10 these lines that were either fully or partially divested
11 over a fair number of years. We found that as the time of
12 full divestiture approached, one had descending
13 profitability relative to the average for companies in the
14 same general industrial line. As seen in table 6-3 on page
15 168 of our book, four years before sell-off, profits as a
16 percentage of assets are below industry benchmarks
17 (averaging 13.93 percent) by 6.4 percent; three years
18 before, they are 9.92 percent below; two years before, 10.6
19 percent below. The year before sell-off profits were
20 negative in absolute terms and below undivested line norms
21 by 13.5 percent. Divested lines had a negative return on
22 assets the year before merger.

23 So, obviously, things were going wrong that led to
24 these divestitures. We did a large number of historical
25 qualitative case studies. They are in our book for the
26 reading, so I won't go into them in detail. But you can see
27 what kinds of things went wrong. Mainly three things --

1 corporate culture clashes, the departure of highly qualified
2 people, and inevitable regression of profitability from
3 earlier peaks.

4 I'm not going to try to use my other slides. To
5 save time, let me just summarize my results. There was a
6 large variance in these findings. On average, mergers led
7 to reductions in profitability after taking into account the
8 method of accounting used. But there were large variations
9 about the central tendencies. The T-ratios reflecting the
10 standard deviations on our merger coefficients typically
11 were on the order of two to three, indicating statistical
12 significance, but revealing that there was a wide variation
13 about the central tendency, indicating that some mergers did
14 quite well. Indeed, we found that certain companies that
15 had engaged in extensive conglomerate merger activity did
16 very, very well.

17 If there were a little more time, I would talk
18 about a subsequent study. I tracked 100 high technology
19 initial public offering firms for a period of about 15
20 years, and of those, about 35 disappeared by merger. Of
21 those that disappeared by merger, on average, they had been
22 under-performing the NASDAQ index, but there were a couple
23 of exceptions.

24 Something that I never studied and I've never seen
25 anybody study is quality of service. Business Week reported
26 about a survey of various service type industries,
27 telecommunications and the like, that surveyed customers

1 about quality of services. They split the responses between
2 those which had just had acquisitions and those which had
3 not had acquisitions. What you find is that service quality
4 deteriorated substantially after acquisition. I personally
5 have lived through about seven corporate control
6 transactions with my checking account bank, and I can tell
7 you, these statistics don't lie. Service deteriorates after
8 the typical service industry merger. That ought to be
9 looked into.

10 But, again, the key finding by Ravenscraft and
11 myself was that there's a lot of variability. Mergers fail
12 for financial reasons. They fail for managerial reasons.
13 But some succeed.

14 Now, how do you find the ones that succeed? I
15 have had a fair amount of experience trying to sustain
16 efficiency defenses. I did so in the Archer Daniels Midland
17 - Clinton Corn Products case. That's written up in the
18 hand-out that's available in your packages. There are ways
19 that one can do this. I used company census filings and
20 census industry benchmark data, among other things, to
21 estimate comparative productivity between the merger
22 partners on the one hand and the rest of the industry on the
23 other hand. I found astounding productivity growth
24 performance in the merged entities.

25 Ex ante, how do you find it out? I think a key
26 thing is the quality of the planning, as Tim Muris said, and
27 also the quality of the staff. But it's very difficult to

1 do this ex ante. Let me just talk about one other case in
2 which I was involved. In the late 1970s Ling-Temco-Vought
3 owned the Jones & Laughlin Steel Company. When Jones &
4 Laughlin sought to acquire Youngstown Steel, I was asked by
5 Attorney General Griffin Bell to write a report on that
6 merger. The parties claimed that efficiencies would be
7 realized.

8 I went back a few years later and looked at what
9 actually happened. What I found was that very substantial
10 efficiencies had been achieved, but they looked nothing at
11 all like the efficiencies that had been claimed in advance.

12 You can find my two analyses of the LTV - J&L
13 experience. One, the pre-merger analysis, is in my book,
14 Competition Policy: Domestic and International. The post-
15 merger analysis is in my book with Ravenscraft.

16 On one other merger I was the government's witness
17 in the attempted merger by Lockheed Martin with Northrop
18 Grumman. Their documents outlined an efficiencies defense.
19 The case never came to trial. But I did an analysis of
20 their efficiencies defense and found a quite remarkable
21 thing. The big efficiencies were to come from closure of
22 R&D labs and from shut-down of production lines. So, I
23 traced lab by lab, hundreds of them, and production line by
24 production line. I found that in 85 to 90 percent of the
25 cases, the lab that was to be shut down had a counterpart
26 lab doing exactly the same thing in the same pre-merger
27 corporation. Similarly for production lines.

1 So, almost all of those efficiencies could have
2 been achieved without merger. If they had two labs in a
3 particular field, they proposed to shut down one. They
4 could have done that without the merger. So, it's very
5 important, I think, to take that into account. The reason
6 for this strange behavior is Public Law 103-337, which
7 creates perverse incentives to claim that any efficiency
8 measures occur because of merger rather than for self-
9 initiated reasons.

10 My time is up. Thank you very much.

11 MR. PAUTLER: Thank you very much. Our next
12 speaker will be Bob McGuckin of The Conference Board, who
13 will discuss the importance of industrial restructuring and
14 his own empirical research on productivity increases
15 associated with plant transfers.

16 MR. MCGUCKIN: I must tell you, I actually
17 searched for efficiencies one time in a steel merger when I
18 was at the Justice Department and I had the same problem of
19 matching up the plants to see where the efficiencies were.

20 I've been doing a lot of work at The Conference
21 Board on international productivity comparisons, and we've
22 been focused on trying to explain things like gaps in
23 productivity between Europe and the U.S., for example. We
24 have argued that a lot of that has to do with the new
25 information and communications technologies, the
26 implementation and diffusion of that, and we've tied the
27 difference in the diffusion rates in Europe and the U.S. to

1 differences in such things as merger policy.

2 It's harder to do mergers in Europe. Regulatory
3 boundaries are also a factor. Things like restricted store
4 opening hours, for example, prevent Wal-Mart from taking
5 account of all their marketing expertise in countries like
6 Germany.

7 The point I want to bring this morning is that in
8 talking about these issues, I typically go through a
9 deregulation story about governments. But my basic lecture
10 to businesses highlighted in the slide on the bottom of p.1
11 of my handout, is usually that structural reform is not just
12 about governments, it's about business as well. So, I go
13 through a story -- and I won't have time to do the whole
14 kit-and-caboodle this morning - about new technologies,
15 government deregulation, changes in law, transition
16 economics, and banking reform. Whether in China, Japan, or
17 Europe, structural reform causes changes in the economic
18 environment and business must adjust to them. They mean
19 changes in the organizational structure of business.

20 So, what I talk to business audiences about is how
21 you meet the needs for organizational change. It's not just
22 about building plants. It's not just about closing your own
23 plants. It's about buying and selling plants. And Mike
24 earlier said something about following up these purchases
25 with divestitures and that's surely a big part of it.

26 The argument from a business standpoint is not
27 about a static price fixing versus efficiency, it's about

1 dynamics and changing the portfolio of activities that the
2 firm manages. Business makes changes through portfolio
3 adjustments. So, mergers and acquisitions are a big part of
4 business restructuring and reform.

5 Now, in my work, I took the next best step,
6 perhaps, to working with the line of business data. In some
7 respects it's better and in some respects it wasn't as good.
8 After I left the Justice Department, I ended up at the
9 Census Bureau, and there we developed something called the
10 Longitudinal Research Database, which is now called the
11 Longitudinal Business Database. It essentially follows
12 individual plants. It starts in 1963 and it reports
13 information on each plant in five-year swatches with some
14 in-between information on most plants. My work was
15 primarily in manufacturing.

16 It is now possible to do such with non-
17 manufacturing. The data has just recently become available.
18 I don't think anyone has replicated the work I did but
19 somebody sure should for non-manufacturing.

20 So, I examined the portfolio of plants owned by
21 the firm. I worried about what was the right counter-
22 factual for a business that's facing changing demand,
23 changing regulations, changing competition. If you think
24 about the '70s and '80s, most of my work went from '73 to
25 '92 or '87, and you start to think about that period, we had
26 a major energy crisis. We had major adjustments in what
27 business had to deal with, including changes in the

1 production techniques. We had enormous increases in foreign
2 competition for example in steel and autos. Japan and
3 Germany were sitting there with new steel plants. (At one
4 time, we actually brought consultants in from Europe and
5 tried to build a steel plant, and I did the same with oil
6 refineries in California.) There were major changes going
7 on and businesses had to adjust to those. They had to
8 reorganize their operations, and we were seeing a lot of
9 mergers.

10 Now, how did I pick all this up in the empirical
11 work? Well, the bottom line is we started with 300,000
12 plants. We looked at about 140,000. That's every plant in
13 manufacturing. And we followed them through the years. As
14 an aside, this work started out focused on drivers of
15 productivity growth. It followed up Frank Lichtenberg's
16 work. There was much other work, including work by David
17 Ravenscraft and Bill Long, looking at leveraged buyouts.

18 The study followed each individual plant and asked
19 the questions: How productive was the plant before it merged
20 and what happened after? It looked at the question with a
21 statistical regression model.

22 The regression model included controls that took
23 account of things like industry, prices, and region. It had
24 firm fixed effects. There were lots of variables included.
25 We controlled for the productivity of the plant before the
26 merger.

27 When you do these exercises you find that, by and

1 large, mergers produce efficiencies. Now, that doesn't say
2 anything about profits. It doesn't say anything about who
3 gets the profits or whether you paid too much or not. I
4 can't really talk about that. But I can talk about the
5 efficiencies.

6 So, I want to make a couple of points. First,
7 mergers are pervasive. (Let me see if I can actually pull
8 together a couple of overheads that would fill in. As I
9 indicated, I talk to business about the need to reorganize.
10 But, there is also a Conference Board report you can find on
11 our website, which is entitled, "Why All the Uncertainty,
12 Few and Doubt? Are Mergers and Acquisitions Bad for
13 Workers?" It focuses on the impacts around labor, because,
14 after all, mergers just aren't about antitrust, they're also
15 about labor unions and press, local plants being shut down
16 and so forth.)

17 The figure that I want to point to is this 66.7 percent
18 figure in the first slide on p. 2 of my handout. Over the
19 period, '77 to '87, 66.7 percent of workers were affected by
20 a merger in manufacturing. That's either they belonged to a
21 firm that had acquisitions or they were in a firm that was
22 acquired. So, that's a big proportion of the manufacturing
23 workforce affected by mergers.

24 Mergers are very pervasive. They involve all
25 industries and most big firms. When you start to look at
26 the firms with no acquisitions, it's only 33 percent.
27 That's the main message of that slide.

1 The next slide, on the top of page 3 of my
2 handout, shows the productivity impacts. You'll notice I
3 broke the acquired plants into kept and sold. The merger
4 took place; the firm kept the plant as part of its portfolio
5 or sold it. And, by the way, again, while all these mergers
6 where going on, the firm wasn't just sitting there; they
7 were building plants at the same time they were buying them.
8 They were building plants and they were closing them,
9 closing some of the plants they bought and some of the
10 plants that they already owned at the time. So, the firms
11 were undertaking major portfolio changes. But they sold off
12 a large number, as well. And you get a productivity impact
13 on the merged plants.

14 The slide records percentage points. It's a log
15 regression, so those are the regression coefficients. They
16 are the coefficient that you get on the ownership variable
17 after controlling for other things. You can do this in a
18 lot of ways, but the productivity gain is the bottom line.

19 I found it interesting and suggestive, and I broke the
20 chart before and after Hart-Scott-Rodino, although I don't
21 want to argue that this is proof of the positive impact of
22 the changes in the merger guidelines. After Hart-Scott-
23 Rodino, we got a bigger productivity bang. In some other
24 work, I looked at mergers that wouldn't have passed the '68
25 Guidelines and looked at them after the merger. I think I
26 had a series of about 20 or 30 in a paper in the Antitrust
27 Bulletin in 1990. Basically, there didn't appear to be,

1 with one exception, anticompetitive effects associated with
2 any of them.

3 So, you're getting a big productivity impact from
4 mergers. And, by the way, the story here is of two kinds of
5 impacts. I want to tell you a story about mergers and
6 corporate discipline and the market for corporate control.
7 The Rand Paper we did took-off from Lichtenberg and Segal's
8 work that looked at large plant mergers. If you look at the
9 large mergers, and I think this fits with some other work,
10 you see that there's a lot of corporate discipline
11 arguments, downsizing, things of that sort evident in the
12 data.

13 We broke the mergers into large and small. I
14 don't think I have the slide that was in my presentation.
15 Basically, the acquired plants are much bigger than non-
16 acquired plants and the firms buying them are much bigger
17 than the selling firms. But if you look at the results, you
18 find the following: We called roughly 80 percent of the
19 mergers synergistic. These mergers showed some gains even
20 though they involved buying a high productivity performer.
21 I think that fits very well with what Mike said earlier
22 about most acquisitions involving the purchase of good
23 performers. But then the acquiring firm improved the
24 productivity of good performer.

25 Acquirers also bought low productivity performers
26 and improved them. But the gains were much less. We found
27 that these plants were usually the largest plants. They

1 were old. Think of Bethlehem Steel in Buffalo, New York and
2 Lackawanna, circa the '80s. Those are the kinds of plants
3 where you have to get rid of the excess capacity.

4 So, there are two main motivations for mergers.
5 Most of the mergers involve smaller plants and most of them
6 are about synergies, even the cross border ones. For
7 example, a large European company just bought in Silicon
8 Valley so it could get some U.S. expertise on computers.
9 Those are the kinds of mergers we're talking about with
10 regard to synergies.

11 A good chunk of mergers are for corporate control,
12 where you're getting a relatively poor performer and
13 improving it. That doesn't mean you're bringing it back,
14 necessarily, to state-of-the-art, but you're improving it,
15 and that's the story we find in our studies.

16 The other point I'll make is that we also find
17 that wages generally go up, except in these large plants
18 where the wages initially are high. We find that mergers
19 are good for employees in the sense that if you start to
20 look at firms that didn't merge, they downsize, too. If you
21 sort them out by size, you find that, in fact, mergers are
22 just a way to do the thing that people do otherwise in some
23 cases. That doesn't mean you have to merge to downsize, but
24 it's often the best way. So, even when you are talking
25 about mergers for control, you find that generally they are
26 good for employees.

27 Unfortunately, most employees don't feel that way

1 because they work in those big, old plants. The size
2 distribution is very skewed and they also are plants that
3 are big parts of local communities. So, you get the press
4 and you get a lot of negatives, and that was clearly the
5 case when we had the state takeover legislation that was
6 pushed in the '70s and '80s, that was all a reaction to
7 downsizing acquisitions and plant closings

8 So -- just to close this up -- mergers really seem to
9 be more an element of dynamic competition, and a tool of
10 firm restructuring. They are good for the economy. That
11 doesn't mean there's never an anticompetitive merger. I
12 even testified in a couple of cases. But most mergers are
13 generally okay.

14 The slide on page 4 of my handout shows mergers
15 taking off in Europe, and one of the reasons is the Euro,
16 and Europe is undergoing a lot of deregulation. For the
17 U.S. it really started, I guess with the 1968 Carter Phone
18 case. That is where I date the beginning. You can pick it
19 up in the '60s, '70s and '80s. And the ICT, Information and
20 Communications Technology, revolution is a major factor in
21 mergers moving forward. That's happening in Europe and
22 we're actually starting to see it happen in Japan.

23 So, bottom line again, we're talking about success
24 in shifting resources to account for new conditions when we
25 are talking about mergers and acquisitions. Thus, the fix-
26 it-first approach to an antitrust analysis of acquisition
27 makes sense. The reason is, if I think about these

1 conceptual and statistical experiments that we ran, breaking
2 down the merger into its component parts, looking at the
3 firm's structure, what its buying and what its selling
4 piece-by-piece, that's what fix-it-first does. It usually
5 breaks the firm down and that was an innovation of Hart-
6 Scott-Rodino. You get the information in first and you can
7 start to deal with it. And that's exactly the way to go
8 about it.

9 That said, ex ante, it is very difficult to decide
10 on the mergers. I'll plug our Conference Board research
11 here for a second. (Most of the reports have an academic
12 paper behind them.) You can find the academic work, but the
13 report is written for business.) There's a list of six or
14 seven papers that discuss how to make a merger successful
15 referenced in my report. So, there's a big business
16 practice in this. This is not an easy game. When you
17 reorganize you have employee issues, you have other issues,
18 and a lot of business research focuses on that. Thank you.

19 MR. PAUTLER: Thank you, Bob. It's clear we've
20 got minor, if not major, differences of opinion about how
21 well mergers generally work, and we may come back to that at
22 the end of the presentations.

23 Our next presenter is Susanne Trimbath of the
24 Milken Institute. She'll provide us with some insights on
25 her recent merger work and she'll be focusing on the ways in
26 which accounting-based results change over time.

27 Susanne?

1 MS. TRIMBATH: Good morning. First of all, I'll
2 clarify that when I say "takeovers," I mean "mergers." When
3 you get into the academic literature, there's a distinction
4 between one and the other. What I'm looking at is a
5 complete change in ownership for an entire company, and that
6 differentiates my work from what Professor Scherer did and
7 also some of the things that Bob was talking about because
8 my work uses whole companies.

9 I wanted to call my book, Mergers and
10 Efficiencies: Temporal Distortions, but the editorial staff
11 found that a little too scary. People were going to think
12 of time warps or something. So, we stuck with Changes
13 Across Time. I measure efficiency using cost per unit of
14 revenue. Basically, cost is defined as fixed and variable
15 cost, which is cost of goods sold, plus SG&A over revenue
16 from the financial disclosures of public companies. I took
17 numbers from very early in the accounting statements to
18 minimize potential distortions from earnings management.

19 For all of the slides that you see today, I'm
20 using my own database for the statistics. My database
21 consists of the Fortune 500 and I update them every year so
22 that I have consistency in the sample. The companies that
23 are in there are not self-selected, as you would get using,
24 for example, all the NYSE-listed firms. I basically have
25 500 companies every year, so I don't have a bias problem
26 from a shrinking sample size, which is common in a lot of
27 large sample studies that examine more than one year.

1 So, the first thing we see in the slide on the top
2 of page 2 of my handout is a black line that shows changes
3 in volume. Using the Fortune 500, I find generally that the
4 peaks lag about one year behind national statistics. I'm
5 looking, of course, at the broad patterns, and the patterns
6 themselves aren't different among data sources. Just the
7 specific numbers might be a little bit different. As the
8 volume of mergers and acquisitions changed, so did the types
9 of research that were being done. The slide on the bottom
10 of p. 2 of my handout shows that not only the methodology,
11 but also the hypotheses, the reasons that researchers put
12 forth as to why takeovers were occurring, changed the way
13 that we measure performance has changed, also, across the
14 decades.

15 As a result of that, what you also get is changes
16 in the evidence, as shown in the slide on the top of p. 3 of
17 my handout. With all due respect to Professor Scherer,
18 who's sitting here with us today, Matsusaka, in 1993,
19 purported to have repeated his research with a sample that
20 was updated in time and found conflicting results. Another
21 example I use is Palepu, who basically showed that the logit
22 model and not the probit model, for those of you who are
23 statistically inclined, was the proper model for examining
24 the probability of takeover. Again, what I want to make
25 clear here is that even using the same sample, the same
26 methodology, the same measurements, when the sample was
27 updated to a more current period, there were actually

1 conflicting results found by Ambrose and Megginson.

2 The slide on the bottom of page 3 of my handout is
3 from my own research. It shows changes in the difference
4 between the median of the performance of all firms and the
5 median of the performance of targets in three different
6 periods. There are a lot of theories about why firm
7 performance changes across time. This shows targets
8 relative to other firms, how their performance has changed
9 in different time periods.

10 One suggestion about why firm performance changes
11 comes from studies of management turnover that show that
12 management turnover is more closely related to performance
13 during periods of active corporate control. So, when there
14 are a lot of takeovers happening, all managers are
15 disciplined not just those in the targets. This is the
16 pressure to perform that is put on firm management by the
17 threat of takeover.

18 More recent studies are looking at the
19 relationship between stock options and firm performance.
20 But I wouldn't be surprised, given the vagaries of the
21 capital markets, if they also find that there are some
22 temporal inconsistencies in that work.

23 Now, I'll just quickly go over some of the results
24 from the research that I did that's in the book that Paul
25 mentioned. Basically, I show inactive firms, firms that are
26 buyers, and firms that are targets, in different time
27 periods, as seen in the slide on the top of page 4 of my

1 handout. By the way, the size figures here are in constant
2 dollars, and they do make these changes, even if you adjust
3 for inflation. Not only each firm, but the firms themselves
4 as a group have changed across these periods. In addition,
5 their relationship to each other, their relative performance
6 and relative size, have changed.

7 When we look at the factors that are common to all
8 firms that are taken over compared to all firms that are
9 not, the statistical results, again, show that there are
10 distortions in size, but not in cost efficiency. The
11 targets' lower efficiency is the reason for selection. The
12 slide on the bottom of page 4 of my handout shows this
13 again, in two different time periods.

14 The first graph on page 5 of my handout covers the
15 1981 to 1985 period. What I want to show you is that it's
16 not just the magnitude of the relationship between size of
17 firms and cost efficiency that changes, but the direction
18 actually changes, as well. So, you go from a negative
19 relationship to a positive relationship in the slide at the
20 bottom of page 5, which shows 1990 to 1997.

21 I did want to get through some of the statistical
22 stuff pretty quickly. At this point, I'll slow it down just
23 a bit and move to some less technical material. The finding
24 shown in the graph at the top of page 6 is actually the
25 reason that the Milken Institute initially became interested
26 in hiring me. This shows the relationship between the
27 volume of takeovers of Fortune 500 firms and the use of

1 high-yield securities. The first use of high-yield
2 securities occurred in about 1983. Then, in 1986, the
3 Federal Reserve Bank changed the margin requirements which
4 basically limited the use of high-yield financing for
5 takeovers. And then in 1989, the tax code was changed to
6 take away the interest deduction for people issuing high-
7 yield securities. That made it very costly to use debt
8 financing for M&A.

9 In a Harvard Business Review article, John Pound
10 calls the 1980s activity of this type against financing,
11 "broad political persecution aimed at the debt markets."
12 Popular suspicion of financiers was not new to that decade.
13 In the 1930s, not only the banking laws, but also the
14 bankruptcy and reorganization laws were changed in order to
15 slow down the merger and acquisition activity of financial
16 firms.

17 Well, the consequence of the 1980's changes was
18 that the size of targets was dramatically affected. The
19 maximum target size shows the impact better than either the
20 average or the median. The top line in the slide on the
21 bottom of page 6 of my handout is the maximum target size,
22 and the lower line is the average. Here you can see quite
23 clearly where, again, the vertical lines show the 1983 first
24 use of high-yield securities, the Federal Reserve Rule in
25 1986 and then the tax code changes in 1989.

26 So, what we have here is something that suggests
27 that the size of targets of takeovers is a function of the

1 availability of financing. There was a study done in the
2 U.K. that showed also that the volume of merger activity is
3 a function of financing availability. Now, that particular
4 study has not been duplicated in the United States, but, by
5 and large, when the funding is available, M&A takes place;
6 when the financing is not available, it doesn't take place.
7 To me, this actually makes more sense than trying to figure
8 out other reasons why merger and acquisition activity rises
9 and falls in what some people have attempted to call
10 "waves."

11 State laws have also had significant changes in
12 different time periods, as shown in the slide on the top of
13 page 7 of my handout. In 1982 there was a Supreme Court
14 case for CTS vs. Dynamic that basically said that the states
15 could not regulate mergers and acquisitions. That was
16 reversed in 1987, at which point there was just a cavalcade
17 of anti-takeover laws in the states, Delaware passing theirs
18 in 1989, Pennsylvania in 1990. These actions helped choke
19 off the volume of takeover activity. The actions in the
20 states especially affected what we call "hostile takeovers"
21 -- those where the target resists the takeover. Again, this
22 was not the first time that this happened. In the 1910s and
23 1920s there were also broad reforms in state laws to try to
24 prevent takeovers.

25 The slide on the bottom of page 7 of my handout
26 shows these changes in takeover moods across time. I've
27 actually used three different definitions here for

1 "hostile." The resistance to the first bid is what actually
2 comes from Vishny's work, which is probably one of the best
3 known studies done on the mood of takeovers. I also looked
4 at resistance to the buyer's bid and to management changes
5 as ways to define "hostile."

6 In 1990, there was a case decided in the Delaware
7 courts that virtually requires the managers of the target
8 firm to get a second bid. In other words, if they don't
9 reject the first offer they receive, they can be sued by the
10 shareholders for not getting the best offer for the firm.
11 As usual, there are unintended consequences to this type of
12 regulatory change. In this case, it was to significantly
13 drop the share prices of all the companies incorporated in
14 the State of Pennsylvania.

15 The states weren't alone in their antitrust
16 activity. The slide on the top of page 8 of my handout
17 shows, across time, how many bills introduced into Congress
18 mentioned "takeover." As you see, during the 1980s there
19 was a lot of activity in Congress. A lot of it had to do
20 with political pressure put on by that 66.7 percent of
21 employees that Bob mentioned who were affected one way or
22 another after the merger. This also had unintended
23 consequences. The slide on the bottom of page 8 of my
24 handout shows the types of buyers, either domestic
25 corporations, foreign firms, financial buyers or employees
26 in this corporate control activity. You can see there are
27 significant differences before and after the anti-takeover

1 laws.

2 For instance, the buyers were foreign corporations
3 in 12 percent of the takeovers before 1990. After 1990,
4 after those types of anti-takeover activities were going
5 through Congress and the states, 31 percent of these
6 takeovers were performed by foreign corporations. There's
7 some speculation that foreign corporations are able to take
8 advantage of distortions created by regulatory activity.

9 So, what happens across time is we have these
10 regulatory interruptions, we have disruptions in the
11 financial markets, et cetera, that affect who can be taken
12 over, when and for how much. As seen in the slide on the
13 top of page 9 of my handout, in the pre-regulatory period,
14 per year, per merger, in the sample that I used, \$46 million
15 were saved annually through cost reductions. Afterwards,
16 \$15 million. And this is the unintended consequence of
17 regulatory interference in these markets.

18 Now, what are the good reasons why mergers occur?
19 Why is it that we want to encourage them? The slides on the
20 bottom of page 9 and the top of page 10 of my handout show
21 some of the structural reasons. This is based on work by
22 Fred Weston and also John Pound. Large technological
23 changes impact the way that we do business. In the 1900s
24 and 1920s, between the transcontinental railroad and the
25 advances in automobile transportation, we developed true
26 national markets in the United States. Firms were able to
27 grow beyond their region by being able to take advantage of

1 broader markets.

2 I'd suggest that we probably achieved some sort of
3 fulcrum point in the 1970s, sufficient globalization to
4 begin to generate an impact on a world economy from strong
5 change forces. The cost of transportation and communication
6 fell sufficiently by that point to create real international
7 markets. I think that you can draw a parallel to the forces
8 in the 1970s that created international markets with those
9 of the early 1900s that produced national markets.

10 In my own sample, I see significant changes in the
11 different time periods as to the sectors that the firms were
12 taken from. This is certainly true before and after 1990,
13 as shown in the slide on the bottom of page 10 of my
14 handout. This shows the percent taken over before and after
15 1990 of the targets taken from individual sectors. Now,
16 certainly before 1990 there just generally was more activity
17 overall. What's interesting to note is that the technology
18 sector is about half and half, whereas the overall split is
19 about 60/40. And so, although the energy industry, for
20 instance, had more targets in the earlier period than in the
21 later period, technology was more spread around.

22 So, for those of you who have to look at mergers
23 and acquisitions and decide which ones are good and which
24 ones aren't, what I would like to suggest to you is that you
25 try to identify where the industrial restructuring changes
26 are coming from. In the slide on the top of page 11 of my
27 handout, I suggest four ideas that will lead you to look at

1 the right industries at the right time.

2 The first is, some industries are dependent upon
3 population growth -- food, for instance. Population grows
4 at less than 1 percent. What company can survive if they
5 grow at 1 percent a year? All the capital markets and all
6 of the investors are going to require a higher growth rate
7 and so that industry is going to require mergers to be able
8 to get that type of growth.

9 Another idea to watch is product life cycles - in
10 the technology sector, in particular. Products turn over so
11 quickly that if firms can't build new products themselves,
12 they are going to have to purchase other firms to be able to
13 keep up with the technological changes.

14 Customer preferences is next. You need to be
15 looking at demographic shifts and also changes in
16 environmental and ecological impacts where people will be
17 attuned to buying certain types of products because they are
18 good for the environment.

19 And then the last, of course, is the post-
20 exuberance excess capacity, which can occur in virtually any
21 industry. Mergers are a way to reallocate resources to more
22 efficient uses.

23 Thank you.

24 MR. PAUTLER: Thanks, Susanne. We'll now hear
25 from Steve Kaplan from the University of Chicago Graduate
26 School of Business, and he'll discuss the finance literature
27 and the results that have appeared there.

1 MR. KAPLAN: Great. Thanks, Paul.

2 As shown in the slide on the bottom of p.1 of my
3 handout, I'm going to begin by presenting some simple
4 criteria and theory about how one can evaluate merger
5 success. Then I'm going to go through the empirical
6 evidence in the finance literature. This begins with stock
7 returns which we haven't heard anything about yet. Then I
8 will discuss some of the accounting-based literature that
9 Susanne, Bob and Mike talked about. Next, I'll talk a
10 little bit about clinical studies, one of which I have done.
11 Finally, I'll talk about what the sources of gains and
12 losses are and a little bit about micro-factors that drive
13 merger success.

14 So, how can you evaluate merger success? There
15 are several different ways. These are shown in the slides
16 on page 2 of my handout. The first way -- the finance one -
17 - is the stock price change at the announcement. This
18 attempts to measure the market's expectations of the change
19 in value from the merger.

20 One key point that is often lost when business people
21 and consultants talk about merger gains is that the
22 appropriate measure of merge success for shareholders and
23 the economy is the combined or total change in value of the
24 bidder and the target.

25 It is not whether the buyer got a good deal. A lot is
26 written about mergers failing because the bidders overpay.
27 Bidder overpayment is arguably irrelevant for economic

1 policy and for shareholders as a whole. What shareholders
2 as a group and policy analysts should care about is whether
3 the total value goes up.

4 To see this, take two companies, B and T, that are
5 worth \$10 billion each. If B buys T, B will be able to get
6 \$2 billion in synergies. B indeed decides to buy T, but
7 agrees to pay \$15 billion. Upon announcement, T's value
8 will increase by \$5 billion (or 50%) from \$10 billion to \$15
9 billion. Upon announcement, B's value will decline by \$3
10 billion from \$10 billion to \$7 billion. Why the \$3 billion
11 decline? B is paying \$15 billion for assets that will be
12 worth \$12 billion (\$10 billion + \$2 billion in synergies).

13 From the perspective of B's shareholders, B's
14 executives, and B's consultants, B has made a bad
15 acquisition, destroying \$3 billion. However, from the
16 perspective of all shareholders, this is a very good
17 acquisition. The combined value of A and B has increased
18 from \$20 billion (\$10 + \$10) to \$22 billion (\$7 + \$15).

19 The implicit assumptions in looking at the stock price
20 changes at the acquisition announcement are that (1) the
21 market is well-informed on average and (2) the only
22 information released is information about the merger.

23 Other finance studies look at the stock price change
24 over the longer run. The implicit assumptions in these
25 studies are that (1) the merger is important enough to drive
26 the stock price, and, again, (2) no other information is
27 released.

1 The accounting-based studies look at changes in
2 accounting-based performance at the company level over the
3 longer run. This involves looking at changes in some
4 measure of earnings or margins. The implicit assumptions
5 here, again, are that the merger is important enough to
6 drive what you're seeing and that no other factors are
7 important on average.

8 Some other accounting-based studies consider changes in
9 productivity at the plant level over the longer run. This
10 is what Bob talked about. These studies measures the
11 outcome of the merger at the plant level so the implicit
12 assumption is that the total productivity change of the
13 merger is largely determined by productivity changes at the
14 plant level. That may or may not be true.

15 There are some studies that consider whether the
16 acquisition was subsequently divested. Mike did that, I've
17 done that. This is interesting, but it is hard to evaluate
18 the non-divestitures.

19 The last way to evaluate mergers and acquisitions is to
20 measure the actual or expected present value, depending on
21 whether you're looking at the merger from an ex ante or ex
22 post perspective, by looking at the actual or expected
23 changes in cash flows.

24 Looking ex ante, you're looking at all the expected
25 changes in cash flows due to the merger, discounting them in
26 some way, and coming up with a value. If you're looking
27 after the fact, you would go three or five years after the

1 merger and look at all the changes in cash flows that
2 actually happened and attempt to come up with a value that
3 way. The implicit assumptions here are that expected equals
4 actual, if you're doing it ex ante. And if you're doing it
5 ex post, the assumption that you can actually measure actual
6 -- which is easier said than done.

7 There's one additional implicit assumption - the merger
8 effects are exogenous and they don't have an effect on non-
9 merging companies. This was probably particularly relevant
10 in the '80s where mergers and hostile takeovers of
11 particular companies arguably had large impacts on the
12 behavior of companies that weren't taken over.

13 So, what can we take away from all these different
14 methodologies? As seen in the slide on the top of p. 3 of
15 my handout, all of these measures are problematic in some
16 way. They all rely on assumptions. All, however, are
17 potentially informative, which is why we look at them. I
18 have a preference for announcement returns as the most
19 informative about expected values. I'd prefer measures of
20 actual cash flow changes from mergers as an ex post measure
21 of success (with the caveat those changes are very hard to
22 calculate).

23 Now, a little bit more theory, and then I'll get
24 to the results. When you measure the change in stock value
25 at the announcement, what you actually measure is the change
26 in the value of the acquirer, (which, as seen in the slide
27 on the bottom of page 3 of my handout is) A^A minus A^O , plus

1 the change in the value of the target, T^A minus T^O . (All of
2 these are market values.)

3 Now, this can be decomposed into A^A minus A^N (the
4 value of the acquirer afterward minus the value of the
5 acquirer once you have new information about the acquirer
6 that comes with the bid) plus T^A minus T^N (the value of the
7 target after the acquisition minus the value of the target
8 once you have the information in the bid about the target)
9 plus A^N minus A^O (the value of the new information about the
10 acquirer) and T^N minus T^O (the value of the new information
11 about the target).

$$\begin{aligned}
 12 \text{ Change in Value} &= (A^A - A^O) + (T^A - T^O) \\
 13 &= [(A^A - A^N) + (T^A - T^N)] + [(A^N - A^O) + (T^N - T^O)] \\
 14 &= [\text{Total synergies}] + [\text{New information}]
 \end{aligned}$$

15 The short description of this equation is that the
16 announcement returns contain an estimate of the total
17 synergies and any new information revealed by the bid about
18 the acquirer and the target. As a result, any particular
19 merger announcement does not necessarily just pick up the
20 synergies.

21 With this in mind, let's go to the empirical work.
22 First, let's look at a summary of the finance literature, as
23 shown in the slide on the top of page 4 of my handout. The
24 best paper of which I am aware is by Andrade, Mitchell and
25 Stafford in the Spring 2001 Journal of Economic
26 Perspectives. They look at all acquirers and targets that
27 were in the merger database of the University of Chicago

1 Research and Security Prices database over a 25-year period.
2

3 As shown in the slide on the bottom of page 4 of my
4 handout, they first look at a three-day period around the
5 announcement. They find that the combined returns over that
6 period are economically and statistically significant and
7 positive. The combined values of the acquirer and target
8 increase by 2% of the total initial value of the acquirer
9 and target. This is equivalent to an increase that is 10%
10 of the initial value of the target alone. This result is
11 consistent across all three decades, the '70s, the '80s and
12 the '90s.

13 The returns to the targets are clearly positive. The
14 returns to acquirers are slightly negative, but not
15 statistically different from zero. The combined returns are
16 positive. If one were to judge merger success only by the
17 acquirer return, one would conclude mistakenly that mergers
18 did not create value on average.

19 If you use a period that's a little longer - 20 days
20 before the announcement until the merger closes - the
21 combined returns are positive, but no longer statistically
22 significant. Again, they are roughly 2 percent of the
23 combined value, but because of the extra time, you get more
24 noise. And again, the returns to targets are positive; the
25 returns to acquirers, slightly negative, but not
26 significant. The table from their paper appears in the
27 slide on the top of page 5 of my handout.

1 Now, turning to the slide on the bottom of page 5 of my
2 handout, recall that acquisitions reveal information about
3 the acquirer and the target that may change expectations.
4 This is, as I said before, clearly relevant for stock
5 performance studies. It's also potentially relevant for the
6 accounting-based studies.

7 When or how is information about the acquirer likely to
8 be in an acquisition? Theoretically and commonsensically,
9 an acquirer is more likely to use its stock to pay for an
10 acquisition when the acquirer believes its stock is
11 overvalued or fully valued. In practice, one might
12 interpret an acquirer as believing its stock is overvalued
13 when it says that it plans to use its stock as currency.
14 Conversely, the acquirer is less likely to use equity when
15 it believes its stock is undervalued.

16 The point of this discussion is that the revision in
17 the underlying value of the acquirer - A^N minus A^0 - is
18 probably negative when an acquirer uses equity to finance an
19 acquisition. The measured combined returns in equity-
20 financed acquisitions include $A^N - A^0$, and, therefore,
21 likely underestimate the value of the acquisition. Because
22 there is likely to be less new information in cash-financed
23 acquisitions, the combined returns to those acquisitions are
24 arguably a better measure of the average value of
25 acquisition synergies.

26 To account for the informational differences in cash-
27 and equity-financed acquisitions, most studies look at those

1 two types of acquisitions separately. The slide on the top
2 of page 6 of my handout (again taken from Andrade et al.)
3 shows that acquisitions funded by at least some stock have
4 combined returns that are essentially zero. Acquisitions
5 funded without stock have positive combined returns.

6 I'm sure some people - including some on this panel -
7 will question whether announcement returns are meaningful.
8 It is true that there is noise or measurement error in the
9 announcement returns. Going back to my earlier point, the
10 information released by the acquisition announcement is not
11 solely about the value of acquisition itself.

12 It is important to stress, however, that if you look at
13 the correlation of announcement returns with what actually
14 happens in a large sample of acquisitions (see Kaplan and
15 Weisbach (1992) or Mitchell and Lehn (1990)), you actually
16 find a positive and significant correlation. It's not
17 perfect. The R-squared is not anywhere near one. But there
18 is a positive and significant correlation suggesting that
19 announcement returns are providing useful information about
20 merger success.

21 To summarize, as shown in the slide on the top of p. 7
22 of my handout, the bottom line of event studies is that
23 stockholders view acquisitions as creating value on average.
24 The combined returns are positive, particularly for non-
25 stock mergers. Announcement returns are predictive of
26 subsequent outcomes. The event studies are not very helpful
27 regarding the source of value change and the determinants of

1 success.

2 Longer run returns are shown in the slide on the bottom
3 of page 7 of my handout. These measure the returns to
4 acquirers for several years after the acquisition. The
5 bottom line from these results is that the value-weighted
6 post-acquisition returns to acquirers are indistinguishable
7 from zero. These represent the returns to those
8 acquisitions that are most likely to receive regulatory
9 scrutiny. Longer run returns to smaller acquirers - which
10 drive the equal-weighted return results - appear to be
11 negative. As with the short-term event studies, there is
12 some difference between stock and non-stock acquisitions.
13 Post-acquisition returns are greater for acquisitions that
14 do not use common stock. Also like the short-term event
15 studies, these analyses are not very helpful regarding the
16 source of gains or the determinants of success.

17 Next, we come to accounting-based studies. These
18 studies use accounting-based measures of performance, such
19 as operating margins - as Susanne and Mike did - and total
20 factor productivity - as Bob did. As shown in the slide on
21 the bottom of page 8 of my handout, the results from
22 accounting-based studies are all over the map.

23 Andrade, Mitchell, Stafford (2001) and Healy, Palepu,
24 Ruback (1990) claim to find positive increases in operating
25 margins or operating performance after an acquisition.
26 However, when one looks closely at the results, they are of
27 very modest economic significance. I would interpret their

1 results as not being powerful enough to find any meaningful
2 change on average. Maksimovic and Phillips (2001) and
3 Schoar (2002) use the LRD, Longitudinal Research Database,
4 data. The conclusions in the first paper are neutral to
5 positive while the conclusions in the second paper are
6 neutral to negative. As is well known, Ravenscraft and
7 Scherer (1987) find negative results although they largely
8 study mergers of the 1960s and 1970s.

9 So, the bottom line of the accounting studies is that
10 there is no clear overall relation between acquisitions and
11 subsequent accounting or productivity performance. It is
12 something of a puzzle in relation to the event study
13 results. The likely explanation is that the accounting data
14 are too noisy to isolate the effects of the acquisition.

15 Clinical studies are referenced in the slide on the top
16 of page 9 of my handout. In my paper with Mitchell and
17 Wruck, we calculate the annual cash flows and the value at
18 divestiture of an acquisition. We then compare the
19 discounted value of the cash flows and divestiture to the
20 pre-merger value. This provides a blueprint for doing this
21 type of calculation. The analysis for that particular case
22 also comes up with a different answer than the accounting
23 study analysis consistent with a great deal of noise in the
24 accounting study approach.

25 Determinants of gains and losses are shown in the slide
26 on the bottom of page 9 of my handout. The best paper along
27 these lines is the one by Houston, James and Ryngaert

1 (2001). They study 41 large bank mergers. They compare the
2 announcement returns of the mergers to the cost savings and
3 revenue increases projected by the banks -- the acquirers -
4 at the announcement of the acquisition. They find that the
5 announcement returns are significantly related to the
6 projected cost savings, but not related to the projected
7 revenue increases. (The revenue result suggests no evidence
8 of market power.) In other papers, there's some evidence
9 that related acquisitions do better than unrelated mergers,
10 although that is, again, somewhat mixed.

11 The last thing I'll talk about is the micro-
12 determinants of success, shown in the slide on the top of
13 page 10 of my handout. The large sample papers are not so
14 relevant here.

15 As Paul mentioned, I edited a book where the individual
16 chapters consist of clinical studies by different authors.
17 The results are sympathetic to what you've heard earlier.
18 Mergers seem to be driven by technological and regulatory
19 change. In successful mergers, the acquirer has a deep
20 understanding of the target, the organizational design and
21 structure is appropriate to the business, and the acquirer
22 introduces appropriate compensation and incentives.

23 Let me conclude by referring to the slide on the top of
24 page 11 of my handout. Do mergers create value on average?
25 My conclusion is yes. I rely on the announcement returns as
26 the critical evidence. They have been reliably positive
27 over the last 30 years.

1 The accounting-based studies are more mixed, but are
2 subject to more noise. The accounting-based studies also
3 would be less likely to pick up performance changes in
4 mergers driven by technological and regulatory change.
5 Mitchell and Mulherin (1996) find that a large fraction of
6 merger activity is driven by such change.

7 Who gains, who loses? Target shareholders gain,
8 acquirer shareholders neutral.

9 How do you evaluate merger success? As shown in the
10 slide on the bottom of page 11 of my handout, the best way,
11 if you can do it, is to use the discounted present value of
12 the changes in cash flows from the merger. Ex ante,
13 announcement period returns provide some help there. It
14 would be better to find the changes in expected cash flows,
15 which is what many of you in the room end up trying to do.

16 Finally, what drives success? Cost cutting rather than
17 top line growth is our best estimate of that. A deep
18 understanding of the business, appropriate organizational
19 design and structures, and appropriate compensation system
20 and incentives improve the likelihood of success.

21 Thank you very much.

22 MR. PAUTLER: Thank you very much, Steve. We've
23 heard four different views about the rates of return or
24 gains from mergers from the various members of the panel. I
25 wanted to give them an opportunity to do a little bit of
26 rebuttal if they want. I've heard differences of opinion,
27 and I thought other people might want to comment. We could

1 go in our original order, I suppose.

2 Professor Scherer, would you be interested in
3 commenting?

4 MR. SCHERER: I'll comment disinterestedly.

5 (LAUGHTER)

6 MR. SCHERER: I guess I'll take them in the order
7 presented. Bob McGuckin emphasized the steel and petroleum
8 industries, which indeed were subject to all sorts of
9 international and technological and regulatory forces. From
10 that I don't think follows the necessity of merger to cure
11 the problem. In many cases, the necessary responses to
12 these changes could have been made equally well within the
13 firm. It takes an additional stretch of logic to show that
14 because one is impacted by some forces implies that the only
15 way to react efficiently to those forces is to merge. I
16 just don't think that's true, having studied the petroleum
17 and steel industries at great length.

18 On the studies that were done at the Census Bureau
19 with the longitudinal database, I didn't hear the full story
20 here, and frankly, I haven't followed it, but my
21 recollection, as of about 10 years ago, when I last looked
22 at these studies, was that there was a difference, yes.
23 Yes, there were productivity increases following merger.
24 But when you then broke down the sample between merger and
25 re-merger -- that is to say, you take a line that's already
26 been acquired, and then it gets sold off to somebody else.
27 For such acquired and resold lines, Ravenscraft and I found

1 productivity increases, and we found profitability
2 increases. My recollection is that either the people using
3 LRD couldn't make that distinction, or when they tried to do
4 so, they found that the first-time mergers didn't have that
5 same effect.

6 I question whether Hart-Scott-Rodino made all that
7 much difference in the regulatory environment, because the
8 FTC's Pre-Merger Notification Program existed from 1967 or
9 1968 on, and except for the mandatory delay, the Hart-Scott-
10 Rodino didn't add much at first.

11 Now, with Susanne, I think there's a kind of a
12 fallacy of composition. The assumption is, you've got a
13 problem and then the further assumption is you need a merger
14 to solve it. Well, that doesn't necessarily follow.

15 An anecdote. I was at a cocktail party a few
16 years ago, and I met a guy and we got talking. What do you
17 do? That's what you always talk about at cocktail parties.
18 He said, well, my little start-up firm has invented a net
19 router switch that is 100 times more efficient than anything
20 Cisco has. Oh, great. Are you going to develop it? You're
21 damn right we're going to develop it and we're going to make
22 a lot of money with it. Well, a couple of years later, I
23 read that Cisco has paid him a billion dollars to acquire
24 this switch.

25 This guy would have put that switch on the market
26 with or without the merger. And so, how can you say that
27 merger facilitated the technology that this guy had already

1 developed?

2 Steve said something to the effect that some of
3 the problems were that mergers need to be important enough
4 to affect the results, and that nothing else is changing.
5 Well, the methodology used by Ravenscraft and me made the
6 merger important in every case because we looked at the
7 individual line of business data, where for the lines that
8 had acquisitions, half of the sales, on average, were
9 associated with acquired activities, so we could control for
10 other industrial and even firm-level events.

11 About reliance on event studies, maybe I should
12 just read the Pope on this. What is an efficient market?
13 Let me quote the late Fisher Black in his presidential
14 address to the American Finance Association.

15 "We might define an efficient market as one in
16 which price is within a factor of two of value; that is, the
17 price is more than half of value or less than twice value.
18 The factor of two is arbitrary, of course. Intuitively,
19 though, it seems reasonable to me, in the light of sources
20 of uncertainty about value and the strength of the forces
21 tending to cause price to return to value. By this
22 definition, I think almost all markets are efficient almost
23 all the time. Almost all means at least 90 percent."

24 Now I quote myself rather than Black. If Black's
25 estimate represents the 90 percent confidence bounds about a
26 log normal distribution, for example, then 16 percent of
27 corporate stocks would be undervalued or overvalued by 34

1 percent or more by any time. That's a lot of noise.

2 MR. PAUTLER: Thank you. Bob?

3 MR. MCGUCKIN: I guess I want to deal with the
4 question of necessity. I mean, I don't think it's necessary
5 to merge to achieve growth or downsizing. I think the issue
6 is what is the most efficient way to do things. Unless
7 there are competitive problems, one would think -- and
8 indeed, if there is competition, one would expect business
9 to take the most efficient way to achieve changes brought on
10 by regulation and new technologies. And so, I don't ask the
11 question necessary. I think there are substitute ways of
12 doing things.

13 We did examine situations where people were able
14 to do downsizing, for example, without a merger, and that
15 happens and that's one of the controls in the model. But
16 that is not necessarily the relevant issue.

17 The other thing that I just want to be clear on is
18 that this is not just about cost inefficiency and managerial
19 discipline, it's about synergies. The vast bulk of the
20 mergers we examined -- and 10 years ago, Frank Lichtenberg's
21 research was finishing up and we were just getting started
22 were synergistic. As I indicated on my slide, you can
23 follow the divested firms. You can make those issues. But
24 synergies come from buying the good performers and making
25 them better. Those are the most numerous and typically the
26 smaller acquisitions in the database. And so, while we
27 don't cover the entire economy -- I covered manufacturing,

1 and manufacturing is a substantial and important part of the
2 economy.

3 Now, the last comment I'll make will, as Steve
4 suggested, push my own stuff. I have a paper that I did
5 about 10 years ago, "The Use of Stock Market Returns in
6 Antitrust Analysis of Mergers." It's, unfortunately, not
7 well cited -- it's in the Review of Industrial Organization.
8 It's work that I did when I was with Rick Warren-Boulton at
9 the Department of Justice and another, unfortunately
10 deceased gentleman, Pete Walstein, and when we left, we
11 never really finished the work. Although there is a lot of
12 noise, the results that Steve mentioned in terms of a big
13 bang for the acquiring and target firms were observed.

14 But we went and tried to look at the rivals. And
15 the way we did it was to estimate the probability of the
16 merger taking place during the event window time period
17 after the merger was announced. The technique worked pretty
18 well, at least in seven of the eight cases. In one merger
19 we had another event intervene. And we got reasonable
20 results. They compared favorably with what you might get
21 from a regular antitrust analysis. But they were very
22 difficult to implement. So, it's not a tool that you could
23 use in all mergers. We had to go to over-the-counter
24 stocks. You have to get a competitor, a real rival, and
25 it's only that piece of the firm which is anti-competitive
26 that is relevant.

27 So, I think there is information in the stock

1 market, but I don't think it is practical to use it alone.
2 Indeed, I think all the approaches we have been discussing
3 have information content. Taken together, they give a
4 presumption that most mergers are pretty successful in the
5 sense of moving resources from lower to higher valued uses.
6 But, they are not necessarily successful for shareholders
7 of the acquiring firms, even though they generate a lot of
8 profits.

9 MR. PAUTLER: Thank you. Susanne?

10 MS. TRIMBATH: Well, Mike threw down the gauntlet,
11 so I guess I have to pick it up and run with it here.

12 I think the important thing to remember about that
13 example, Mike, (that the product could have been made
14 without a merger) is that even though the merger may not
15 have facilitated the production of the product, I guarantee
16 that the merger facilitated getting that product to the
17 marketplace. That's what the bigger firms can do that the
18 smaller firms can't.

19 Certainly, as Bob pointed out, I don't think
20 anyone is saying that mergers are the only way to get some
21 of these things done. What we are saying is that some of
22 these things get done with the merger in place.

23 There are a lot of things about mergers that we
24 don't know yet. For instance, the productivity gains that
25 Bob talked about, I'm wondering if he had controlled for the
26 fact that there was an overall increase in the rate at which
27 productivity in the United States grew during the same

1 period. So, how much of it was from mergers? I think a
2 lot. But individually, at the micro level, can we control
3 for that differentiation? That's hard to say.

4 By the way, Bob, I did read your paper. I didn't
5 cite it because I'm allergic to stock price studies. I
6 include stock prices as one of the potential measures of
7 both the characteristics of the targets and as a result of
8 the merger. Basically, what I found was that stock prices
9 are more reactive than predictive. In particular, if you
10 look at Pennsylvania after the passage of their anti-
11 takeover laws, which were absurdly strict, all companies
12 incorporated in the State of Pennsylvania had their stock
13 prices drop on that news. So, the prices were reacting to
14 the passage of the law and not to whether or not the
15 takeovers were efficient or inefficient or profitable or
16 anything else. So, I think that's an important point to
17 keep in mind.

18 Another thing that has not really been studied is
19 the characteristics of the buyers, and I think that before
20 we can say that we know why takeovers occur and whether or
21 not certain products will get to market with or without a
22 merger, I think we have to know a whole lot more about who
23 the buyers are and what their characteristics are.

24 We've spent way too much time looking at the
25 targets, and I think, generally, a lot had to do with the
26 stock price studies, because people were looking for stock
27 price bets. If you could identify the targets, you could

1 buy the portfolio, you could make a lot of money, because
2 target stock prices go up by 25 percent, et cetera. And I
3 think that that was very misleading.

4 I think it misled us as economists, as financial
5 analysts. It pointed us in the wrong direction. I think it
6 may also have misled management towards focusing far too
7 much on stock prices. I'm concerned about this. I think we
8 need to consider whether or not some of the most recent
9 problems that we had associated with stock prices and
10 corporate performance may have been the result of what
11 economists, in general, did by pushing stock prices as the
12 only way to measure firm performance.

13 And I'll stop there because I would definitely
14 like to take some questions from the audience.

15 MR. PAUTLER: Thank you. Steve?

16 MR. KAPLAN: A few comments.

17 I want to agree with what Bob and Susanne said about
18 mergers being better than the alternative.

19 Take the Cisco example. I teach a case on a switch
20 company that is trying to decide whether to do an IPO or
21 sell to Cisco. They decide to sell to Cisco. Two years
22 later, instead of having the \$200 million in revenues they
23 forecast they would have if they had done the IPO, the
24 division of Cisco that they have become has something closer
25 to \$1 billion in revenues. The point Susanne made that an
26 acquirer may have assets the target doesn't have was
27 certainly true in that particular example.

1 Of course, it's only an example and that's why you try
2 to look at the larger sample studies to find out what
3 happens on average. The event study evidence on acquisition
4 announcements isn't perfect, but it is positive on average
5 over many different time periods. There is no reason to
6 believe that the market has gotten it wrong for thirty years
7 and continues to get it wrong.

8 One last point concerns the LRD data. The most recent
9 studies that use that data (and use it comprehensively) find
10 mixed results. The paper by Schoar (2002) finds that target
11 plants in diversifying acquisitions become more productive.
12 However, existing plants of the acquirer become less
13 productive and the net effect is negative. The
14 interpretation of these results depends on what the acquirer
15 and target plants were expected to do before the
16 acquisition. On the one hand you could say the results are
17 positive because the target plants became more productive.
18 On the other hand, overall productivity went down.

19 MR. PAUTLER: Thank you, Steve. There are just a
20 couple of questions I'd like to ask and then I'm going to
21 throw it open to questions from the floor, which I hope
22 we'll have a little time for.

23 In hearing everyone discuss the returns to
24 mergers, we've got some differences of opinion there. But I
25 think, perhaps, everyone believes that the distribution of
26 returns is sufficiently wide. The FTC largely looks at
27 horizontal mergers, and we tend to only look in detail at

1 anywhere from 2 to 4 percent of those mergers - those are
2 the ones where we issue second requests for information.

3 Does the evidence from the large-scale studies
4 really help us analyze those individual cases or are we
5 going to have to think about the individual cases we're
6 looking at a little more like case studies? Because we're
7 looking at a very small piece of the merger activity that's
8 out there in the world when we sit in front of our 500 boxes
9 of documents, and our ability to go talk to darn near
10 everybody in the industry if we want to. We're really doing
11 case studies in a sense. I happen to find the large-scale
12 studies very interesting. I think they provide essential
13 background on mergers. But will they really help us a lot
14 in figuring out what we need to do on cases or do we have to
15 go to the case study work to really figure out the answers
16 we're looking for?

17 MS. TRIMBATH: I'll start on that for you, Paul,
18 because I think that the first thing you have to recognize
19 is that managers make mistakes. I always say, if managers
20 didn't make mistakes, we wouldn't need bankruptcy laws. But
21 they do and we do and that's why they're there because
22 sometimes managers make mistakes.

23 What the large-sample studies show you is that the
24 potential is there for these types of savings. My study,
25 and I think also Lichtenberg and some of the other work,
26 show that a lot of the savings is coming out of overhead. I
27 call it "cost-cutting for dummies" because almost any two

1 companies that get together can find cost savings just
2 basically from the overhead, without reducing output,
3 without reducing employment or anything else. But, do they
4 actually get there? That's where you're going to have to
5 look at the specific companies involved, as to whether or
6 not they have the capability.

7 In this case you almost become like venture
8 capital investment bankers having to evaluate the management
9 of the two companies as to whether or not that individual
10 firm has the capability of recognizing the savings
11 potential. But I think the large-sample studies show you,
12 by and large, where these types of efficiency gains can be
13 had, and then in the case level study, it's a question of
14 whether or not that specific company is capable of finding
15 it.

16 MR. PAUTLER: Anyone else care to take a shot at
17 that?

18 MR. SCHERER: Yeah. There's a tremendous spread
19 of outcomes. What you referred to as large-scale studies
20 means statistical studies, and what they reflect is the
21 average tendency. There's a lot of disagreement among us as
22 to what that average tendency is. I'm obviously, at one
23 extreme of the spectrum, not only from my own work, but from
24 the work of Dennis Mueller and many others, Len Weiss and so
25 forth. These are, to be sure, older mergers. I don't know
26 what's happened in the last 10 years. But at the time I was
27 looking at the situation, it seemed to me that the spread

1 was such that on average, mergers didn't yield much in the
2 way of superior efficiency.

3 Now, to deal with a merger in an antitrust
4 context, yes, indeed, you are doing a case study and the
5 evidence is very difficult to analyze, to get together and
6 to analyze. I've been involved in several of these myself.
7 The Youngstown Steel/Jones & Laughlin Steel one is
8 interesting because I've documented it both before and
9 after, and again, the efficiencies that were predicted
10 before turned out to be very, very different from the
11 efficiencies that I found in my follow-up case study
12 actually to have happened.

13 Where the so-called broad ranging or statistical
14 studies come in, I think, is in devising tiebreaker rules.
15 A company makes an efficiencies defense, the evidence is
16 ambiguous, you don't know. Is it going to lead to
17 efficiencies or not? That's where the tiebreaker rule comes
18 in. If, on average, you think that mergers yield
19 efficiencies, then the tiebreaker ought to say, allow the
20 merger, all else equal. If, on the other hand, on average,
21 mergers neither yield efficiency nor make things worse, then
22 the tiebreaker would say, let's let our skepticism overrule
23 the ambiguous evidence.

24 MR. MCGUCKIN: The reason I brought up fix-it-
25 first is I think it is important that you look at specific
26 mergers and they are case studies. You're not going to get
27 those from the broad studies, and I agree with Mike on that.

1 But I guess I would argue that, given my read of the
2 evidence, that the presumption is that mergers move
3 resources in useful ways and they're efficient.

4 We're never completely sure when we decide whether
5 a merger is anti-competitive. We're making guesses about
6 entry barriers and foreign competition and whether there's
7 power to raise price. So, that ought to at least look a
8 little bit toward the burden of proof and I think that
9 coincides with what Mike just said, except I would come at
10 the burden a little differently.

11 MR. PAUTLER: I'd like to get some questions from
12 the audience. Anyone? Alden?

13 MR. ABBOTT: Yes, one general question. Isn't the
14 relevant question really not on average are mergers
15 efficient, but would regulatory and legal changes that make
16 it more or less difficult to merge affect productivity or
17 efficiency in positive or negative ways?

18 Because even if one found, on average, there's no
19 real effect, that doesn't tell you the effect of the
20 existing ability to merge on the incentives of firms that
21 aren't merging to maintain productivity. It doesn't tell
22 you what would happen if merging somehow were made more
23 difficult because of, say, going to 1960s antitrust
24 standards or securities laws that made it more difficult to
25 merge. Isn't that a relevant set of questions to examine?

26 My name is Alden Abbott. I'm in the Bureau of
27 Competition at the FTC.

1 MR. KAPLAN: That's a very relevant and important
2 point. The best example of this is probably the hostile
3 takeovers in the '80s. The raiders, buyout firms, and
4 hostile bidders arguably had a large effect on corporate
5 management at companies that were not attacked. In many
6 cases, companies attempted to pre-empt hostile takeover bids
7 by implementing the same changes that raiders or hostile
8 acquirers would have brought.

9 MR. PAUTLER: Anyone else?

10 MS. TRIMBATH: I'll just make one comment. There
11 have been studies done that show that management performance
12 is more closely related to turnover during active corporate
13 control markets. So, it is important that we not limit the
14 ability of firms to take part in M&A.

15 What affects the level of activity is the
16 financing being available; a lot of that is controlled by
17 regulation; also as I shared earlier, the state anti-
18 takeover activity has an impact. But, clearly, the link
19 between management retention and firm performance breaks
20 down during periods when the potential for M&A activity is
21 reduced by some type of regulatory interference.

22 MR. PAUTLER: Anyone else? Dave?

23 MR. SCHEFFMAN: Yeah, there was certainly some
24 disagreement here amongst the researchers, but I suspect
25 there may not be as much disagreement on what we do. So,
26 I'll ask Steve the following question. I think you have a
27 different view than Mike about the overall average effect of

1 mergers. But let me tell you where we live. We're looking
2 at a typical merger which is, say, four-to-three in a
3 concentrated industry protected by entry barriers. As the
4 Chairman said, that's not enough for us to believe that we
5 have a problem. But, suppose we have some basis of concern,
6 customer complaints, documents and other sorts of things.
7 Yet the case is not a slam dunk -- not a clear case, as
8 efficiencies are not going to overcome a very strong case,
9 but one in which we have reason to believe there's a
10 problem.

11 Based in your assessment, is it your view that we
12 put our thumb on the scale for that case if we have an
13 efficiency story that's not very well documented or proved?
14 Or should we go the way Mike said, and err on the other side
15 assuming that in this situation the merger might actually be
16 anti-competitive?

17 MR. KAPLAN: Let me begin by saying that without
18 more details, it is really impossible to answer that
19 question. How large are the potential efficiencies? How
20 large are the potential anti-competitive effects?

21 That said, other things equal, the empirical evidence
22 with which I am familiar tends to favor the efficiency
23 effects rather than the anti-competitive effects. For
24 example, in the paper that studies the large bank mergers,
25 the results suggested that the market ignored the top line
26 growth estimates (which would presumably represent anti-
27 competitive gains), but, instead, focused on the cost

1 savings. The large sample evidence as well as the case
2 studies I have looked at also suggest that anti-competitive
3 effects are more difficult to find or obtain than efficiency
4 effects.

5 MR. PAUTLER: I think we had one more, perhaps,
6 mini-rebuttal from Professor Scherer.

7 MR. SCHERER: Well, I wanted to answer more on the
8 last question, although maybe I'll put a footnote on what
9 Steve said.

10 For the period that Ravenscraft and I studied,
11 which ended about 1975 or so, there were very few legal
12 barriers to merger except for the antitrust laws, which were
13 interpreted in a very tough way, much tougher than today,
14 against horizontal mergers and also against vertical
15 mergers. Now, that definitely had an impact on merger
16 activity. It biased merger activity in the direction of
17 conglomerate type mergers. And what Ravenscraft and I found
18 was that these were the mergers that most likely led to loss
19 of managerial control and inefficiency. So, there's a nexus
20 of causation that I think is important.

21 Now, what really surprised me, reading my book
22 over again after 15 years, was that the horizontals had
23 almost the same kind of degradation of baseline
24 profitability and cash flow as the conglomerates. That was
25 surprising to me. I've learned enough in 15 years that I
26 didn't think I'd find that. I thought I'd find something
27 else.

1 Why? Again, the antitrust laws had an impact
2 there, I think, because the antitrust laws forced any
3 horizontal mergers we've got in our sample to be so small
4 that they were going to be innocuous from the point of view
5 of enforcers. And our study showed the small guys who were
6 acquired had very high profitability. So, therefore, after
7 the merger, there tended to be a degradation of
8 profitability -- from superior levels to roughly normal
9 levels. So that, I think, is how policy and merger effects
10 interact.

11 Now, let me just say a thing about financial type
12 mergers and cost savings. I don't doubt for a moment that
13 they've yielded cost savings, but is service worse after
14 merger? I want to refer, again, to the survey results
15 reported by Business Week. It was on p. 10 of their August
16 6, 2001 issue.

17 Anderson Consulting conducted a survey in June,
18 2001 that compared customer dissatisfaction ratios involving
19 companies that merged within the last six months to those
20 that did merge within the last six months. And you find
21 systematically --cable companies, Internet service
22 providers, cellular phone companies, long distance
23 companies, local phone companies -- you find in all cases
24 more dissatisfaction with service for those companies that
25 have recently had mergers.

26 All I can say is, yes, I've lived it
27 experientially.

1 MR. PAUTLER: Thank you. We're just about out of
2 time. I'll take one more very quick question. Bill?

3 MR. KOLASKY: Bill Kolasky, Wilmer, Cutler and
4 Pickering. That last line I felt particularly amusing, if
5 not perhaps a little annoying. If you look at some of the
6 detailed case studies that have been done of some of those
7 mergers, particularly in the telco industry, you'll find
8 exactly the opposite of that.

9 AARP, which was an opponent of both the Bell
10 Atlantic/Nynex merger and the SBC/PacTel merger, did a
11 detailed retrospective study of the results of those mergers
12 and found, (a) that they delivered more in the way of cost
13 savings than the companies had promised, and (b) that they
14 resulted in significantly improved service for customers of
15 the acquired companies. So, I think you need to be very
16 careful before you look at a slide like that.

17 The second thing I question for Mike Scherer is,
18 isn't your book really more of an indictment of conglomerate
19 merger policy 25 years ago than it is a useful study of
20 horizontal mergers? Wouldn't you agree that our management
21 control systems are far more sophisticated, in part because
22 of computer technology and information technology, than they
23 were in the period 1965 to 1974?

24 And then the final question that I have is, one of
25 the things I found interesting about the panel is that we
26 were talking either at massive studies that were looking at
27 merger outcomes on average or case studies of individual

1 mergers. What I'd be interested in hearing about are
2 industry-wide studies. I think there was one reference to
3 bank mergers, which would be such a study. But, for
4 example, one area where we've seen a lot of merger activity
5 over the last 20 years has been those industries that have
6 been recently deregulated, and in almost every case,
7 deregulation was followed by a massive consolidation, a real
8 merger wave. A very good literature review by Cliff Winston
9 in the Journal of Economic Perspective found that those
10 industries' prices, not just costs, but prices came down on
11 average, from 35 percent in some industries to as much as 70
12 percent in other industries. I'd be curious if you're aware
13 of any studies that try to disaggregate the effects of
14 deregulation to show how much of those cost savings and
15 consumer-benefiting price reductions resulted from
16 consolidations and mergers? Thank you.

17 MR. SCHERER: I guess that was directed towards
18 me, and there were several sub-parts. The first thing,
19 haven't our control systems for conglomerates become much
20 more effective in recent years? The leading conglomerate,
21 in view of what I've seen in the news lately, is TYCO
22 International. I guess they had a pretty good control
23 system. They controlled all the profits into Mr.
24 Kozlowski's pocket.

25 Didn't the antitrust laws affect merger activity?
26 Yes, indeed, as I said in my previous answer, they did.
27 They biased it away from horizontals and to the extent that

1 there were horizontals, they involved relatively small
2 horizontals. The study by Ravenscraft and me and lots of
3 other studies indicate that it's the larger horizontals that
4 are more likely to yield efficiencies.

5 Now, this leads me to a point. I've been pushing
6 for an efficiencies defense since 1975. I think it's a good
7 thing. One of the reasons -- it's not the only reason I
8 think it's a good thing -- but one of the reasons I think
9 it's a good thing is that, like the prospect of hanging in a
10 fortnight, it wonderfully concentrates the mind. I've seen
11 an awful lot of mergers on which I've done case studies in
12 which the managers just didn't think about how they were
13 going to wrest efficiency from the subsequent post-merger
14 situation.

15 When you go into a merger unprepared, unthinking,
16 you're liable to have bad results. So, the very fact of a
17 merger efficiencies defense may wonderfully concentrate the
18 mind to get better results.

19 MR. KAPLAN: Let me take the industry question.
20 There's a paper by Mitchell and Mulherin (Journal of
21 Business 1996) that looks at how mergers concentrate in
22 particular industries. Their results (as well as those in
23 the Winston paper you mentioned) are strongly supportive of
24 your observation that regulatory or technological changes
25 affect merger activities.

26 MR. MCGUCKIN: Just one comment. I tried to
27 emphasize it earlier. All this work, whether you're dealing

1 with stock markets or you're dealing with a full firm or
2 you're dealing with pieces of a firm, you're dealing with
3 accounting or productivity measures, ensuring scientific
4 validity with controls is very difficult.

5 One of the things that I think we have to
6 recognize is that while you can get these correlations,
7 getting causation is tricky and controlling appropriately to
8 be sure you get the right effect when many things are
9 related is very difficult. So, you just shouldn't minimize
10 that and I think that comes through all our work. It's an
11 attempt to control and that's what you need to do. Broad
12 generalizations, which I made this morning, come after lots
13 of studies and reading.

14 But to nail it down, in particular, with respect
15 to Cliff Winston's work which you mention let me restate my
16 comment from earlier. When I showed you that Hart-Scott-
17 Rodino slide and said the increase in productivity after
18 1977 showed that the merger law change improved things, I
19 was very careful, I hope, to say I can't prove this.

20 MR. PAUTLER: I want to thank all the speakers for
21 Panel 1. We're going to now take a short break and I'd like
22 to reconvene at 11:25 if we can do that. Thank you very
23 much.

24 **(Whereupon, at 11:15 a.m., Panel 1 was concluded.)**

1 done a lot of important work in publications on business
2 strategy. He also contributes to this tremendous national
3 resource we have: the Harvard Business Case Study. Having
4 taught MBA students for many years, the case studies have
5 been an essential resource, and they have also been very
6 useful to us at the FTC. When we get a case in an industry,
7 we can look and see if there is a Harvard Business case on
8 it.

9 Pankaj has led the Business Strategy Program and
10 Competitive Analysis at Harvard Business School, and has
11 consulted with many, many companies.

12 Our second panelist today is Mike Shelton. Mike
13 Shelton is Associate Principle in McKinsey's Chicago office
14 and he's the leader of the McKinsey post-merger management
15 practice.

16 For those of you who don't know about M&A
17 consulting -- and I don't know nearly as much as these folks
18 do, but it used to be, back in the old days of business
19 consulting, around the time my former colleague, Bruce
20 Henderson founded Boston Consulting Group, that consultants
21 gave strategic advice to companies. In fact, it was that
22 strategic advice that led to many of the mergers that Mr.
23 Scherer analyzed during the '60s and '70s that didn't turn
24 out very well.

25 Where merger consulting has gone is to a greater
26 focus on implementation, on implementing the deal, and Mike
27 is certainly going to talk about that. He has 19 years of

1 consulting experience, and has been with McKinsey since
2 1998. So, he has very extensive experience in M&A
3 consulting.

4 The third panelist, Mark Sirower, is a corporate
5 development advisor with the Boston Consulting Group and a
6 global leader of BCG's M&A practice. He's also a Visiting
7 Professor at NYU's Stern School of Business. He's taught
8 M&A at the Wharton School at Penn. He has written some very
9 interesting books and articles on mergers and acquisitions.
10 He will conclude our panel and presentations, and then we
11 will have discussion amongst the panelists and questions
12 from the floor.

13 So, we'll begin with Pankaj.

14 MR. GHEMAWAT: Thank you, David. Well, good
15 morning and I appreciate this opportunity to talk to this
16 very distinguished group about mergers. Since it's just
17 after rather than before a break, I think it's reasonably
18 safe to mention that of all the speakers today, I probably
19 have the least to do with mergers of anybody on any of the
20 panels here. My sort of contact with mergers and the little
21 writing that I've done on mergers really stemmed from a
22 client that I had been involved with for a while, and in
23 1999, I found this company, which was generally pretty
24 analytical, generally very thoughtful about its investment
25 decisions, deciding to make a big leap and do a big cross
26 border merger. I was sufficiently staggered by the
27 reasoning involved to write a Harvard Business Review

1 article with the non-judgmental title, the Dubious Logic of
2 Global Mega Mergers, and I suspect that that's the reason
3 why I've been invited here today.

4 As shown in the slide on the bottom of the first
5 page of my handout, I'm going to be talking about things a
6 little bit more from the nitty gritty perspective that David
7 mentioned. The one thing that I should stress is that I'm
8 sort of more used to talking to audiences interested in
9 business policy than in public policy. So, while I will try
10 and reframe things appropriately as we go through the
11 various paces, I may not always have the mental agility
12 necessary to do that, and so, if you can sort of translate
13 appropriately, that would be useful as well.

14 In any case, my brief for the 15 minutes of fame,
15 or however one describes this that one has today, was to
16 cover a fairly broad territory and of the various things
17 that I talked about with David, these are things that I
18 figured I could at least touch on in passing in the course
19 of 15 minutes.

20 First question is a paradox or partial paradox of
21 why managers' assessment of the success of mergers generally
22 tends to be much more positive than their assessment of the
23 financial success of mergers.

24 Second, there's the issue flowing from the first
25 question of what exactly do managers mean by merger success?
26

27 Third, can we actually get a little bit beyond

1 simple advice to get the cash flows right, in terms of
2 thinking from an ex ante perspective of what's likely to
3 drive success versus failure?

4 And finally, David also expressed some interest in
5 having me talk very briefly about bases of value creation a
6 little bit different from what the FTC traditionally focuses
7 on; in particular, bases for value creation that go beyond
8 cost savings and just market power to jack up prices, and
9 I'll try and do that as well with a couple of examples. So,
10 that's the agenda.

11 To start off with measures of success, we do have
12 this partial paradox of why it is that when you ask managers
13 how well the mergers they've participated in have done, you
14 generally get positive reactions, and when you ask them
15 specifically about financial success, you get much more
16 muted reactions. Now, some of this is not much of a
17 paradox. If you go and ask somebody who's just been
18 responsible for investing a big chunk of his company's net
19 worth in a merger, it is relatively unlikely that they are
20 going to go out on a limb to stress the extent to which the
21 merger failed to accomplish their objectives.

22 But even if one discounts that particular
23 hypothesis, it does seem that there are some differences in
24 terms of how researchers have traditionally defined success
25 versus what business managers tend to think about when they
26 think about the extent to which a merger has succeeded or
27 failed.

1 So, this morning, earlier this morning, if we
2 think back to our first panel, much of the discussion really
3 focused on -- well, actually, there was less focus on stock
4 price performance than I had expected and a little bit more
5 discussion of accounting measures of profitability. But it
6 is worth sort of thinking about reasons that managers will
7 give you or reasons that you can infer if you talk to them
8 about why they undertook particular efforts or what they
9 regard as indicators of success in the efforts that they've
10 undertaken.

11 In addition to stock price performance and
12 accounting measures of profitability as measures of success,
13 the slide on the top of page 2 of my handout has a
14 miscellaneous list under the "others" category. This list
15 is by no means meant to be complete. It is more to give you
16 a flavor of the different kinds of considerations that
17 managers might bring to bear in assessing merger success.
18 Even if they aren't making their assessments on an entirely
19 self-serving basis, why might there be a bit of wobble
20 between how academic researchers look at the problem and
21 what managers might report?

22 First, under the other category is the idea that
23 there is the possibility of exploiting overvalued stock.
24 Now, of course, no manager that I've ever met has ever sort
25 of regarded his or her company's stock as overvalued, so
26 this is more traditionally framed as we have a strong
27 currency and we want to use the currency while it's strong

1 sort of argument. Functionally equivalent, I suspect, to
2 exploiting overvalued stock. But there might be some nuance
3 differentials there.

4 Notice that to the extent that one believes this,
5 this does have somewhat strong implications, and I think
6 Steve Kaplan alluded to these. This does have some
7 implications for the use of stock price performance studies
8 to try and infer, even over a three-year time period, how
9 well or how poorly a merger has done.

10 A second common kind of motivation and the one
11 that really stood out to me when I was looking at the merger
12 games that were on in a bunch of globalizing industries is
13 this idea of maintaining or improving market share position.
14 So, if you take, for instance, the sort of very elaborate
15 minuet that was going on in the worldwide aluminum industry
16 back in 1999, where first Alusuisse, Pechiney and Alcan
17 announced that they were going to combine in APA, and then
18 very quickly Alcoa announced that it was going to be buying
19 up Reynolds. If you talked to the people involved, it's a
20 little bit hard to resist the conviction that certainly the
21 desire to retain the position or build up the position of
22 the world's largest aluminum producer played as large a role
23 in these combinations or attempted combinations as did any
24 sort of quantification of cost savings, et cetera.

25 Third, and I think this sort of falls in the
26 category of something that we want to treat, perhaps, most
27 seriously of these other reasons, is the idea that you can't

1 really look at mergers as one-off transactions. In some
2 sense, to the extent that a merger should be or is part of a
3 carefully crafted strategy that cuts across multiple
4 domains, a manager might very well regard a specific
5 transaction as actually having been successful based largely
6 on the contribution that it makes towards the implementation
7 of that chosen strategy.

8 And then finally, there's achieving a strategic
9 transformation. People wait long times before they get to
10 be CEOs, and so, one can find lots of sort of interesting
11 examples of people stepping up to the plate and deciding
12 that for better or worse they're going to transform the
13 company and using their ability to actually do that as a
14 measure of merger success or failure.

15 This list could be added to, and as I said
16 earlier, should not be inferred to be complete. But it does
17 sort of suggest a couple of things. One is -- if we're
18 trying to understand merger motivations in particular, we
19 probably want to go beyond just the measures of performance
20 sanctified by research tradition and start thinking about
21 what some of the motivations are for the people who are
22 actually responsible for making these decisions, subject, of
23 course, to your concurrence, what these people say about why
24 they're engaging in some of these mergers.

25 I think the second point that's sort of worth
26 mentioning in this context is that while some of these
27 explanations listed under "others" certainly seem to make

1 sense from the perspective of a value maximizing or profit
2 maximizing private enterprise, there are others that at
3 their outer limits start to verge on, if not self-
4 indulgence, perhaps one could go so far as to say fantasy.
5 Therefore, it's useful to try and think, well, not just what
6 reasons do managers actually articulate when you ask them
7 why they're engaging in particular mergers, but whether it's
8 possible to devise some kind of framework for thinking about
9 whether these promised gains, whatever they happen to be,
10 are actually likely to be realized.

11 Since I have five minutes left and only about
12 three-quarters of my presentation left to go through, let me
13 try and speed things up.

14 Very simply, the traditional advice in terms of
15 sort of ex ante assessment of mergers is along the lines of
16 try and see if you can do the discounted cash flow analysis
17 properly. If that turns out to be positive, you should go
18 ahead, and if it turns out not to be positive, you should
19 not. In the field of strategy, we like to think that we've
20 sort of gone some distance trying to think about the
21 economic primitives that are the underlying drivers of the
22 cash flows that you should be plugging into your cash flow
23 models to figure out whether value is likely to be added or
24 not.

25 Very simply, when I work with companies or when I
26 try and teach my students about mergers, we spend a fair
27 amount of time actually trying to think about what the

1 different components of value from a firm's perspective
2 might be, and decomposing those into things that we think
3 business strategy has had something to say about. The slide
4 on the bottom of page 2 of my handout helps illustrate this.

5 I'm not going to explain the logic of this beyond
6 noting that value is the product, roughly speaking, of
7 volume and margins. If we decompose margins, at least one
8 particular way of doing it that has a certain amount of
9 precedent in strategic practice, as well as an internal
10 logic, is to think about how attractive an industry will be
11 on average - Mike Porter's work on industry attractiveness.
12 Then think about deviations from that average by trying to
13 think about whether a merger is, in fact, likely to improve
14 your relative cost position or your relative differentiation
15 position in ways that are likely to make your margins, as a
16 particular company in a particular industry, differ from the
17 average industry margins.

18 This is a very cunning device whose subtlety may
19 not be entirely apparent at first glance. The items listed
20 in the slide on the bottom of page 2 of my handout are all
21 helpfully alphabetized so that my students can remember to
22 think through factors A through G as they think about merger
23 assessment.

24 Rather than spend more time talking about the
25 subtlety of this, let me just sort of give you an example
26 using the slide on the top of page 3 of my handout. This is
27 a company that I spent a fair amount of time studying. In

1 response to a question that was raised earlier, it's
2 actually part of a study that I'm doing of mergers in the
3 cement industry overall. Cemex probably dramatizes, in a
4 cross border context admittedly, some of these potential
5 gains, in line with the template on the previous slide, that
6 it might be worth thinking about if one's really trying to
7 cast one's net broadly to figure out the potential for value
8 creation through a merger.

9 Accelerating growth, back in the late 1980s, Cemex
10 wasn't even the largest player in Latin America. If they
11 hadn't embarked on an aggressive program of mergers, they
12 would probably have stayed smaller than Votorantim, which
13 was the largest player in the America's at that point, and
14 which, since it ran out of space to grow in its domestic
15 market of Brazil, really engaged in an unprofitable strategy
16 of horizontal diversification as opposed to growing within
17 cement.

18 The important point here is that if you believe,
19 as I do, that Cemex has some important firm-specific
20 capabilities in terms of cost reduction within the cement
21 industry, and given their reluctance to add lots of new
22 capacity to markets they were entering, because they did not
23 quite have shutdown economics, mergers were, in some sense,
24 essential to trying to apply their cost reduction expertise
25 to a broader capacity base than just the capacity that they
26 controlled within Mexico.

27 Second, in terms of cost reductions, clear

1 examples of some cost reductions associated with reductions
2 in operating costs through post-merger integration, scale
3 economies and IT. One interesting feature of the cement
4 industry in general, though, and a reminder that our usual
5 assumption that cost savings are good, other kinds of things
6 not so good necessarily, is that the big cost savings that
7 the big cement players have actually gotten by acquiring
8 players in other countries really stem from taking advantage
9 of financial distress in local markets.

10 So, if you look at the Asian crisis, basically all
11 the cement majors paid about \$100 to \$110 per ton for a
12 capacity that was valued at typically between \$150 to \$200
13 per ton, and while that's probably good for the cement
14 majors, certainly when we're taking a global federalism kind
15 of perspective, it's not clear that that should be treated
16 as a significant source of value creation. That was really
17 just redistribution going on between the distressed sellers
18 in these local markets, and the buyers who happened to be
19 multi-market players, not quite as exposed to the regional
20 downturn as the people whose capacity they were buying up.

21 Example of differentiation, willingness to pay,
22 this is sort of mixed. You can think of some cases in which
23 some of what they were trying to do to raise willingness to
24 pay would probably fail an antitrust test of is this good.
25 So, Cemex operates the biggest trading network in the
26 industry, even though it's not the largest player. And as
27 far as one can tell, this trading network is used partly to

1 ensure that flows of cheap imports get diverted to markets
2 where Cemex does not have a major presence of its own to
3 defend. Good from Cemex's perspective, hard to sort of
4 argue that this is a very good thing from the perspective of
5 poor customers suffering in Cemex-dominated markets.

6 On the other hand, you may find this remarkable,
7 but within the cement industry, there's recently been a move
8 towards branding cement, and this is particularly important
9 in emerging markets. Before we dismiss this as somebody
10 just getting a little bit too carried away by their
11 marketing courses, it's sort of worth remembering that one
12 of the major problems in these markets is the adulteration
13 of cement, which frequently leads to collapses of buildings,
14 fatalities, et cetera. So one can see, in Cemex's brand-
15 building campaign, which again you presumably need some
16 firm-specific skills to be able to pull this off, they've
17 had a chance to apply this to markets outside Mexico, places
18 like the Philippines. They're starting to do this in India.
19 There's a potential for some significant consumer gains
20 associated with actually having quality assurance and a
21 product that seems less likely to simply have been diluted
22 with sand than the typical bag of cement that you might
23 purchase in an emerging market.

24 The big thing that seems to be going on here
25 overall is very much what you people really care about.
26 There is significant evidence of multi-market collusion in
27 this industry, and so, if one looks at EBIT margins, which

1 are the standard measure of performance here, and just
2 correlate those with the share of local market capacity held
3 by the top three global players, you end up with a R-square
4 of about 60 percent.

5 So, that's suggesting that, again, the story is
6 somewhat mixed. We can see some good things that are
7 associated with what's been going on around these mergers
8 and we can see some bad things that are associated with
9 these mergers.

10 I think forestalling risk is relatively obvious.
11 This is simply the idea that in a very cyclical industry
12 there are some advantages both in terms of exposure to
13 competitive attack and in terms of exposure to local country
14 risk associated with operating in multiple markets. If you
15 buy the point that cement players typically do not have
16 shutdown economics in new markets that they get into,
17 mergers presumably are the most obvious way of tapping these
18 kinds of risk reductions.

19 And finally, there are some examples of learning
20 benefits. So, Cemex, back in the early 1990s, acquired
21 Valenciana in Spain just before a big downturn hit the
22 Spanish market. They were forced to rummage around in
23 Valenciana's files to figure out if there was any way of
24 salvaging the solution. This is where they figured out that
25 it was feasible, in fact, to use information technology to
26 really achieve significant cost reductions in the Spanish
27 operations that subsequently have ended up flowing back into

1 their operations in Mexico and being applied to their
2 operations in other countries.

3 So, this is an atypical case because I suspect
4 that the number of different levers that Cemex has pulled to
5 actually tap gains from mergers are a little bit broader
6 than those available in the case of the typical combination,
7 and for the typical combination, one can talk about a whole
8 bunch of problems that arise that make the Cemex case a
9 little bit less representative. Typical combinations
10 usually don't manage to achieve an acceleration of growth
11 rates; often exaggerate cost savings; often miss out on the
12 diseconomies of scale, scope and complexity associated with
13 more complex product lines than simply cement; and don't
14 have quite the same ability to enhance willingness to pay,
15 et cetera.

16 I realize my time is up, so let me just sort of
17 talk you through one counter-example case and then wrap up.
18 I said the Cemex case is atypical. Just to give you a sense
19 of variation, let's compare Cemex with another merger that
20 I've spent some time looking at, Daimler/Chrysler. The
21 interesting thing about Daimler/Chrysler was that apparently
22 at the initial meetings between Shrimp, the CEO of Daimler,
23 and Eaton, who was the CEO of Chrysler, the early
24 discussions seemed to have been entirely focused on
25 achieving tax benefits or making sure that the potential of
26 tax benefits of the merger were not somehow dissipated away.

27

1 So, that's where they decided that the merger
2 would be a stock swap, that it would be a pooling of
3 interest type merger and that the entity would continue to
4 be incorporated in Germany to take advantage of German tax
5 laws, carry-forward, et cetera.

6 But remarkably enough, there actually does not
7 seem to have been any discussion at the level of these
8 different functional elements that I've talked about in
9 terms of where the savings were going to come from above and
10 beyond the tax economies, until at least a year or a year
11 and a half into the merger's process.

12 And also remarkably, when you actually quiz
13 Daimler-Benz executives about the strategic logic of the
14 merger, what you see over and over again, because I've seen
15 them quizzed about this in multiple fora, what you see is
16 the slide saying the world is getting more concentrated,
17 only four or five or six big auto players are going to
18 survive, and the merger was clearly essential for us to be
19 one of them.

20 I actually had a very lively session with Daimler-
21 Benz's top management where I pointed out that our own
22 concentration data on the auto industry, using a Herfindahl
23 Index so we could leverage some of Ray Vernon's old data,
24 indicated that the big problem in the auto industry has
25 actually been that concentration has declined more or less
26 continuously since the mid-1950s (as shown in the slide on
27 the top of page 5 of my handout), and therefore, if you

1 thought that you were going to get huge gains associated
2 with buying up a competitor, well, you have to put that
3 against the fact that concentration levels in the auto
4 industry worldwide are at levels that we hadn't seen for the
5 last 40 or 50 years, and that led to a big theological
6 dispute about, well, should we measure number of competitors
7 or should we make some attempt to weigh the number of
8 competitors by their market shares. I suspect that we
9 probably have more of a common understanding in this room on
10 what the right way of resolving that particular debate is.

11 The slide on the bottom of page 5 of my handout is
12 my last slide. So, I think in conclusion, I'd just sort of
13 like to stress four things. First is -- and this stood out
14 at the end of the previous panel as well -- we can talk
15 about averages, but it's also worth remembering that there
16 is enormous variation in outcomes, and digging deeply into
17 that variation typically requires more of a clinical or case
18 study or whatever else your preferred terminology might be,
19 in terms of approaches, so that there is some value to
20 supplementing large-sample analysis with detailed studies of
21 individual cases.

22 Second, I'd argue that a lot of the work that is
23 done, especially the large-sample work, takes a very
24 transactional focus on mergers and acquisitions, and
25 particularly when you look at serial acquirers like Cemex.
26 It's very, very hard to assess their strategy without really
27 considering in some depth both how their industry is

1 evolving and what their overall strategy is as opposed to
2 simply asking, well, did it make sense for Cemex to buy this
3 particular cement company.

4 Third, in terms of analysis of benefits and costs,
5 I do think that it's worth sort of thinking beyond the
6 traditional categories of cost savings and increased market
7 power to at least make sure that one's done one's due
8 diligence on some of the other categories of potential gains
9 that I talked about.

10 And lastly, it's sort of worth remembering that
11 practice can be improved greatly, which probably has some
12 implications for, as the FTC goes into the discovery process
13 or something else, this may have some implications for what
14 you should expect to find when you look at some companies.
15 Certainly, not all companies can be expected to have
16 analyzed these issues in quite the depth that would benefit
17 them and, perhaps, even benefit society as well.

18 Let me stop there. My apologies for running over.

19 MR. SCHEFFMAN: Okay. Next we have Mike Shelton
20 from McKinsey.

21 MR. SHELTON: Hello, everybody. As seen in slide
22 1 of my handout, I want to spend a little bit of time today
23 just talking, first, about some research that consulting
24 firms have done. What we've done is look over consulting
25 firms overall and just get an overall perspective for you of
26 some of the viewpoints.

27 Second, to focus on where the value is in these

1 deals, and then third, to bring to life just one example of
2 a success. And David asked me, the last time we had talked,
3 he said, there's no shortage of organizations that you can
4 pick about how they failed in a merger. So, it would be
5 good to see one that was really successful. So, that's what
6 I'll end on.

7 If you look at my experience, I've been involved
8 with over 50 mergers in terms of going through the
9 implementation of integrating the two organizations. So, I
10 do tend to come from the perspective of the deal's going to
11 happen, now what can you really do to make sure that we make
12 this successful. So, I'll try to bring some real tangible
13 issues as we talk about the values of a deal.

14 I've always felt and been told, over the last 10
15 years, you need to start every M&A, mergers and
16 acquisitions, presentation with a slide that shows an arrow
17 going up, just to reflect, I think, subliminally that M&A is
18 here to stay and that they're always growing. Now,
19 unfortunately, the last year and a half, you see, in slide 2
20 of my handout, this tail going the wrong way. But
21 nonetheless, if you look at 2001, and I know that 2002 is
22 even going a little bit down, but it's probably about equal
23 to the 1995, 1996 times, those years were the top year ever
24 before. So, while we have seen a flip down, there's still
25 just a tremendous amount of mergers going on.

26 If you look at different consulting firms and
27 businesses that have done research, generally overall you

1 see somewhere in the neighborhood of 60 to 75 percent of
2 mergers fail from the perspective of the studies that are
3 going on, and a lot of different organizations have done
4 studies. Slide 3 of my handout has just some of the
5 samples. But this is what you're seeing in the businesses
6 and in the research and in the newspapers.

7 If you look at them overall, what are these
8 studies saying? As shown in slide 4 of my handout, these
9 studies, overall, in terms of the failures, they're saying
10 about 30 percent of the failures are due to poor deals.
11 Basically, you just pay too much. These synergies were
12 unrealistic, the prices were too high. Seventy percent of
13 them, usually when you look back at these, they reflect back
14 at the implementation. Whether it is some of the softer
15 issues like the communications or the cultural differences
16 or if it's customer loss or if it's just poor implementation
17 going through the actual merger.

18 I'll go ahead and flip through some of the
19 different studies just to give you highlights of what we've
20 seen. First, about two years ago, McKinsey did a study and
21 this study really focused on performance and performance
22 ethic. As seen in slide 5 of my handout, the key finding in
23 this study is that 65 percent of the mergers failed. And
24 then the focus for companies that did the mergers well, one,
25 they were able to maintain the performance ethic of the
26 stronger company throughout the merger. So, in other words,
27 in most organizations, when you have two companies with two

1 performance ethics, one of them tends to lower the other,
2 and because of that, the overall organization tends to not
3 achieve as well as it did. The second major result was
4 being able to retain the key people.

5 KPMG did two studies, one in 1999 and one in 2001.
6 In their most recent study, referenced in slide 6 of my
7 handout, they indicated that 70 percent of mergers failed.
8 They did that based on shareholder value, really looking at
9 pre-deal and then to a year afterwards and trying to
10 compensate for the other "noise" that takes place during
11 that whole year. The results that they found there were
12 basically focused on how well the integration was managed.

13 But then if you look at their study from two years
14 prior to that, referenced in slide 7 of my handout, they
15 found that 83 percent of mergers failed. So, if you look at
16 KPMG's results, they're basically saying that mergers have
17 been improving even over the last couple of years. And what
18 they had shown as reasons for organizations that had been
19 successful, back in 1999, was really a much better job in
20 terms of evaluating the synergies, in terms of focus on due
21 diligence.

22 The organizations that did well, also, were able
23 to select a more comprehensive leadership team, management
24 team that was able to drive the organization forward, and
25 then finally they focused more on the cultural and
26 communication issues.

27 A.T. Kearney did a study in 2000. During that

1 study, they looked at a three-year period in terms of
2 shareholder value, and, again, trying to take out the noise
3 of everything else that was going on within these mergers.
4 That's a very difficult thing to do. As shown in slide 8 of
5 my handout, they found that 58 percent of the mergers had
6 failed. The main two issues that they found for
7 organizations that were successful were, one, in terms of
8 leadership issues, and two, that organizations that failed
9 had an over-emphasis in the cost early on, and because of
10 that, they lost opportunities in terms of growth.

11 Mercer Management Consulting was the only company
12 that actually showed in the 1990s that more mergers
13 succeeded than failed, and they had contrasted those to the
14 1980s, where they had shown that there was only a 37 percent
15 success rate. These findings are shown in slide 9 of my
16 handout. Again, in that particular study, they looked over
17 a three-year period. I won't go into the Coopers & Lybrand
18 study.

19 But if you look overall in terms of where the
20 value is, and the deals, we've talked about this mostly in
21 the morning in terms of whether or not it's the economies of
22 scale or the economies of scope. We've talked about
23 Daimler/Chrysler before in terms of market power and we even
24 mentioned about Cisco before in terms of access to R&D or to
25 products.

26 But, generally, in terms of the sources of value,
27 we see four major sources, whether it's the cost synergies

1 that you try to go after, the revenue synergies, looking to
2 improve the management or operational improvements. These
3 are shown in slides 11 and 12 of my handout.

4 In terms of the values and who benefits from this,
5 there are three major categories, shown in slide 12 of my
6 handout. First, there's the increase in shareholder worth.
7 When you look at shareholders, from all of the perspectives,
8 from the different studies that we showed within the
9 consulting firms, you'll see one thing different from some
10 of the comments that were made in the morning. In terms of
11 the overall perspective, it's always from the acquiring
12 companies because whether or not they're from the overall
13 economy's, the target company ended up with more value in
14 the organization. But obviously that's irrelevant to the
15 shareholders of the acquiring company. The acquiring
16 company is never going to go forward and do a merger just
17 because it's good for the shareholders of the target.

18 So, who overall can benefit from a deal? One,
19 obviously, the shareholders overall. Oftentimes, the
20 shareholders don't see the money because the value actually
21 goes back to the company, and so, it's reinvested into the
22 company in order for the organization to be able to succeed
23 and move forward long-term.

24 Also, there are three benefits that customers
25 oftentimes see, and I know that that's a particular interest
26 that the FTC has. One is price reductions. Second is
27 efficiencies that they are able to gain due to the mergers.

1 And then finally new opportunities, and the classic
2 indication of new opportunities was when Mattel bought
3 Fisher Price. Fisher Price had a certain understanding in
4 terms of hard plastics. Mattel had jungle gyms that were
5 not made of hard plastic. A whole new product emerged from
6 that of hard plastic jungle gyms that moved forward.

7 When an organization looks at the value,
8 basically, they look at four particular areas, as seen in
9 slide 13 of my handout. One that is oftentimes overlooked
10 is just ensuring that the business momentum is maintained.
11 Always when you look at the deal, the total synergies of the
12 deal are much less than, for example, in this case, the 2003
13 business goals that the organization has. Second, capturing
14 the near-term synergies in terms of the redundancies, the
15 economies of scale. Third, organizations that are
16 successful spend a tremendous amount of time focusing on the
17 unfreezing aspects in terms of the skills that can either be
18 shared between the two organizations or basically taking two
19 organizations and improving those to a level that wasn't
20 sustained before.

21 The classic example of that is Novartis, where you
22 had two really average pharmaceutical companies. The CEO
23 really moved the two organizations together saying, the
24 purpose of the merger was to use that as a catalyst event to
25 upstage and increase the performance of the combined
26 organization, and they were successful in doing that.

27 And then finally, oftentimes, the value comes from

1 a strategic change, in other words, a business being able to
2 go into an area that it would not have been able to do if it
3 wasn't for the merger.

4 So, in looking at overall, what do you need to do
5 or what do organizations, once they are going into a merger,
6 how can they be more successful in actually integrating the
7 two organizations? I won't go through all 10 of the items
8 mentioned in slide 14 of my handout because of time, but let
9 me pick out a couple of them.

10 One is in terms of making sure that you focus on
11 the business momentum. Again, with regard to any
12 integration that takes place, the key is not to focus on the
13 integration overall, but to pick out the areas where there's
14 real value in the deal and then make sure that your most
15 talented people are focused on those areas. Losing sight
16 of, in this case, your 2003 goals, can dramatically decrease
17 the success of the merger. The merger will suffer, even if
18 you capture all your synergies, if you lose some of your key
19 clients, if you lose some of your momentum.

20 An example is a large Fortune 500 paper company
21 that merged a couple of years ago. The CEO had indicated
22 the major failing that they had was losing their number one
23 client, and he said that was just clearly because of a lack
24 of focus because so many people were focused on the
25 integration. That's one of the key things that
26 organizations need to be focused on.

27 Second, in terms of number four here, the

1 unfreezing opportunities. Lots of organizations like
2 Novartis, that I had mentioned in the past, have really been
3 able to take advantage of the merger, not just because of
4 the natural synergies, but being able to use that as a
5 catalyst event to upstage your overall efficiencies or
6 performance within the organization.

7 Number five here, in terms of moving quickly,
8 organizations that tend to fail tend to not be able to make
9 their decisions quickly. So, put a management process in
10 place to ensure fast decision-making. Oftentimes we'll say,
11 come up with decisions that are 70 percent solutions that
12 are 100 percent executable. If we make the wrong decisions,
13 we'll turn around and fix them later, but we have to be able
14 to move quickly, because as soon as you announce the merger,
15 your competitors are going to be reacting in specific ways,
16 especially in terms of your people and your customers. So,
17 you have to be able to react fast.

18 One other one in terms of cultural change. Some
19 of the more practical ways we've seen organizations deal
20 with culture, the ones that are successful at it, identify
21 the cultural issues up-front and then focus specifically on
22 them. A classic example where organizations fail in terms
23 of culture is their performance ethic. Two very strong
24 organizations that manage their people or control their
25 people differently will have a very difficult time
26 integrating and will not be successful because they don't
27 take that into account.

1 And let me be very specific with that. If you
2 have an organization that focuses on operations in terms of
3 controlling their people, think about somebody like a
4 Microsoft. When they look at their organization, they'll
5 look at the operations and they'll be very specific and the
6 management will focus very hard on the operational goals, on
7 their business plans in terms of whether or not they're
8 going to be successful. Another organization focuses very
9 much on values. Where a third organization could focus on
10 finances, and in terms of finances, as long as you make your
11 numbers, we're not concerned about how you get that done.

12 So, how a company focuses on those controls
13 between those three specific areas, if they try to integrate
14 without compensating for that, we'll find that they're not
15 successful.

16 On the other hand, organizations incent their
17 people very differently. Some organizations incent because
18 they have the values, like a Southwest Airlines, we have the
19 values that people believe and want to work for our
20 organization versus some organizations that incent purely on
21 incentives, and others on the opportunities that they bring
22 for their employees.

23 Organizations that try to combine their two
24 companies, with regard to those three aspects, if they don't
25 take that into account, they're not going to be able to
26 integrate their different management processes and retain
27 their best people.

1 And I will end with just one success story, shown
2 in slide 15 of my handout. Very briefly, BP/Amoco ended up
3 with a market cap organization of over \$200 billion. They
4 were able to go into different areas that they had not been
5 able to go into before; for example, natural gas, going into
6 the Far East and becoming a stronger player in terms of some
7 of the best retail markets. And some of the specific things
8 they were able to accomplish during their merger, one was
9 they were able to cut 20 percent off of their cost base.
10 Very specifically with that, in the first 100 days, they
11 were able to reduce their headcount by 10,000 people, which
12 resulted in their stock price increasing over 11 percent.

13 Sir John Brown, the CEO, very much led the
14 integration and was very visible throughout it, and at the
15 end of the day within the first year, they achieved \$2
16 billion in cost savings, which was a year ahead of the
17 expectations that they had sent to the marketplace. So,
18 they were 12 months ahead in their initial synergy capture.

19 I'll turn things over to Mark.

20 MR. SCHEFFMAN: Okay, thanks, Mike.

21 MR. SCHEFFMAN: Mark?

22 MR. SIROWER: Good morning. Let me try that
23 again. I just got back from a couple of days in Cleveland,
24 that's where I grew up, and we say things like, is it cold
25 enough for you? It is quite cold in here.

26 (LAUGHTER)

27 MR. SIROWER: Good morning. Great. That's what I

1 like to hear. Well, thanks to Pankaj and Mike and Paul
2 Pautler for putting this program together. I thought I'd
3 start out with a couple of jokes. Well, maybe they're not
4 so funny, but they're quotes from CEOs at the time some
5 major deals were announced -- just to give my remarks a
6 little bit of context.

7 The first one is from Bernie Ebers. This is right
8 after the MCI board voted to accept the all-stock WorldCom
9 offer as opposed to the \$34 billion all-cash offer from GTE.
10 Some of you might remember this one. During the investor
11 presentation someone asked Bernie the following question: so
12 how much is this really going to cost? And Bernie
13 responded, not a red dime is needed, and if I ever needed
14 any money, my investment bankers are sitting two seats to
15 the left -- which was greeted by uproarious applause.

16 There's another here, this one is from Barry
17 Diller, and this, I think, says a lot about the lack of PMI,
18 post-merger integration, preparation that's often present
19 when mergers are announced. But this is what it sounds like
20 when a CEO answers questions from the press or from
21 analysts. I think it was Steve Lipin at the Wall Street
22 Journal who asked Barry Diller, then CEO of QVC, why he was
23 offering to pay a 33 percent premium for CBS and whether
24 there were any synergies. This bid for CBS came shortly
25 after QVC had lost its bid for Paramount to Viacom. Mr.
26 Lipin asked, why is QVC offering a 33 percent premium for
27 CBS? And Barry Diller said, there are some synergies here

1 for sure. I don't know where they are yet. To say that now
2 would be an idiot's game.

3 Now I'm sure Barry didn't mean it, but this is
4 what you never want to say to public markets. And I hope
5 that when I'm finished that I've sort of captured how
6 telling these quotes are and I've shown what regulators
7 ought to be looking for early on, to see if a company is
8 really prepared to deliver on what it is promising,
9 especially around that golden synergy promise.

10 I'm going to cover several things in my 20
11 minutes. I'm first going to sandwich Mike Shelton's review
12 of studies between a couple of my own. I don't have any
13 slides, but I've handed out my book, *The Synergy Trap*, and
14 some articles, so you should at least have more weight than
15 anyone else.

16 The first is a study from *The Synergy Trap*. That
17 study looked at acquirer shareholder returns from deals from
18 1978 through 1990 and then tracked them over time for four
19 years. And then, a recent study that we did at The Boston
20 Consulting Group that was published in *Business Week*
21 Magazine, the October 14th cover story, looked at 302 major
22 deals worth over \$500 million from mid-1995 through mid-
23 2001. And there are three levels of analysis and results in
24 these studies.

25 The first level is, how do these deals perform, on
26 average, for shareholders of the acquirer, and more
27 specifically, what's the split between winners and losers?

1 Well, in both studies, we found a significantly negative
2 mean return on announcement, and roughly the same 65 percent
3 negative return, 35 percent positive return split, in both
4 the Synergy Trap and the Business Week study. This is a
5 result that was actually found many times before, detailed
6 in an appendix in the Synergy Trap. That is, several prior
7 studies in the financial economics literature found this
8 same negative initial return for acquirers, with a 65/35
9 negative/positive split. And these findings are also
10 consistent with the later studies that Mike reviewed.

11 But let's go into these averages and de-average
12 them a bit. When I say 65/35 negative/positive, I'm
13 referring to the stock market reaction to deal
14 announcements. Given the reality that no one manages an on-
15 average deal, and Pankaj made a very good point that there's
16 so much variation around these averages, when we delve
17 inside the simple averages we find some very interesting
18 things. One of the things that we find, and Steve Kaplan
19 alluded to it earlier from one of his studies, is the
20 importance, the predictive power, of the initial stock
21 market reactions to deal announcements. This represents the
22 second level of analysis in my findings. And here's how we
23 investigated whether these initial investor reactions told
24 us something about the future.

25 In Synergy Trap and this most recent study
26 published in Business Week, we formed two portfolios of
27 companies based on investor reactions at the time of deal

1 announcements; one portfolio of those companies where
2 investors reacted positively initially and one portfolio of
3 companies whose investors reacted negatively. So we had a
4 positive reaction portfolio and a negative reaction
5 portfolio. And what we found is some pretty strong evidence
6 that investors understand the economics of deals, and the
7 chances of success, right from the beginning.

8 In our most recent study of 302 large deals, the
9 positive reaction portfolio had an average initial return of
10 about positive 5 percent; the negative portfolio about
11 negative 9 percent. And then we just tracked these
12 portfolios over time. And isn't it interesting that the
13 means of those two portfolios remain pretty much the same
14 over time. So, even at the end of a full year, the positive
15 portfolio return is still positive and the negative
16 portfolio return is still negative, and the mean one-year
17 total shareholder return on these portfolios is roughly the
18 same as the initial reaction returns. Investment bankers
19 hate to hear this kind of evidence because what do they tell
20 their acquirer clients when their stock price falls on the
21 announcement of a deal? Oh, it's just a short-term
22 reaction, it doesn't mean anything, we're in this for the
23 long term. Well, surprise, surprise.

24 What's even more interesting is what you find when
25 you actually get into the data a bit deeper, the third level
26 of analysis -- because we do know some of these companies
27 turn around from their initial reactions. Well, it turns

1 out that 70 percent of the negative reaction companies are
2 still negative a year later, and about 50 percent of the
3 positive reaction companies are still positive a year later.
4 So indeed some initial reactions get reversed but clearly
5 the majority of investor reactions are indicative of what
6 will be said about success or failure down the road,
7 especially given a negative reaction. Now, along this third
8 level of analysis, we'd certainly want to know the returns
9 to the majority of acquirers whose longer-term returns are
10 in the same directions as their initial reaction.

11 In other words, what about those companies whose
12 stocks react positively or negatively on their merger
13 announcements and then actually deliver, so to speak, on the
14 initial expectations of investors, thus confirming the
15 initial positive or negative expectations? And it turns out
16 that the positive portfolio winners, those companies that
17 start out positive, deliver on their promises, and then
18 maintain a positive return over the course of a year,
19 actually have a total shareholder return, industry-adjusted
20 a year later, of roughly 33 percent. Again, this is the
21 result from the most recent study of major transactions.

22 The negative portfolio losers, that is the 70
23 percent of companies that start out negative and confirm
24 those negative expectations a year later, have a total
25 shareholder return for that first year of a negative 25
26 percent. That means there's a 58 percent total shareholder
27 return difference between those companies that start out

1 positive and stay positive, deliver on expectations or at
2 least confirm expectations, and those companies that start
3 out negative and confirm those negative expectations.

4 What's the big implication of this? Well, it
5 seems like investors do a pretty good job of listening
6 carefully to what senior management teams tell them when
7 they bring deals to market. This gets me to why I wrote the
8 Synergy Trap several years ago. Two specific reasons. The
9 first one is what seems to be this gap between what
10 investors see and what company executives see. And I often
11 say it this way, geez, if investors can get it right, well,
12 shouldn't we expect companies' officers and directors to get
13 it right? So, what are the things that investors are
14 looking at that companies seem to miss? Well, we need to
15 understand what we, as consultants or as regulators, can
16 look for early on to get a sense of whether companies will
17 likely deliver on their promises.

18 The other reason I wrote Synergy Trap was I sort
19 of got tired of what I call the key success factor approach
20 to acquisitions. You so often hear, don't pay too much,
21 manage the cultures right, and have a strategy -- real
22 motherhood and apple pie stuff. And I turned it on its ear
23 a bit and I asked, well, what does it mean to have a
24 strategy? How do you even measure synergy so that we can
25 price it? Because if you can't measure synergy, then you
26 can't price it, and then you know it's a dead-on-arrival
27 deal or at least it's a value-destroying deal from the

1 beginning -- because you're paying the purchase price
2 upfront for something you can't define. And finally, is
3 there going to be an operating model in place that can
4 actually turn that business case or that strategy into real
5 value?

6 So, let me go through those three issues. Is
7 there a strategy? How do you measure the benefits? And
8 would there be an operating model in place? I'm going to
9 focus on the second and third issues.

10 I'm not going to say too much about the first one
11 because Pankaj did a nice job on that. But I always have
12 this overall rule of thumb when I'm looking at a potential
13 deal. Is there a strategy there? I'm always asking, is
14 there something that a company is going to do that's tough
15 for competitors to replicate? I don't care how innovative
16 something might be -- they might talk about great new
17 products, for example -- but if it's easy to copy, it's
18 unlikely to be worth much value, particularly on these
19 visionary deals about changing the industry landscape and
20 that sort of thing. It's often vision without strategy.
21 So, I'll leave strategy with that.

22 Now, the issue of measuring synergy is really
23 important for today. I'll take it first from the investor
24 perspective and then an FTC or regulatory perspective,
25 because I think from the investor perspective it's very
26 clear how you just have to measure synergy. It's a little
27 bit less clear from a regulatory perspective, and let me go

1 through this.

2 When I was an academic, even back as a doctoral
3 student for that matter, I was troubled by a lot of the
4 academic work on measuring changes in performance following
5 mergers, particularly in the management field where the
6 success of deals was measured simply by comparing post-
7 merger performance to pre-merger performance. I always
8 thought this made absolutely no sense from an investor
9 perspective because a lot of the so-called improvements,
10 beyond pre-deal performance, are already priced in the
11 shares of both the acquirer and the target. I thought, how
12 could you not look at the amount of performance that's
13 already priced, as the appropriate benchmark for measuring
14 post-merger performance. In other words, what were
15 investors already expecting these companies to do before
16 they were put together as a new enterprise?

17 And that led me to define synergy as operating
18 gains over stand-alone expectations, and that if you didn't
19 take into account those stand-alone expectations, you
20 basically got one big synergy trap. You'd get there post-
21 merger, you'd start getting some cost savings or revenue
22 gains and you'd say, well, geez, I'm still not making money
23 from an investor perspective -- my stock price is still
24 down. Well, that's because you paid for something that was
25 already priced into your shares, and worse, you paid a
26 premium -- more money than anybody else in the world thought
27 the target company shares were worth -- for gains that were

1 actually already priced by investors.

2 I published a paper with Steve O'Byrne in the
3 Journal of Applied Corporate Finance a few years back that
4 focused on this issue of post-merger benchmarking. We found
5 if you benchmark post-merger performance correctly, initial
6 market reactions are actually a very good predictor of the
7 actual operating gains over and above, or below, what was
8 already expected that will likely result from mergers. So,
9 I believe that from an investor perspective it's very
10 important to measure synergies as operating gains over
11 stand-alone expectations already priced.

12 But, from a regulatory perspective, where the
13 issue is measuring efficiencies, it's a little bit less
14 clear. For example, suppose you take the AOL/Time Warner
15 deal and you look at the pre-offer share price of AOL.
16 Well, there may be performance gains priced there that will
17 never happen, ever. And yet, there may be some efficiencies
18 in the deal, depending on the benchmark. The question is,
19 are the performance improvements that are priced there in
20 shares, a realistic view of the future without the merger?
21 From an investor perspective, you've got to consider them.
22 And when you buy another company, you're fixing the price of
23 that target company, and the embedded expectations, once you
24 pay for it. The target's price can't fluctuate once you buy
25 it. I mean, you're really promising these gains to your
26 investors. And the acquirer has generally been telling
27 investors that its own shares are undervalued, so acquirer

1 management has actually been promising those embedded
2 expectations as well.

3 But, I think, from the government's perspective,
4 you've got to come to terms with what the right benchmark
5 is. It's either going to be the combined current
6 performance of the acquirer and the target without future
7 expectations that is the appropriate benchmark -- and a
8 regulator asks, well, can the new company beat combined
9 current performance? Or you have to pick a benchmark that
10 has something to do with what those companies would look
11 like without doing the deal. And that's a little bit less
12 clear to me. From an investor perspective, it's very clear.
13 You look at the stock prices and see what performance is
14 already expected and then you frankly ask, can I beat it?
15 But from a regulatory perspective, that seems to be a huge
16 issue. Maybe we can talk about that in Q&A.

17 Which gets me to the third issue I said I'd talk
18 about here, which is the operating model that must be in
19 place. This, I think, is much more clear. Specifically,
20 what are the signals that you would look for from a
21 management team if you were a director or if you were
22 someone from the FTC interviewing management of a company on
23 whether they were prepared to really deliver on what they
24 were promising.

25 One of the articles that I've handed out is a
26 piece from Directors and Boards Magazine where we talk about
27 something we call the PMI Board Pack. For any major

1 integration effort there are generally four stages. First,
2 you have to set the direction, and that's what I'm going to
3 focus on next. Then you gather data and build a fact base
4 on how both companies operate. Then you make the decisions
5 on that fact base, and then you implement those decisions.
6 Whatever major integration effort you look at, you'll
7 generally find those four phases.

8 Now, let me talk about five specific pieces of
9 evidence of readiness that you could look for from a senior
10 management team to see if it has really set a direction that
11 will allow the company to deliver on promises. The first
12 one is a calendar and phasing of major activities over the
13 course of the integration effort. Is there some calendar
14 showing one or two months for gathering data, two months on
15 making decisions, et cetera? We need to see some sort of
16 tight calendar that indicates when key activities will be
17 completed and, down the road, when the board of directors is
18 going to revisit the performance of what they've approved.

19 Second, is something we call high-level shaping
20 decisions. Is it clear what the new senior management team
21 is going to be and what the key reporting relationships are
22 going to be? Are there any integration issues that are
23 going to be deliberately postponed or taken out of the
24 initial integration effort? Is it clear, as Mike said, what
25 are the major drivers of value on which large amounts of
26 attention will be focused? Presumably those factors drove
27 the deal in the first place. And, also, what is the new

1 organization structure and what are the new business units?

2 Let's take the AOL/Time Warner deal for a moment.
3 I believe very, very little of this was sorted out. When
4 the deal was announced, you had little idea what the new
5 organizational structure would be, what the new business
6 units would be, and that contrasts dramatically with a
7 merger like Pepsi and Quaker, an exceptionally well planned
8 large deal, which I'll close with.

9 The third component of readiness is a tailored
10 integration approach, where you're really setting
11 expectations for the organization during the integration
12 process. One of the things that, unfortunately, is a fact
13 of life in mergers and acquisitions is uncertainty. You
14 want to do some things early on to try to take out some of
15 that uncertainty, which we believe comes under the heading
16 of how we approach the integration. So, what's the tone?
17 Will it be managed as a merger or as an acquisition?
18 Obviously, well, as you might recall, this issue was one of
19 the big failures in the Daimler/Chrysler integration. How
20 fast is this going to move? There are different degrees of
21 speed, and senior management ought to understand what
22 different degrees of speed mean for the integration. Some
23 things can move more quickly than others. Finally, how will
24 decisions be made, who will be involved in those decisions,
25 and how and to whom will they communicate those decisions?
26 These are things that are perfectly realistic to have in
27 place, at least to set some broad guidelines and

1 expectations for the organization, before the deal is done.

2 And now, parts four and five are really where the
3 rubber meets the road in pre-merger integration planning.
4 So, number four is integration structure, teams, and
5 resourcing. Mike Shelton did a nice job of talking about
6 the need to preserve momentum, what I've called the
7 performance that was already priced in the shares of both
8 companies; you've just got to preserve that. And one of the
9 things critical to understand in post-merger integration is
10 that the PMI is actually a discrete structure. It's a
11 living, breathing structure that goes on separate from the
12 operation of the individual businesses.

13 And the senior management team, particularly in
14 large deals, has to have a view of what that structure is
15 going to look like. Who's going to be housed in that
16 structure? There's a picture of a typical structure, by the
17 way, in the PMI Board Pack article that's available to you.
18 This leads to teams and resourcing. So, who is going to sit
19 in the senior steering committee? What's the hub -- who's
20 going to run the hub and really manage the entire
21 integration effort? Approximately how many teams are we
22 talking about throughout this PMI structure? If you don't
23 see a view of that in the management team, you can bet
24 they're in no position to run the integration, because
25 that's where the work gets done. It's within that PMI
26 structure.

27 And one of the easiest sort of no-brainer

1 questions is just ask management, how many people from your
2 organization or the combined organization are going to be
3 involved in this effort? If it's a big deal, say above \$5
4 billion, they should have a pretty good view of this. Is it
5 1,000 people, 2,000 people, 5,000 people? Is it 10,000
6 people? If there's not a fairly clear view of just how many
7 people are going to be involved in this effort, you know
8 they're not going to hit the ground running.

9 Finally, number five in my list of five components
10 of readiness is the business plan, and here's where the
11 definition of synergy is crucial. When we talk about the
12 business plan that has to be in place before you do a post-
13 merger integration, we know there has to be clarity about
14 the base case, and the base case is essentially the combined
15 forward plan without synergies. Now, presumably, in a good
16 deal, the combined forward plan will discount back to the
17 combined pre-deal market value. When it doesn't, you know
18 you've got a big hurdle to deal with from the beginning,
19 particularly if you've paid a premium.

20 But, essentially, you need to see that the
21 management team has an idea of what was already promised to
22 investors and also to employees for that matter, because the
23 employees are going to have to deliver on this thing. And
24 believe me, they have a certain set of expectations
25 themselves.

26 So, is there a base case in place that allows a
27 new forward plan to be constructed? Then, any efficiencies

1 that management claims will result from the merger can be
2 overlaid on top of that base case. Can you observe the
3 amount of improvement over the base case that management
4 expects in year one, year two, year three? You should be
5 able to see those numbers, maybe not with great detail
6 underneath it, but at least some high-level view.

7 So these are the five components of readiness you
8 as regulators can look for if you have an insider view, if
9 you're actually able to sit with management or examine the
10 deal documents. In short, you can ask very specific
11 questions.

12 Now, suppose you're a complete outsider and all
13 you can look at is the investor presentation. Here are the
14 three things that I believe you can look for, to determine
15 whether any significant synergies are going to occur. I
16 think PepsiCo's acquisition of the Quaker Oats Company is a
17 great example of a company that really had their ducks in
18 order right from the get-go and you could see it in their
19 investor presentation. I'll go through this very briefly in
20 a moment. But what are the three things?

21 First, is trackable improvements. One of the
22 things I criticized about the HP/Compaq deal announcement
23 is, you just cannot go to the markets with a two and a half
24 billion dollar synergy number as management did, and be
25 believed. Two and a half billion of what? When? You
26 really have to break it down. It's an asymmetric
27 information problem. If you don't break big synergies

1 numbers down into components for investors, they just assume
2 you don't know. So, look for trackable types of
3 improvements.

4 Second, is a story that reduces uncertainty,
5 rather than injecting uncertainty, for the employees who
6 have to deliver. I thought another problem with the
7 HP/Compaq announcement was that management injected
8 tremendous uncertainty into both organizations. Management
9 stated that 75 percent of that two and a half billion dollar
10 synergy number was going to come from workforce reductions
11 and those reductions weren't going to happen fully until the
12 end of the second year. And the amount of headcount
13 reductions was going to be 15,000 people. But that was
14 15,000 people over a combination of 11,000 job cuts that had
15 already been announced at both organizations before the
16 deal. So, HP/Compaq management injected about as much
17 uncertainty at announcement as would be possible in a
18 merger.

19 And then third, and this is less important from a
20 regulatory perspective or an efficiencies perspective, but
21 it might send a strong signal: the PMI plan must be tied to
22 the economics of the transaction. And that's where most of
23 these investor presentations fall apart. You can just see
24 there's no link between what management is promising and the
25 value that they paid for the deal.

26 So, let me just quickly outline the Pepsi/Quaker
27 example -- for me, it's a benchmark to hold other investor

1 presentations against. PepsiCo's investor presentation had
2 two major parts. First was a review of what was already
3 promised to investors, and management went through the
4 growth issues by several measures, such as EBIT and revenue
5 growth. They went through about three or four different
6 performance measures and basically said, here's what we've
7 already promised you -- now here's how we're going to go
8 beat it. And that was the second part of the presentation.

9 They broke down the announced \$230 million of
10 synergies into components. They stated the top line
11 improvements and then what the flow through would be to pre-
12 tax operating profit. And they detailed the cost savings.
13 Every component had a reasonably detailed logic that backed
14 up the numbers.

15 Forty-five million would come from the Tropicana-
16 ambient business because of the strength that Gatorade, a
17 Quaker brand, would bring to PepsiCo; 34 million from
18 selling Quaker snacks through Frito Lay; 60 million through
19 procurement savings; 65 million from savings in SG&A and
20 logistics and hot fill manufacturing; and 26 million of
21 corporate redundancies. And management stressed several
22 times that these were conservative estimates and they were
23 not going to include the potential of the Pepsi network to
24 add to Gatorade sales.

25 And by the time the deal actually closed, PepsiCo
26 actually increased synergy estimates from 230 million to 400
27 million, with a detailed analysis of all of those changes in

1 a day-long investor presentation.

2 If you're not seeing that kind of preparation,
3 then that should send up some big red flags, particularly if
4 they're visionary deals and you only hear talk about
5 changing the world and great new products or services, with
6 single number synergy estimates. It's a pretty good bet
7 that those efficiencies aren't there. And those are my
8 comments. Thank you very much.

9 MR. SCHEFFMAN: Thanks, Mark. Some brief
10 reactions from the panelists to anything they've heard
11 before we open up to questions?

12 MR. SHELTON: Personally, let me pass on any
13 queries and see if we can get more quickly to the Q&A.

14 MR. SIROWER: Yes, I would suggest that. I didn't
15 sense the huge differences, as we had, in the first panel.

16 MR. SCHEFFMAN: Okay. We'll start questions from
17 the audience or are you all frozen? Susanne?

18 MS. TRIMBATH: I would just like to hear, in
19 particular, from Mike and Mark. It seemed to me that you
20 had different definitions of synergy. In the base of that
21 pyramid that you showed, Mike, your definition of synergy
22 looked a lot like cost reductions to me as opposed to the
23 more classic definition of "one plus one equals three." The
24 things that Mark talks about seemed more like the classic
25 definition. I'd like to hear from the two of you a little
26 bit more about how you're defining synergy and how you think
27 you might differ on that.

1 MR. SHELTON: We look at it from the viewpoint of
2 what should the acquiring company look at as synergies
3 moving forward in terms of capturing, and from that, it is a
4 perspective of both cost synergies, revenue synergies,
5 synergies that you can get -- in other words, transforming
6 or sharing best practices, as well as negative synergies
7 that come from a merger because of lost opportunities,
8 specifically around when you lose customer share, you lose
9 revenue, you lose key talent. So, that's how I would define
10 synergies.

11 MR. SIROWER: I'm not sure we're really apart on
12 this. The question is, what's the benchmark? Actually,
13 Mike brings up a really good point about the possible
14 negative synergies. At BCG, we call it the synergy matching
15 principle. For anything good you're going to get, there may
16 be some costs that result from it, too. You've got to net
17 those out when you value the premium you are willing to pay
18 for the deal. The benefits and costs for those benefits
19 also help you lay out the roadmap for the integration
20 efforts.

21 But you have to be clear about what the base case
22 is first. You have to look at what these two companies look
23 like together line by line going forward, so you can then
24 measure and track the performance gains over the base case
25 going forward, and those gains will break down to revenue
26 synergies and cost synergies.

27 MS. TRIMBATH: So, a cost synergy is one plus one

1 equals one?

2 MR. SIROWER: Well, once you lay out the base
3 case, which is what you already expect, you overlay the
4 synergies on top of that. So, in my view, that's the only
5 sensible way to do it; otherwise, you're jumbling forward
6 plans that are already there and you haven't separated it
7 from the new stuff. If you're trying to incentivize someone
8 to get performance gains, you've got to make sure they
9 achieve what they've already promised to do as an
10 independent company, and you're overlaying the additional
11 benefits on top of that. You want to make sure there are
12 tangible benefits for managers who really achieve those
13 synergies.

14 MR. BOWER: Joe Bower from Harvard Business
15 School. I guess the question that intrigues me is based on
16 your more general findings. They indicate that a lot of the
17 mergers don't work out. Suppose we stipulate that those
18 numbers are more or less right and that two-thirds of the
19 deals don't look good from the perspective of the acquirer.
20 And now, let's take a public policy perspective on that.
21 Does that mean that you should have a predisposition to let
22 mergers go ahead because, in fact, they're not going to
23 achieve the objectives that the managements had in mind
24 anyway?

25 MR. GHEMAWAT: I think this is sort of just
26 harking back to Steve's presentation this morning. If the
27 major reason the mergers don't work out is that the premium

1 was too large, then presumably, this is sort of a matter
2 between shareholders of acquirer versus acquired company,
3 and at least I personally have trouble seeing a public
4 policy rationale for intervention in that particular regard.
5 I think the general issue that comes up is that, sort of the
6 wobble between the private benefits from a merger and the
7 social consequences is actually fairly substantial.
8 Therefore, I would suspect that probably there should be
9 more attention to sort of trying to figure out where the
10 sources of wobble come from. There's obviously the private
11 benefits from the merger to the parties, and that presumably
12 one could deal with by looking at it from a public policy
13 standpoint by looking at both the acquirer and the acquiree,
14 rather than worrying about the distribution of gains between
15 them.

16 There may be externalities on the rest of the
17 industry, which seems to be another useful, separate pasture
18 to focus on. Then there's probably some other sort of
19 implications above and beyond that that might also be worth
20 factoring in. But we were talking primarily, or at least I
21 was talking primarily, about the private benefits from
22 mergers. To go from there to -- we know mergers destroy
23 value for the acquirers, so let's stop them. I would
24 certainly stop well short of such a conclusion.

25 MR. SIROWER: Yes. These debates often get muddy
26 because you mix up levels of analysis. I mean, we have the
27 macro level of analysis. Are mergers good for the economy?

1 And I believe the answer, after 20 years of evidence, is
2 yes. You add the two sets of performance together, the
3 gains to acquirers and the gains to targets, and you get a
4 positive number. That's a different level of analysis from
5 whether the officers and directors of acquiring companies
6 are doing as good a job as they should.

7 And so, when you go to that next level of
8 analysis, there are a lot of things we learn about acquirers
9 that lose money versus those that seem to do really well.
10 So, there are two very different levels of analysis, and I
11 would agree with both Steve and Pankaj that from policy
12 perspective, you don't want to stop mergers.

13 MR. BOWER: Let me follow up because, in a way, I
14 think that's ducking. Let's just take as a category an area
15 that Pankaj has studied, which are the consolidations, the
16 global mega mergers. Basically, they don't seem to achieve
17 the objectives that managements had in mind. Then why
18 should we worry about them from an antitrust perspective?
19 My impression is that what happens in those mergers is that
20 the managements enter into them, perhaps with anti-
21 competitive objectives. But they don't succeed. That, in
22 fact, what happens is they form the merger and then, by God,
23 competition takes over and you get very positive outcomes
24 from the point of view of the economy and you get the
25 results that you are talking about from the perspective of
26 the firms and their managements. That's a question.

27 MR. GHEMAWAT: I don't know whether I should stand

1 up to respond to it so that I don't get further charged with
2 ducking. Clearly, a lot of these mergers have elements of
3 that. At least my understanding of BP, with some of its
4 mergers, yes, it was probably sensible to require some
5 constraints in what they were going to be doing on the West
6 Coast of the United States, because otherwise, after
7 acquiring ARCO, these guys were going to end up with
8 substantial market power in that regard.

9 I think it's hard to take some of the very largest
10 deals and separate them very cleanly into this is primarily
11 a market power-driven merger versus this is primarily a cost
12 efficiency-driven merger, and that's where I think things
13 start to get a little bit muddy. But, certainly, if things
14 are driven primarily by market power and if it turns out
15 that these market-powered gains are greatly overestimated
16 partly due to the diligent work of people at this agency and
17 elsewhere in Washington, then it's sort of shareholder
18 beware. But we don't necessarily need to alter very much
19 what's happening with the process. I'm just not quite that
20 clear that that's the only thing that's going on in any
21 complex transaction.

22 MR. KLEINER: I'm Thibaut Kleiner from the
23 European Commission. Chairman Muris, this morning, started
24 with saying we had a chicken and egg problem in this whole
25 debate because basically firms didn't come up with good data
26 or information about efficiencies and, therefore, efficiency
27 claims couldn't be integrated very well by authorities in

1 their analysis. But then, listening to what has been said
2 so far, I'm not sure we're escaping this trap and this
3 problem. The first panel has explained that it's not clear
4 whether efficiencies are there or not.

5 What you are telling us is that you need to go
6 very much into the details of how to integrate the two
7 companies and really to have a very precise view about how
8 to do it if you want efficiencies to be realized. But then
9 the question is, how do you get this information ex ante?
10 How are you able to make precisely your calculations so that
11 you can come up with these good ideas and synergies? So,
12 how is it possible from a public policy point of view, then,
13 to escape this kind of information gap where you don't have
14 the right data to present efficiency claims?

15 MR. SHELTON: A merger is a risky deal, and it
16 requires a lot of execution done properly by the management.
17 I think it would be very difficult and I would really
18 question if we would run public policy to try to estimate,
19 first, how well management's going to do, and then based on
20 that, to make a decision. So, I think whatever public
21 policy we come up with can't be contingent on guessing right
22 whether or not management's going to execute.

23 MR. SCHEFFMAN: Let me chime in because I think
24 maybe we're talking past one another. Mark eloquently
25 advocated, as I think all the literature on merger outcomes
26 indicates, that integration is really important and that
27 planning for integration is important. So, the issue is

1 what should we see on that? -- and, I should say, we don't
2 see very much. We'll talk about this somewhat tomorrow. It
3 maybe there are antitrust risks. Remember, we're looking at
4 a deal before it can be consummated and maybe they can't do
5 full due diligence.

6 So, we actually don't see much on integration
7 planning in the documents, and we get all the company
8 documents in a typical deal. Is that because with your
9 clients you say not until the deal is consummated can you do
10 it, or are we seeing deals that are remiss?

11 MR. SHELTON: Well, I would actually say, the
12 companies that do this best do a tremendous amount of
13 integration planning beforehand, and they're pushing up
14 against what you're allowed to do pre-regulatory approval.

15 So, while I would say many companies don't do as
16 much planning, the companies that are doing it well are
17 doing a large amount.

18 MR. SIROWER: Yes, except I'd just break the
19 issues down a bit. You're looking for two different things.
20 One is, is there a real business case there supporting the
21 deal? Is there a real strategy? And then, is there any
22 evidence of the planning or the operating model that's going
23 to take that business case and turn it into the value that's
24 built around that business case? So I think there are these
25 two separate but essential pre-closing issues. Is there
26 evidence of a real strategy or business case, and are there
27 the components of just what absolutely must be in place to

1 turn that business case into value?

2 We regularly work through long merger approvals,
3 long regulatory processes, and it's amazing how much work
4 can get done without violating any sharing of information
5 constraints. All these different building blocks that Mike
6 talked about and that I talked about need to be in place
7 before companies can successfully go forward with the
8 integration -- it's just that simple. And all you're doing
9 by not having them in place is introducing more and more
10 uncertainty to the organization, the people who are going to
11 eventually have to deliver on the business case. And so,
12 the best people with options simply don't believe that the
13 deal has much chance of working and they start looking for
14 other opportunities.

15 MR. GHEMAWAT: My colleagues on this panel have
16 talked about best practice. The one thing that I'd sort of
17 stress once again, huge variation in practice. So, if you
18 can't find the documents, it may be that somebody is playing
19 a strategic game of non-exposure, but it may also simply be
20 sheer ineptitude in terms of actually thinking through the
21 issues, and that possibility should not be ruled out before
22 inferring sinister intent from the non-production of the
23 documents.

24 MS. DETWILER: Thank you. Alice Detwiler with the
25 FTC. This follows up -- Dave's question touched on this a
26 little bit. It was clear from both Mike's and Mark's
27 presentations that the speed of decision-making and the

1 speed of integration planning by itself was a key factor in
2 the success of the mergers and in realizing the synergies
3 that companies had predicted, and that's probably a very
4 intuitive proposition to any business person. But it's
5 useful to explore that since this audience is mainly
6 regulators and it has implications both for the Hart-Scott
7 review, since that's often a key source of delay, and also
8 for the rules on pre-close integration planning, which we'll
9 be touching on in Panel 5 tomorrow.

10 I wonder if you could just explore that for a
11 moment and explain why it is that the passage of time itself
12 and the need for quick decisions can have that much of an
13 impact.

14 MR. SHELTON: Well, what organizations are
15 generally finding is that as soon as you announce a merger,
16 that, one, the marketplace is looking for establishing ideas
17 of whether or not you're achieving the synergies or whether
18 or not you're likely to. And the marketplace, the analysts
19 and other shareholders are very tough on organizations that
20 cannot prove that they are moving towards those synergies.
21 So, that's one.

22 Two is that competitors are reacting. So, in an
23 organization, especially when it takes a year to gain
24 approval or nine months to gain approval, your competitors
25 are moving already to try to counteract whatever strategies
26 you're putting into place and you're in almost a hold
27 pattern. And so, a lot of things are done to try to find

1 out how can we make up for that and what can we do, even
2 though we can't share the information that we need to keep
3 up with the competitors.

4 And the third is in terms of talent that
5 recruiters have learned that as soon as you announce a
6 merger, you go after that talent because, again, they're in
7 a vulnerable period of time, and because of that, you're
8 able to extract that talent during that time. And your
9 competitors are doing the same thing to your customers. So,
10 you're in a very defensive position, needing to move very
11 quickly.

12 MR. SIROWER: I would just add to Mike's comment
13 on recruiters going after talent. We know several cases
14 where competitors have held job fairs immediately after
15 announcement, or soon after announcement, at the airport
16 hotels close to the headquarters of both companies. So,
17 it's clear that there are those competitors out there that
18 are aggressively trying to poach talent.

19 But one other detail around post-merger
20 integration. Mike said something about trying to make
21 decisions -- how did you say it -- decisions that are 70
22 percent --

23 MR. SHELTON: Seventy percent solutions that are
24 100 percent implementable.

25 MR. SIROWER: I'll give you our version, it's very
26 similar. You essentially want to take actions that are
27 generally right, but not specifically wrong. One of the

1 greatly underestimated issues about post-merger integration
2 is the sheer number of decisions that are required. Take
3 big pharma deals, for example. We've counted up to 10,000
4 non-routine decisions that have to be made during the
5 integration process.

6 Well, the longer you put off decisions, the
7 greater the chance of important decisions getting out of
8 sequence. Another problem in PMI is that the 80/20 rule
9 doesn't really work all that well. You know, focus on the
10 20 percent of things that get you 80 percent of the value.
11 So, where there are 10,000 non-routine things that have to
12 get done, you can really get yourself into a lot of trouble
13 by ignoring the details. These things just have to get done
14 and decisions have to be made, all the way down the line.
15 For example, imagine the merger of safety teams in a large
16 pharma deal. Decisions have to be made on everything from
17 pre-clinical trial reporting to first time in man to
18 labeling issues on new drugs. All of these little nitty
19 gritty activities just have to get done and decisions have
20 to made.

21 And the longer you put them off, the more
22 disarray, the more people get upset and irritated about the
23 uncertainty. But I would close my response with the really
24 big internal factor you deal with, the longer you put things
25 off -- just plain fatigue. I mean, people just get tired.
26 They're doing their regular jobs, they're maintaining what
27 they're already supposed to do, and you're asking them, in

1 many cases, to put another 50 percent of their time into the
2 integration effort. The longer that deal doesn't close, the
3 longer all the things that still have to get done just weigh
4 on people. So, whether you go out six, eight, nine, 10, 12
5 months, you've got a lot of fatigue in the organization and
6 people know they've got the whole implementation effort
7 ahead even after the deal closes.

8 MR. GHEMAWAT: Just two caveats to that, if I may
9 add, partly because given where we are. I'd like to stress,
10 once again, the general importance of taking a rule of
11 reason as opposed to a per se approach to these things. One
12 is that -- particularly in the context of cross border
13 mergers it really varies, and while Cemex has done very well
14 with an aggressive integration strategy, Holder Bank has
15 done relatively well with a strategy of just buying stakes
16 in local companies around the world, and over time, sort of
17 figuring out other ways to tap some of the benefits
18 associated with that. So, it really depends on the
19 strategy. They don't have a strategy of centralizing that
20 much, and therefore, they don't feel that need to have the
21 PMI team in there.

22 The second sort of also depends on competitive
23 dynamics. My guess is that obviously from EchoStar's
24 perspective, the first best thing would have been to buy
25 Direct TV right away. But I'm not sure that they're
26 entirely unhappy with the fact that the review process has
27 been dragging out given some of the contractual provisions

1 that they have with Direct TV in terms of being able to
2 essentially stop their momentum in the market, look at all
3 their books, et cetera.

4 And so, again, even within a purely domestic
5 context, I have a feeling that given that they couldn't have
6 their first best, this is probably close to their second
7 best in terms of a protracted regulatory process.

8 MR. PETIT: I am Laurent Petit, Merger Task Force,
9 European Commission, Brussels. Consulting firms have shown
10 that the vast majority of mergers fail, at least from a
11 financial perspective, essentially because they fail to
12 deliver on their promises. Does that mean that, from an
13 antitrust agency perspective, we have to be extremely
14 careful and maybe reluctant to take into account their
15 "hopes and dreams" whenever they come to us and they talk
16 about possible efficiencies?

17 MR. SIROWER: There are two issues. What's being
18 paid versus what's being promised? And are there really any
19 efficiencies in the deal? You can have a deal that has a
20 lot of efficiencies, but just not worth what's being paid --
21 but it's still good for consumers. It's a better, stronger
22 company from a competitive perspective and consumer
23 perspective, but it hurts the acquirer's shareholders
24 because management paid too much.

25 So, that's why, I think, one of the things you
26 have to come to terms with is what is the appropriate
27 benchmark you should use to measure whether there will be

1 performance improvements or efficiencies. Is it their
2 current performance? Is it the improvements that are
3 already priced in the shares of both companies, or is it the
4 amount that management is promising based on the total price
5 that they're paying for the deal? I certainly don't think
6 from an antitrust perspective you look at the total promises
7 that are priced by the market plus the premium being paid.

8 I think you either pick the current performance or
9 you pick the performance improvements that you try to
10 estimate would be there if the two companies didn't do the
11 deal, and you look for evidence on how they will beat that.

12 MR. SHELTON: If I could add on to that with one
13 other comment. One thing you definitely want to appreciate
14 is that the competitors are going to react very aggressively
15 to it, and when the company initially lays out its plan,
16 it's oftentimes not taking that into account to the extent
17 it needs to. They're generally in a very difficult industry
18 environment to begin with. So, you're in very uncertain
19 times.

20 MR. SCHEFFMAN: One more question. Neal?

21 MR. AVERITT: Neal Averitt, FTC. A lot of the
22 disagreement in the discussion seems to have built from the
23 initial observation that about two-thirds of mergers are
24 financially unsuccessful. Could the members of the panel
25 give us any further guidance by subdividing that data into
26 smaller universes of acquisitions in the first place? In
27 other words, do you see significantly different success

1 ratios in large mergers or mergers with high market shares
2 or mergers that have some identifiable characteristic that
3 might tell us something about where we should be focusing?

4 MR. GHEMAWAT: Well, my contribution to the
5 response to that question would be a suggestion to read Joe
6 Bower's very interesting typology of different mergers,
7 which does sort of have the myriad of really slicing things
8 up by their business purpose as well as uncovering some
9 variations in the success rates. I think that some kind of
10 taxonomy along those lines, what are the industry dynamics,
11 what's the business purpose, is probably the single most
12 fruitful way to go in terms of sort of getting to a more
13 nuanced understanding of what lies beneath the averages.

14 MR. SIROWER: And, again, I want to emphasize when
15 we talk about the success studies, we're combining issues.
16 Let's think for a moment, why would an acquirer's share
17 price go up or down around the announcement of a deal. It's
18 not just about the potential synergies. It's the benefits
19 minus the premium, synergies minus the premium. So, even if
20 you have a typology of deals as Pankaj suggests, you still
21 have to look underneath any success studies carefully and
22 tease out projected synergies from the up-front premium
23 offered. It may be that a deal offers tremendous synergies
24 but at an even more tremendous price. So just using a
25 typology of deals may not get you to a better understanding
26 of which deals will produce more efficiencies than others.

27 I go back to what I said earlier, you want to make

1 sure that there's a real strategy in place and some logic
2 around how they're going to get any gains from that
3 strategy. That's a separate issue from the price that
4 they're paying. Both of those get combined when we look at
5 merger studies.

6 MR. SCHEFFMAN: Well, thanks very much for a very
7 interesting panel and good questions. We'll see you back
8 again at 2:00.

9 **(Whereupon, at 1:00, a luncheon recess was taken)**

1 business that you are buying. You can look at this three
2 kinds of ways, as seen in the slide on the bottom of p. 1 of
3 my handout. First, there are variations in what management
4 is trying to accomplish. Second, the M&A process, itself,
5 is spread out over time and there are variations in the
6 process. And third, there's the process of implementation
7 itself, which can vary extraordinarily. We heard just a
8 sense of that when Pankaj Ghemawat talked about Cemex
9 looking at the process of acquisitions in the cement
10 industry one way, Holder Bank looking at it a totally
11 different way. Both could be successful.

12 A group of us at Harvard Business School were
13 trying to understand this complex set of issues. As a way
14 of sorting things out, we identified seven major strategic
15 objectives that lead to M&A -- sometimes a given deal may
16 involve more than one objective. I will take a few moments
17 to present these seven objectives, which are shown in the
18 two slides on p. 2 of my handout.

19 One is simply reducing industry over-capacity.
20 When Chemical Bank merged with Chase, both the company and
21 the financial markets estimated that savings from reduction
22 of excess capacity were worth \$7 billion and it showed up
23 the day after the announcement. It was basically a New York
24 City bank acquiring another New York City bank. They
25 understood each other's businesses, they had a pretty grown-
26 up management and they were involved primarily in
27 rationalization.

1 In some of these deals, not this one, there is the
2 hope that you can use larger market share to strengthen
3 pricing. My impression -- I've been studying this since the
4 early '80s -- is that almost never happens, that while this
5 is something that regulators are frightened of, that we are
6 in a period of hyper-competition in most industries and much
7 as companies would like to get pricing power, they've been
8 unable to do it. It's remarkable.

9 A second kind of deal is the roll-up of a
10 fragmented industry, and here the example I use is Bank One
11 in the 1980s. They picked up what was happening in
12 deregulation and began to build a national bank. Roll-ups
13 like Bank One involve expanding geographically in an
14 industry where there's local delivery. There is saving
15 through shared overhead, and improvement in products and
16 service. Some of these have been quite successful. A third
17 category is the product or market extension. So, Quaker
18 thought it would buy Snapple. They had Gatorade, why not
19 add Snapple? I'll come back to that. And what that really
20 is is a product line extension or sometimes entering other
21 countries' markets.

22 A fourth case is where a company is using M&A as a
23 substitute for R&D. They're buying a product or a process
24 technology that they need but cannot develop themselves, or
25 cannot develop fast enough. Microsoft bought Vermeer, that
26 gave them immediately front page capability in their web
27 browser. We'll hear more about that today from one of our

1 panelists, I suspect.

2 Sometimes there's a thought of building a new
3 industry. When Viacom, which was at that time primarily in
4 cable television and primarily cable television content,
5 bought the Paramount Studios, they were, in effect, trying
6 to create a new industry -- branded content. It was a bet
7 that there were strategic benefits to be gained from
8 integration across industries. Each attempt at industry
9 convergence is different and pulling it off is a different
10 kind of challenge.

11 Then there are the investor buy-outs. Here what
12 you have are people with significant financial skills
13 betting that value can be created with new, private,
14 leveraged ownership. That's still another kind of
15 operation.

16 And finally, there's what I call bluefish. Some
17 of you have had the pleasure of standing in the surf when
18 the bluefish are running. The amazing thing is that when
19 they are running, they will bite at anything. So, you have
20 a lot of fun fishing, but they're liable to also bite your
21 feet, they'll bite anything, and that's what seems to happen
22 during the merger frenzy. There are a lot of deals done
23 that are explained as one of the other six, but when you
24 really go look at them, it's bluefish.

25 (LAUGHTER)

26 MR. BOWER: Now, what I did was look at all the
27 M&A in the United States in a three year period that was

1 bigger than \$500 million and try to sort it out by motive,
2 leaving out bluefish. In order to know whether you're
3 dealing with bluefish, you have to get inside and actually
4 look at the plans or the absence of plans. You can't find
5 that out from public data. What you see from the slide on
6 the top of p. 3 of my handout is that most of the deals were
7 product line extensions or consolidation. Then there were
8 roll-up and investor deals, the latter of which accounted
9 for about 13 percent of the deals, and then you have a very
10 small bit of M&A as R&D and a small bit of industry
11 convergence.

12 Now, what difference does it make? For
13 managements the work is totally different depending upon
14 what the objective is. To understand these differences we
15 found it useful to think of companies not just the way
16 economists do, as just resources, but as resources,
17 processes and values. As seen in the slide on the bottom of
18 p. 3 of my handout, the resources are the assets, they're
19 both tangible and intangible. Processes are the way
20 companies convert those assets into goods and services, and
21 values are the way employees think about what they do and
22 why. And they shape priorities and decision-making.

23 Now, it's relatively easy to assess and
24 rationalize assets. Companies have become pretty good at
25 this. It's very hard to assess processes or to change them.
26 And it can be even harder to see the depth with which values
27 are held and whether they are subject to change. Just think

1 of the world we're living in -- the centrality of political
2 and religious values. The same forces operate in companies.

3 Whatever the strategic objective, M&A itself is a
4 business process, as seen in the slide on the top of p. 4 of
5 my handout. Managements have to learn how to do it well.
6 Some do it very well. The initial piece of the process is
7 targeting: assessing the resources, the processes and the
8 values. Then there's doing the deal: negotiating, getting
9 the price right, and getting to the closing. Lastly is the
10 integrating process discussed this morning. Integrating
11 involves rationalizing the resources. That's not always as
12 easy as it may seem because there may be debates as to which
13 plant is really the most efficient. Integrating also
14 involves imposing or modifying processes. That may be just
15 brutal. Then there is the question of values.

16 Everyone knows about Quaker's acquisition of Snapple,
17 that it was such a disaster. Basically, the problem with
18 integration was that the companies used two different
19 processes to do business. Quaker brought big, big trucks to
20 the back door of a supermarket, a lot like Procter & Gamble,
21 and they stock the shelves. Snapple had small trucks going
22 to the front door of mom and pop convenience stores, totally
23 different. They also had totally different advertising, and
24 basically Quaker could not manage Snapple.

25 Implementation is also affected by the price of a
26 deal, as shown in the slide on the bottom of p. 4 of my
27 handout. If the price is too high, then even if

1 efficiencies are realized, the deal may destroy shareholder
2 value. Or, as I mentioned, those efficiencies may be lost
3 through price competition. But a high price may have a more
4 destructive affect. Sometimes it forces companies to try to
5 realize benefits very, very quickly, in a situation where
6 the integrating process requires more time. Moving too fast
7 can wreck the implementation process.

8 Still another aspect of the process is how the
9 deal is financed. Someone might want to study carefully the
10 relationship you can see in the slide on the top of p. 5 of
11 my handout. What we've got here is high-yield bonds and
12 bankruptcy assets, and it turns out that the improper
13 financing of mergers is the leading cause of bankruptcy.
14 What you can see is that the high yield bond issues seem to
15 be a leading indicator of bankruptcy. The high yields peak
16 here in the '80s and then you get the bankruptcies. Someone
17 should do that study.

18 Research on implementation shows that there are
19 two dimensions to success, the level of completion of the
20 human integration and the level of completion of the task.
21 This is shown in the slide on the bottom of p. 5 of my
22 handout. The problem with speed is if you move too fast to
23 get to task integration, it may lead to a failed acquisition
24 because the human integration never gets done. So, the
25 success seems to me to take both.

26 Now, as seen in the slide on the top of p. 6 of my
27 handout, that two by two matrix on the previous slide is

1 just based on a longitudinal study of nine companies, major
2 deals over time, and it was quite striking. So, the basic
3 finding is that value creation requires both.

4 Now, what we're going to do in the panel
5 discussion is to essentially structure our discussion along
6 the process of a deal. As seen in the slide on the bottom
7 of p. 6 of my handout, we're going to start by talking about
8 targeting and then we're going to talk about doing the deal,
9 then about implementation. In the process, I think we will
10 be drawing lessons. In the back of our minds will be what
11 Dave Scheffman and Paul Pautler have called the cosmic
12 question, which is what are the implications of all of this
13 for antitrust.

14 Now, the panelists are really quite remarkable
15 because they are both very experienced and accomplished, and
16 interestingly, the work they've done covers the whole
17 spectrum of deals that I laid out.

18 Peter Brodsky is a partner of Hicks, Muse, and
19 they are investors that have a remarkable record of
20 successful buyouts.

21 Bill Earnest, sitting next to him, is the General
22 Manager of Corporate Planning and Strategic Transactions at
23 ConocoPhillips. He's been involved with Conoco through its
24 life as Continental Oil, Conoco, DuPont, and then
25 ConocoPhillips, -- a whole set of deals involving
26 consolidations, a remarkably interesting experience.

27 Juan Pedro Hernandez is Vice President and

1 Treasurer of Procter & Gamble and has started out in Spain,
2 then Brussels, Cincinnati, back to Europe -- and now back in
3 Cincinnati with a wealth of experience around the
4 transactions of P&G - product and market extensions.

5 Robert Ingram is currently the Chief Operating
6 Officer of GlaxoSmithKline, but at various points in time
7 was the Chairman and Chief Executive of Glaxo. Therefore,
8 he is well-positioned to talk to us about the mega mergers
9 in pharma.

10 Michael Jones is Business Development Leader for
11 GE Medical Systems, which has had a really remarkable record
12 of growth inside the GE organization.

13 John Mayfield is Group Controller, Construction
14 Products and Finishing Systems Group of the Illinois Tool
15 Works. Some of you may not know Illinois Tool Works, but it
16 is one of the stronger, more profitable, heartland
17 industrial organizations in the country, and they have done
18 hundreds of deals in a product and geographic roll-up.

19 Finally, Dan Scheinman is the Chief Strategy
20 Officer of Cisco, which has a remarkable record of doing
21 deals in the high tech end of things, where much of the M&A
22 is a substitute for R&D.

23 So, this panel really covers the range of deals as
24 they are done in the United States. They represent really
25 great companies. It is my great pleasure to work with them.
26 We're headed into a very interesting afternoon.

27 Once again, we will begin by considering the front

1 end of the M&A process. Juan, do you want to get us
2 started?

3 MR. HERNANDEZ: That's fine. Good afternoon.

4 The agenda for this afternoon is going to be
5 pretty straightforward, as seen in the slide on the bottom
6 of the first page of my handout. What I want to do is to
7 share with you the mergers and acquisitions program, process
8 and planning at Procter & Gamble. I will share, afterwards,
9 some examples about how P&G approaches M&A, mergers and
10 acquisitions, as a way to build shareholder value.
11 Obviously, we are going to have plenty of time for questions
12 and answers in each of the portions of the panel.

13 Our M&A process is only understood if
14 contextualized within the Procter & Gamble statement of
15 purpose, shown in the slide on the top of page 2 of my
16 handout. Our M&A program flows from here. We are a
17 consumer-centric company. Consumers drive everything we do
18 in Procter & Gamble. And innovation becomes our lifeblood
19 and our mantra in the company.

20 We are in the branding business and we believe in
21 science and consumer understanding as a way to create
22 sustainable shareholder value. Our business model is very
23 simple. When consumers choose our products, when customers
24 display our products at the right place and when our pricing
25 is competitive, our shareholders win, our consumers win and
26 our customers win.

27 This is, again, to emphasize simply how linked our

1 M&A program is to the corporate strategies.

2 We think about planning very holistically
3 throughout our M&A process. So, it is present at all stages
4 of the acquisition process. As seen in the slide on the top
5 of page 3 of my handout, I have broken this down into eight
6 elements. I'm going to very briefly cover six of them.
7 Transition and integration will be further discussed by
8 other panel members later on.

9 But I want to emphasize, specifically, that our
10 strategic planning process determines portfolio needs and
11 identifies targets that could eventually fit with the
12 business.

13 In our company, we are organized on a number of
14 operating units: fabric and home care, beauty and health
15 care, snacks and beverages, and paper. As shown in the
16 slide on the bottom of page 3 of my handout, those business
17 units develop business strategies and set the long and
18 medium term goals. The business units M&A program flows
19 from those strategic choices. The screening, the targeting
20 starts at the business unit level. Obviously, we prioritize
21 at the Corporate/CEO level -- based on our where to play and
22 how to win corporate choices.

23 That leads me to the target selection stage, as
24 shown in the slide on the top of page 4 of my handout.
25 Target selection needs to leverage on P&G core competencies.
26 Branding, innovation and scale/efficiencies are derived from
27 the growth of our equities; our technology and consumer

1 understanding across different business units; and the scale
2 from our materials procurement, manufacturing, engineering,
3 and go-to-market capabilities. We are able to go to market
4 with a \$40 billion plus portfolio of businesses. So, we can
5 use co-marketing and co-promotional efforts across brands
6 and business units.

7 Our M&A target selections need to fit with Procter
8 & Gamble's growth strategy and core competencies. Our
9 declared intention is to make our company more beauty care-
10 like, more personal health care-like. Those categories have
11 favorable demographics, are faster-growing businesses,
12 higher margin, and more efficient businesses from an asset
13 utilization standpoint.

14 As shown in the slide on the bottom of page 4 of
15 my handout, planning requires a great deal of analysis to
16 understand the current business model of the target, its
17 sustainability, its current performance and its future
18 potential if combined with our business. It requires the
19 clear identification of where, how and when value is
20 created. M&A creates value essentially through revenue
21 efficiencies and/or by lowering costs throughout the value
22 chain: that is, in sales and distribution, manufacturing,
23 materials and media procurement, product development et
24 cetera.

25 At this stage, our analysis focuses on the
26 identification of value creation, which in turn helps us to
27 start defining our walk-away price range. This is critical

1 when it comes to the success or failure of the M&A program.
2 Discipline in pricing, obviously, needs to be present at
3 every different stage of the M&A process: at the offering
4 memorandum stage, at the due diligence process, and at the
5 actual negotiation of the terms.

6 The next item is due diligence, and again, you
7 need to plan well in advance for it. As shown in the slide
8 on the top of page 5 of my handout, you need to have the
9 right team and the right objectives properly identified.
10 You need to make sure that eventually the right individuals
11 are going to be freed up and you need to make sure that
12 there is business ownership through the entire M&A process
13 from planning to integration. You ideally want due
14 diligence to be led by those who are going to ultimately own
15 the results of the business.

16 Transition and integration are shown in the slide
17 on the bottom of page 5 of my handout. I've already defined
18 these as part of the planning process. It reinforces,
19 again, the comment that I have made before, i.e. the need to
20 think about M&A planning as a continuum of the different
21 stages through the actual integration.

22 I first want to share a few learnings regarding
23 transition and integration from our M&A activity. Those
24 learnings have consistent themes: First, never take your
25 eye off the ball relative to meeting consumer and customer
26 needs. Competition, will welcome you! Your competitor will
27 take advantage of the distraction associated with the

1 transition period to hurt the acquired business.

2 Second, the need to properly explain your
3 transaction to the investment community, your shareholders,
4 and to the credit rating agencies. This is a critical
5 element that needs to be thought through, again, at the very
6 earliest stages of any M&A process. It forces you to
7 articulate the transaction, consistent with the strategies
8 and goals that are supposedly well understood by your
9 investors.

10 Third, the importance of identifying and
11 addressing transition issues. We have found that very basic
12 things are often overlooked during the transition periods,
13 simple things without which we cannot operate efficiently.
14 For example, systems, and specifically, systems
15 compatibility is an issue that needs to be addressed
16 upfront. You cannot wait until you have closed a deal to
17 start addressing basic capabilities like an Order, Shipping,
18 Billing system.

19 Finally, fourth is the identification of the
20 capabilities and human talent from the acquired asset.
21 Keeping the talent, keeping the capabilities increases the
22 chances for an acquisition to be successful.

23 I have already talked about most of the items in
24 the slide on the top of page 6 of my handout. The more our
25 M&A program is linked to our strategy and the better it
26 leverages on the company's core competencies, the greater
27 the chances are for value creation maximization.

1 Consequently, our success rate is highly a function of the
2 clarity of our strategic choices and the fit with our core
3 competencies.

4 Conversely, when you cannot leverage on those core
5 competencies, where the strategic rationale is unclear, the
6 chances for failure increase.

7 To sum up, our business model is very simple; it
8 is not rocket science. We develop and nurture equities that
9 are relevant for consumers. We believe in innovation, and
10 in products that make the lives of consumers better and more
11 delightful. We price these products competitively and we
12 have a cost structure and capital structure that supports
13 our consumer proposition while providing appropriate returns
14 to our shareholders.

15 When we operate within these parameters, our
16 company does well: we deliver good returns and we generate
17 healthy cash levels. Our free cash flow, before dividends,
18 last year was \$6.1 billion. Our acquisition program is
19 obviously one of the key uses of cash. We give back 40
20 percent of our profits to our shareholders via dividends,
21 and we have a strong share buyback program as well. Our use
22 of cash is completed with our strategic acquisition program.

23 I want to refer to three examples where we believe
24 we have been successful with our M&A program, and I'm going
25 to defer today reference to those where we have not been
26 that successful. Richardson-Vicks Inc. is one of our big
27 successes. It probably is the most successful acquisition

1 that Procter & Gamble has done in its 165-year history. I'm
2 talking about an acquisition, in 1986, that was
3 transformational for Procter & Gamble because we were not
4 participants of the personal care business other than with
5 bar soaps.

6 RVI was a terrific acquisition for P&G, not only
7 because it transformed our company, but, as seen in the
8 slide on the top of page 7 of my handout, it gave us global
9 beauty care infrastructure, access to skin and conditioning
10 technology, and great equities like Olay and Pantene that
11 today have revenues of more than \$1 billion each. Olay and
12 Pantene are great equities that have developed into global
13 brands over time.

14 In addition to acquiring these equities, we
15 captured efficiencies across the businesses value chain. At
16 the plant, our shampoo surfactant technology is derived from
17 the laundry manufacturing process. RVI has delivered not
18 only a great value to shareholders, but through our
19 technology we've brought forward real science to consumers.
20 Consumers can get Olay Daily Facials and Olay Total Effects
21 at one-half of the price and better efficacy than they could
22 get in other competitive products in department stores.

23 The second example, shown in the slide on the
24 bottom of page 7 of my handout, is Iams. It is obviously a
25 different profile of acquisition, which will benefit greatly
26 from the technology platforms that we have developed in
27 Procter & Gamble from Dental Care, in particular. We are

1 currently selling a tartar control technology for dogs that
2 is delivered through food. So, our product is making pets
3 live longer and healthier.

4 With this acquisition, we acquired two great
5 equities, Eukanuba and Iams. And we got access to specialty
6 channels.

7 Through our go-to-market capabilities, we expanded
8 Iams to food, drug, and mass retailers, so consumers can buy
9 this brand anywhere they do their shopping. Revenue synergy
10 is what drives the value in the Iams acquisition. We are
11 now launching the product internationally, in the U.K.,
12 Japan, and some other places in the world.

13 The last example that I want to mention is
14 Spinbrush. It's shown in the slide on the top of page 8 of
15 my handout. Spinbrush is a battery-operated toothbrush. It
16 is a very simple, low cost and ingenious technology
17 developed by toy manufacturers in Cleveland. The product
18 delivers better performance than manual toothbrushes as it
19 addresses one of the problems that we consumers have in
20 brushing our teeth: we don't brush them long enough. So,
21 the end result is not the desired result. Spinbrush is
22 marketed under the Crest brand name and is a great success.
23 It is more than a quarter of a billion dollar brand here in
24 the U.S. alone, and keeps growing. It has driven huge
25 category revenue growth by offering consumers a very
26 affordable product that delivers a better end benefit.

27 I'm going to finish here. I could talk about

1 other acquisitions. Clairol may be on your mind. It has
2 only been one year since we acquired that asset -- still too
3 early to declare a success or failure. But prospects look
4 good. Now, I'll be happy to answer any questions.

5 MR. BOWER: Juan Pedro, why don't we let the
6 others speak and then we'll take questions from all of you.

7 MR. HERNANDEZ: Fantastic, thank you.

8 MR. BOWER: Bob Ingram, do you want to --

9 MR. INGRAM: Oh, I'd be glad to, Joe, thank you.
10 I'll just do this from my seat if that's all right. I don't
11 have any overheads.

12 I'll talk as concisely as I can about two deals
13 that I have been routinely involved with personally. One,
14 an acquisition that was treated, as far as its
15 implementation, more like a merger, and that was when Glaxo
16 acquired what most people in the United States refer to as
17 Burroughs Wellcome in 1995, and obviously, more recently, a
18 true merger of equals when Glaxo Wellcome and SmithKline
19 Beecham came together at the end of the year 2000 to form
20 what is now GlaxoSmithKline.

21 I'll speak more to GlaxoSmithKline because it's
22 more recent, it's a larger scale and it is a true merger.
23 But both were driven by, I think, very common forces coming
24 out of, as Juan Pedro said in the case of Procter & Gamble,
25 a look at our strategy. In 1995, Glaxo, which was then the
26 second-largest research-intensive pharmaceutical company in
27 the world, but had been built on largely the success of one

1 large blockbuster medicine called Zantac, was looking at
2 patent expiration in the United States for Zantac in the
3 year 1998.

4 And, frankly, the pipeline of new products was at
5 a stage where we knew that we were not going to be able, in
6 that first year of patent expiration, to replace the almost
7 80 to 90 percent of sales that you lose in the first few
8 months today in the United States, with new product sales
9 because the pipeline just wasn't that far along in terms of
10 its timing.

11 So, the interesting thing here with Burroughs
12 Wellcome is that we were both British-based global
13 companies. Ironically, we both had our U.S. headquarters in
14 Research Triangle Park, North Carolina. In fact, we were
15 adjacent to each other. There was already a walking trail
16 connecting the two campuses.

17 The Wellcome business was owned by a trust, the
18 Wellcome Trust, which as some of you may know, even today,
19 is the world's largest medical philanthropy, and it was
20 operated more like an academic institution and more like a
21 non-profit institution. It was renowned for the quality of
22 its science. It had a number of distinguished Nobel
23 Laureates as scientists, God rest their souls, the two most
24 recent being Trudy Elian and George Hitchings, both of whom
25 were the lead scientists in discovering products like AZT,
26 which was the first anti-retroviral treatment for
27 HIV/AIDS.

1 However, the Wellcome Trust, which was the largest
2 shareholder, could see in their business, even in the mid-
3 '90s, that the research productivity was waning, and
4 frankly, the commercial capability was not competitive with
5 companies like Glaxo or Merck or Pfizer or Lilly, to name
6 some of the names you're familiar with.

7 So, Sir Richard Sykes, who at the time was our
8 chairman, and myself and our chief financial officer, we
9 approached Sir Roger Gibbs who was then the head of the
10 Wellcome Trust, about the possibility of Glaxo acquiring the
11 Burroughs Wellcome pharmaceutical business. We presented a
12 strategy that said, as we looked then and as we continue to
13 see today, that the science in our industry, and the science
14 drives our business, is moving very fast.

15 This is an industry that has historically been
16 built upon the discovery and development of good medicines
17 that treat large populations. We can very well manage
18 hypertension, we can very well manage diabetes, we can very
19 well manage a number of diseases. We can also, through
20 vaccine research, actually cure and prevent many of the
21 diseases that killed our grandparents at a far too early
22 age.

23 But as we go forward, we can see that the science
24 and technology, it's becoming more and more clear now that
25 the mapping of the human genome is going to not only be more
26 complex but more expensive. We will transform ourselves
27 from an industry that, as I said, has discovered and

1 developed good medicines for big groups of people to an
2 industry that actually discovers and develops and ultimately
3 delivers great medicines for subsets of those big groups.
4 We'll be able to actually not just treat hypertension, but
5 we'll be able to see what causes your hypertension and we'll
6 be able to, in many cases, interrupt that chain of events
7 before it actually presents itself as a chronic disease.
8 Now, some of that's occurring. More of it will occur as we
9 go forward.

10 We could also see that -- and we see it most
11 pronounced in the United States -- that the patient would
12 become an ever more important driver as a consumer of health
13 care products, whether they be over-the-counter health care
14 products or prescription medicines. And in both cases, you
15 need an increased scale to invest in R&D and you need an
16 increased scale and expertise to commercialize across not
17 only a physician-prescribing audience but a consumer-based
18 population, the outcomes of that discovery effort.

19 So, we approached the Wellcome Trust in late '94.
20 After three meetings, we reached an agreement which we
21 announced in January of 1995. The Wellcome management,
22 frankly, was taken by surprise, which presented a challenge,
23 which I'll come to in just a minute. We made an active
24 effort, obviously, to meet with the other investors in
25 Wellcome, the large institutional investors, to share with
26 them our vision of an enhanced science base. Not only was
27 that the legacy of Wellcome, but an enhanced science base

1 also would greatly increase and enhance the commercial
2 capability of the products Wellcome already had on the
3 market. Through the increased scale and effectiveness of
4 our commercial capabilities in marketing and selling, both
5 in the United States as well as around the world, we would
6 produce a much more effective return for those shareholders.

7 We were pleased when it was approved
8 overwhelmingly in late March of 1995. The consummation of
9 that acquisition went very fast. It was quite rewarding
10 working not only with our regulators in Brussels but our
11 regulators here at the FTC -- to look at us in terms of
12 where were the overlaps, and we had some. But fortunately,
13 there were not that many and we, as a result, divested some
14 medicines that later have shown up in competitors'
15 portfolios both in the area of treatment of migraines and in
16 asthma, two areas where Glaxo particularly was already a key
17 player and where Wellcome was an emerging player.

18 Now, the challenge then really began. I'll come
19 back in just a minute to the GlaxoSmithKline true merger.
20 But let me try to finish in a very abrupt fashion what
21 became Glaxo Wellcome. When Joe asked me to be part of the
22 panel, where I think I could share some insight is it's one
23 thing to make the acquisition or a merger and get the
24 agreement of your shareholders, get the agreement of the
25 regulatory agencies that must approve your transaction.
26 It's quite yet another challenge to then actually make the
27 acquisition or merger work. And therein, it isn't, we have

1 found, that difficult to get cost savings. You can, you
2 should and you will, and I'll come back to that.

3 The real challenge we found, and we found it
4 particularly in the case of the acquisition of Wellcome, is
5 the so-called soft side of creating a new culture out of
6 what are always going to be different cultures or different
7 sets of value in any two organizations. You can look at the
8 process integration and we looked at that and paid a lot of
9 attention to that. We put together a team that was
10 comprised of legacy people from both Glaxo and Wellcome,
11 augmented by the inevitable consultant. But the inevitable
12 consultant in this case, you limit their role, I believe,
13 based on your experience. We've done some things better
14 than others, to help you define a process. They can't own
15 the process. You have to own that.

16 The interesting thing is, and I hope you find it
17 interesting, remember, this was an acquisition, and yet,
18 when we announced it, we said that we would take the best in
19 people, in processes, in policies and in values from each
20 company. And therefore, we were saying to the legacy Glaxo
21 people, the acquiring company, there was no guarantee that
22 just because we were the acquirer, you automatically won
23 when it came to who got what jobs.

24 And I can remember vividly within the first few
25 days of the announcement, one of my colleagues, who, to his
26 credit, had the courage to raise it directly with me said,
27 Bob, didn't we acquire them. And, of course, the honest

1 answer was yes. And his question was, well, then why is my
2 job at risk? And the honest answer then was, and should be
3 today, we want to make sure that we take the best of both if
4 we're going to really capture the optimal value out of this.

5 And the culture side, and I'll try to be very
6 concise here because I could talk at length about it, could
7 best be described at Wellcome as being an academic type
8 culture, valuing themselves on the high science that they
9 did, almost viewing sales and marketing as a necessary evil.
10 At Glaxo, where there was good science, but not great, there
11 was much more of a commercial, harder-edged, take no
12 prisoners culture. I say that as the Wellcome people would
13 have told you at the time looking at Glaxo.

14 And I think the proof of the pudding is that,
15 today, in GlaxoSmithKline, yet obviously, another true
16 merger of equals -- and I'll come back to that in just a
17 second -- of the five people who report directly to me and
18 who, today and shortly, will even more so run the five
19 largest segments of our company, two of the five are
20 Wellcome heritage people. And if you look at the portfolio
21 of medicines we sell today, four of our fastest-growing and
22 largest medicines were medicines that were Wellcome heritage
23 medicines that were already on the market in 1995.

24 And I remember vividly meeting with my counterpart
25 at the time who was the president of the Burroughs Wellcome
26 U.S. business, and to this day, remains a good friend. And
27 I was saying to him that I saw in two of their products, an

1 anti-depressant called Welbutrin, which some of you may know
2 by brand name, and in their anti-viral AIDS portfolio,
3 medicines that in 1995 were in global sales \$100 to \$150
4 million a year, saying that I thought within five years we
5 could take each of those medicines to a billion dollars or
6 more. His response was, if you can do that, why, I will tip
7 my hat, but I don't believe it can be done.

8 Well, at the end of the year 2000 when we formed
9 GlaxoSmithKline, those two medicines alone cumulatively were
10 doing over \$3 billion. One was doing a billion eight, the
11 other was doing about a billion three. And it was because
12 they were excellent medicines that benefited from the
13 enhanced scale and effectiveness of promotional capabilities
14 that Glaxo Wellcome had that Wellcome alone didn't have.

15 Now, as a result, we delivered out of that
16 acquisition far ahead of the expectations we had set. We
17 delivered in excess on cost savings. We greatly exceeded
18 the sales growth projections that we had set. But it
19 started, Joe, by saying we saw here a company with great
20 science, but if you will, not great commercial skills. And
21 it's clearly seen, by acquiring the company, we got the
22 benefit of the science, much of which is still in place
23 today in our new company, GlaxoSmithKline. We built in the
24 enhanced selling commercial skills, and as a result, we
25 became, as Glaxo Wellcome, by the year 2000 -- and this was
26 just before Pfizer purchased Warner Lambert, the largest
27 pharmaceutical company in the world.

1 Now, what drives the consolidation of our industry
2 is basically three things. First of all, we are still a
3 very fragmented industry. Today, Pfizer, before Pharmacia,
4 GlaxoSmithKline, Merck, J&J, Lilly, if you add the top seven
5 or eight companies, cumulatively, we still won't represent
6 much more than 36, 37 percent of the global market. In the
7 U.S., even slightly less. So, it's fragmented, although not
8 as fragmented as it was 10 years ago.

9 Secondly, and I've touched upon this already as it
10 related to the history of Glaxo, but it's true in every
11 company's case, it's a matter of where you are in the cycle.
12 We're all exposed to patent expirations, and I don't know
13 how many of you realize, but the research intensive
14 pharmaceutical industry gave up in 1984 something that no
15 other industry has ever given up in terms of intellectual
16 property rights.

17 As part of what is now referred to as the Hatch-
18 Waxman Legislation, patent term restoration and reform, we
19 now allow a generic copier to have access to all of our data
20 while our patent is still in force. They can see all of our
21 bioavailability, all of our bioequivalents, all of our
22 manufacturing, all of our QA, quality assurance, data. The
23 end result being that the day our patent does expire, they
24 come to the market that day, -- in no other industry is that
25 the case.

26 And as a result -- and you've seen it very
27 recently with medicines that have become household words,

1 like Prozac, for example. Within the first two months of
2 its patent expiration, Prozac in the United States lost
3 about 85 percent of its sales.

4 So, you have a fragmented industry, you have
5 patent risk, and you have this escalating cost and
6 complexity of R&D, and you have the consumer growing as a
7 greater and greater force in terms of the outcome of health
8 care choices.

9 So, in the year 2000, we tried actually first in
10 '99 and it didn't work, to put Glaxo Wellcome and SmithKline
11 Beecham together in a true merger of equals. Now, here
12 again, two British-based companies. Neighbors in London,
13 but unlike Glaxo and Wellcome, not neighbors in the U.S.
14 SmithKline Beecham's U.S. headquarters were in Philadelphia;
15 obviously Glaxo Wellcome's headquarters were in Research
16 Triangle Park, North Carolina.

17 Here, the history was quite different. These are
18 two companies that had been very aggressive competitors. I
19 take you back to 1980, '81 when the largest-selling medicine
20 in the world was a product called Tagamet, the first of the
21 H2 antagonists for ulcers. But in 1983, Zantac, the second
22 H2 antagonist came to the market, and frankly, ate their
23 lunch. It quickly became the number one product, and it was
24 a very fierce competitive battle, later joined by Pepcid, by
25 Axcid, then succeeded by the proton pump inhibitors like
26 Prilosec and Prevacid and others.

27 So, here were two British-based global companies,

1 each with over 50 percent of their sales in the United
2 States, but who had been real competitors. But while we
3 were real competitors, we had also each developed a very
4 similar approach to the changing nature of research and
5 development. We both had seen, on our own, the increasing
6 importance of genomics, genetics, and high throughput
7 combinatorial chemistry -- that by making the right
8 investments and gaining the right capabilities in those new
9 disciplines, one could improve your batting average.

10 I frequently explain our business to lay people in
11 the most simple way I can explain it. Pharmaceutical
12 research is basically a game of failure. The challenge for
13 us is to learn to fail more quickly and more cheaply.
14 Today, the average cost of discovering and developing a new
15 medicine is \$800 million. And one out of 5,000 makes it
16 from the time it's synthesized as a compound to the
17 patient's medical cabinet. So, it is a high failure
18 endeavor. But today, and going forward tomorrow, we'll
19 improve that batting average, because, as I've already
20 alluded to, we'll have a better understanding through the
21 study of genetics, genomics, through the ability to screen,
22 through high throughput combinatorial chemistry, millions of
23 compounds in a day.

24 When I started out 40 years ago in this industry,
25 the rule was one compound, one chemist, one week. Today,
26 any company in our business will screen millions of
27 compounds each day and will be able to screen them against

1 targets very quickly to understand which targets have the
2 greatest affinity for which compounds. Within the cell,
3 which part of that cell is it that you're trying to target?
4 And by developing proteins, small molecules, the promise of
5 this science, again, is enormous.

6 And, frankly, the leaders of the two companies at
7 the time, again, Sir Richard Sykes, a scientist from the
8 U.K, and Jan Weshley, a Danish businessman, by birth, an
9 American, had worked together at Squibb, and both, on their
10 own, had made these investments. SmithKline Beecham in
11 human genome sciences. In the case of Glaxo Wellcome, in a
12 number of genetic start-ups, in which we had acquired
13 further technology.

14 So, we started having discussions about the real
15 benefit of putting these two companies together to create,
16 again, a world leader in research. That was and is our
17 vision. So, we tried it in early '99 and we even announced
18 it, and it fell apart for a very simple reason. We had too
19 many cooks in the kitchen, and I don't say that to be
20 sarcastic. We had too many people at the top with not very
21 clear role definitions. And as a result, it didn't take
22 very long before this situation was going to create a
23 nightmare. And as such, we would be hard-pressed to deliver
24 something that really did add value. So, it was called off.

25 Within a matter of a couple of months, because the
26 vision was so compelling, the two respective boards asked
27 myself and J.P. Garnier, who was my counterpart at the time

1 at SmithKline Beecham -- and J.P. and I have known each
2 other and were friends then and still are today -- if we
3 could see if we could get together and see if we could make
4 this work.

5 To make a long story short, we did. The end
6 result was both Sir Richard Sykes and Jan retired, to their
7 credit, because they could see that there were too many of
8 us, and we then got on with putting that vision into place.
9 Let me fairly quickly here talk about the benefits we saw
10 short-term, medium-term, long-term, how we've done, and what
11 were some of the key issues. It's still a story in
12 progress.

13 The obvious short-term issues were cost savings,
14 significant cost savings annualized at around \$5 billion a
15 year. We delivered that savings no later than the end of
16 year two and we actually exceeded that. You get a lot of
17 those savings in a global pharmaceutical business in
18 manufacturing. We started out as GlaxoSmithKline with 117
19 plants around the world. They vary in size. Most are
20 secondary manufacturing plants. A few are primary bulk
21 chemical plants. If you were starting a business of our
22 size from scratch and you had a clean sheet of paper, you
23 could operate a global company of our size with maybe six or
24 seven plants if you scaled them up right and sided them
25 right, but we didn't have that luxury.

26 In the first two years, we were down to around 71,
27 72 plants, more to go. The challenge in our business is you

1 have to do that, while at the same time, not interrupting
2 the supply of life-saving medicines as you move product
3 supply from one plant to the next. This is particularly
4 true if you're supplying the United States, where the FDA,
5 as it should be, has to approve that. So, it's time-
6 consuming.

7 We saw the enhanced marketing scale again. Today,
8 GlaxoSmithKline has 8,000 medical reps in the United States,
9 similar to what Pfizer has. The reason that's important is
10 because you're promoting a broader and broader portfolio of
11 medicines, and when you consider that the average face-to-
12 face selling time of a physician in our business is four to
13 five minutes, you need to have a number of different
14 salespeople to make sure that each medicine gets its
15 appropriate time.

16 We saw an ability to create leadership in key
17 therapy areas. We are the world leader today in four out of
18 the five leading therapeutic areas. The one that we're not
19 is the one I wish we were, cardiovascular.

20 Medium term, we, again, coming back to the patient
21 being an ever-increasing driver in health care, saw in
22 SmithKline Beecham consumer marketing skills. Certainly,
23 Procter & Gamble would stand out in that area, but
24 SmithKline Beecham has a very good consumer business, and we
25 wanted to make sure that we had the ability to take some of
26 the consumer marketing skills and apply them to the
27 marketing of prescription medicines.

1 We saw an increased resource for the pipeline.
2 Today, we invest roughly five billion U.S. dollars a year in
3 research and development. As separate companies, we were
4 investing at roughly three and one. So, we've actually
5 stepped up that investment. And then longer term, we want
6 to, again, be the world leader in research.

7 How have we done? I've talked about the cost
8 savings. We've delivered those and we continue to deliver
9 those ahead of target. We have real financial strength, and
10 I'll just highlight a couple of facts. In this year that
11 we're about to complete, we have announced and largely
12 completed a 4 billion pound share buyback program, while at
13 the same time delivering mid-teens percentage growth and
14 earnings per share, and reducing our net debt by over two
15 billion pounds.

16 Sales and marketing scale in effectiveness and
17 efficiency, we're providing better service to our customers.
18 Although I could give you a lot of statistics on that, I'll
19 spare you. But I can tell you that today, as
20 GlaxoSmithKline, we provide much better coverage of not only
21 prescribers, but we now provide much better response to any
22 patient, pharmacist, nurse or any other health care
23 professional around the world, much more effectively than we
24 ever did as legacy individual companies.

25 Now, in the area of R&D productivity, we took this
26 \$5 billion R&D investment every year, and we frankly changed
27 it. We don't have one monolithic R&D organization, unlike a

1 lot of pharmaceutical companies, because the key challenge
2 facing this industry is R&D productivity. So, what we've
3 done is to create what we call Six Centers of Excellence in
4 Drug Discovery, SCEDD is the acronym. And what we've done
5 is to focus them along therapeutic lines. So, one focuses
6 on metabolic disease, one focuses on anti-infective disease,
7 one focuses on respiratory disease, one focuses on C&S
8 disease, et cetera. And they compete for resources. And
9 they're funded much like six individual biotech companies,
10 if you will. And scientists in those centers, who actually
11 do discover and develop a medicine that makes it to market,
12 actually get an equity stake because we realize that one way
13 you attract and retain top quality scientists is to be able
14 to do that even in a large pharma company.

15 We also, by virtue of our scale in marketing and
16 sales, we want to be the partner of choice. If you're a
17 biotech company or if you're a Japanese pharmaceutical
18 company or an Indian pharmaceutical company, and you have a
19 great idea but you need somebody to develop it and really
20 commercialize it, we want to make sure you know that we're
21 the best able to do that.

22 As far as the issues were concerned, this was a
23 merger of equals, so there was no premium. The financial
24 analysis was pretty much confined to cost savings. There
25 was due diligence, but I think Joe's comments were
26 absolutely right on due diligence, you have to do it right
27 with a clear set of objectives with the best people you can

1 find.

2 In our case, we knew a lot about each other. We
3 were large, publicly-traded companies. There's not much
4 secret about us. What we did do in each case was really
5 look at two areas, the pipeline, the early stage pipeline to
6 see where there was overlap, both in terms of our
7 preparation for discussions with regulatory agencies and in
8 terms of things we should just quit doing. But also, the
9 other area, not surprising, particularly in the United
10 States, is what's your exposure to litigation, because
11 there, again, that required clear due diligence.

12 In terms of the differences between a merger of
13 equals and as acquisition, and I've touched on how we
14 treated Glaxo Wellcome, the key thing is once you announce
15 it, put in place very quickly the right integration planning
16 in terms of organizational design and candidate selection.
17 You have to understand that as soon as you announce a
18 merger, everyone feels at risk. And the sooner you can work
19 with the regulators to gain an agreement, the better,
20 stating the obvious. But then also concurrently with that,
21 you cannot over-communicate. You have to share with your
22 people what's going on, and you have to have an open line so
23 that you understand daily what are the questions. In some
24 cases, you'll be able to answer them that day. In other
25 cases, you won't, but you've got to get back to them.

26 We employed both the Boston Consulting Group as a
27 consultant to help us with, if you will, the organizational

1 design, and Spencer Stewart, a search firm that neither
2 company had used because we didn't want there to be a bias,
3 to help us set in place a process for candidate selection.
4 And we were able, when the deal was approved, at the end of
5 the year 2000 -- so the company will be two years old the
6 27th of this month -- within the first six to eight months,
7 to have our entire global management team, and I'm talking
8 down to the plant manager, down to the district manager,
9 down to every department head, chosen and in place. That
10 may not seem like a lot to you, but we're talking, in this
11 case, an employee base to start with of 110,000 people, a
12 management staff within that of about 25,000.

13 I'll wrap up very quickly and say that if we're
14 looking at it today, has it been a success? Yes, in terms
15 of cost savings. Yes, in terms of financial strength. Yes,
16 in terms of sales force, commercial scale and effectiveness.
17 Partially yes in terms of R&D. We have become the partner
18 of choice in that we have completed, since we formed
19 GlaxoSmithKline, 23 business development agreements, largely
20 where we're acquiring product from early stage biotech
21 companies, in some cases Japanese companies. But it is
22 still too early to tell whether we have, in fact, improved
23 the cycle time in terms of R&D productivity, and that will
24 be the ultimate barometer of whether or not this was a
25 success.

26 I'll just close by saying that the cost savings
27 you must get and you can. The speed of implementation is

1 critical. It's not only critical in terms of getting the
2 cost savings, it's even more critical in terms of capturing
3 and retaining the most important asset that you have, and
4 that is the people that are always going to feel at risk.

5 MR. BOWER: Thank you. Thank you, Bob.

6 MR. SCHEINMAN: I want to start first by thanking
7 Joe and David for making me feel so at home here. Since the
8 NASDAQ dropped below 1500 and the California energy crisis,
9 we've ceased heating our house as well, so I feel very
10 comfortable here. I also would say that it's an
11 accomplishment that I've stayed off Welbutrin, even despite
12 the NASDAQ falling below 1500.

13 (LAUGHTER)

14 MR. SCHEINMAN: I want to talk a little bit today
15 about the things that are unique in our space and in our
16 industry, and I know a lot has been made about what's
17 different in high tech and what the differences were. But
18 we've heard a lot, I think, that is very common across many
19 of our industries, and I'm just going to focus on some key
20 things that are different from our vantage point and try and
21 touch some of the highlights. There are a lot of things
22 that I could really reinforce that my colleagues have said,
23 which I'm just going to skip over.

24 For Cisco, M&A, mergers and acquisitions, are a
25 critical activity. It's really A, it's not really M&A.
26 We're really doing acquisitions and it is critical because
27 we exist in open markets.

1 Now, unlike the pharmaceutical industry where you
2 have 17 years of patent protection, we frequently have a
3 week or two, because what happens is that the underlying
4 standards and protocols in our markets are open, which means
5 that anybody can, and in periods of high investment,
6 frequently anybody does, come into our market and build very
7 similar products.

8 If you would have looked at what broke Cisco out
9 of its oligopoly back in 1992, it was really the M&A
10 strategy that allowed us to hit scope and scale before our
11 competitors did. I'm going to come back and talk a little
12 bit about the role of failure because failure is very
13 important to us, as well. It's a critical part of what we
14 do. In fact, I was going to use your line, which is that
15 failing early is a core part of our M&A strategy.

16 Our critical metric is earnings per share, EPS,
17 growth. We try and do that two ways, and I'll go back to
18 Joe's terms. We have our own, but I want to use Joe's words
19 because I think they were much more articulate than ours.
20 We really look at product line extension and R&D as the two
21 areas that we're going to operate in. If we can do that
22 effectively, then we can hold our margins, which is a third
23 benefit. In open markets, the place that you're going to
24 have margins is where you add value, and for us, if we can
25 extend our product lines and if we can enter new markets, we
26 can extend our margins in the markets that we're in very
27 effectively. So, it's critical to us.

1 When you look at what we've done, I think the
2 single most successful deal in the history of the networking
3 industry, and I would put it on par with any deal in
4 technology, was an acquisition we did of a company called
5 Crescendo -- we acquired it for \$85 million. The only press
6 at the time, if you go back, will say that Cisco overpaid.
7 Today, Crescendo and a couple of market extension deals we
8 did represent approximately 40 to 50 percent of the revenue
9 of Cisco. The deal was a new market for Cisco. The
10 management team was largely in place. The president of
11 Crescendo today runs the engineering group for Cisco, and
12 most of his key lieutenants are still in place and still
13 showing up to work despite all that they have. So, I guess
14 that means they're happy, or they want more.

15 And for us, what it allowed us to do was to enter
16 new markets and, again, it allowed us to preserve our
17 margins in routing and to continue to grow and expand, which
18 we would not, otherwise, have been able to do.

19 The other thing that was interesting has been that
20 until this recent slowdown, the market was really
21 characterized by an increasing rapidity of decision. So, in
22 1992, we probably had a year or two before we had to make
23 decisions. By the end of the bubble in 2000, we were having
24 to make decisions within sometimes four to five weeks. The
25 market cycles were shortening and becoming rapid, and the
26 penalty for us was increasingly draconian. If we missed a
27 market or we weren't able to develop something internally,

1 we were either out, as happened in a bunch of cases, or we
2 had to pay what seemed like outrageous prices at the time in
3 order to enter the market. That obviously has implications
4 for our ability to generate EPS, and general success for our
5 shareholders.

6 The environment now has actually changed and we're
7 180 degrees from the environment that we were in. Today,
8 there's a draconian penalty if you go too early. If you go
9 too early, you frequently end up with a product that the
10 customers aren't going to want because it's developed too
11 early, it doesn't have the right feature sets, and you're
12 going to be spending all your time re-engineering something
13 that you've brought too soon, -- or you're going to end up
14 with employees building a product that there's no market
15 for, and there has been, quite frankly, a lot of that out in
16 the public markets. I'll give you an example. The soft
17 switch market is one where people were predicting a market
18 worth billions and billions of dollars. But nobody that's
19 there has been able to make much of a market. Competitors
20 that are public are all trading for under \$2, and acquiring
21 them only would have led to expense to us.

22 So, our environment has changed, which is also
23 bringing us back to pricing discipline and other things that
24 we used to do in the old days.

25 But for us, risk really is critical and what we've
26 discovered when we look at our M&A activities is that really
27 10 to 15 percent of our deals generate 95 percent of our

1 returns. If you think about it, it's really an extension of
2 the venture business. The venture business is the same way.
3 When you look at the funds, it's 10 to 15 percent of the
4 deals generate the returns. If you look at technology
5 across the public companies, same thing, a very, very small
6 number of companies, year over year decreasing actually,
7 generate most of the value that's created.

8 And so, our business is no different, but if we
9 can react quickly, if we can move fast or if we can either
10 succeed or fail faster than the next guy, we are going to
11 have a competitive advantage over them. In fact, I think
12 one of the unsung benefits of our merger and acquisition
13 spree was that it encouraged others to go down the same
14 path, and because we were the premier acquirer of choice,
15 they frequently got second tier companies and it took them
16 longer to either reach their decisions or to unwind the
17 things and we had already moved on from mistakes. And the
18 key for us was just to learn and develop that body of
19 learning and then keep moving forward.

20 I think the role of due diligence is critical, and
21 our benchmark for due diligence is not whether or not
22 ultimately we discover and solve every last problem. It is
23 whether or not we identify the issues and whether or not we
24 were accurate in identifying the issues. And particularly,
25 we spend a lot of time focused on chemistry. I've never
26 been involved in a deal where the two sides have ended up
27 hating each other at the end of the negotiations where the

1 deal has worked. Most of our deals are small enough that
2 the negotiating team can't hide from the integration team.
3 So, we find we spend a lot of time on non-metricable items
4 like chemistry, shared vision and how the two teams feel
5 about each other, which, quite frankly, drives a lot of the
6 quantitative types who work for me crazy because they're not
7 quite sure how you measure these things, and yet, we find
8 that those are sort of the critical success factors.

9 So, we spend a lot of time, too, on our teams
10 making sure that the high EQ, emotional intelligence
11 quotient, people are as rewarded as the high IQ people and
12 that we make sure that we do both EQ and IQ due diligence
13 when we look at things.

14 The other thing I would say that our industry
15 dominates is that we have battles internally within the
16 companies going on between the go-to-market side of the
17 house and the product side of the house. Decisions are
18 dictated at varying times by perceived strength or
19 weaknesses between the go-to-market side or the product
20 side. Almost invariably deals fail when one side or the
21 other uses the deal as a fix for a perceived weakness on the
22 other side. So, when people say, gee, we don't really have
23 a good sales strategy in market X, if only we acquire them,
24 then everything will be fine. Well, what will happen is the
25 people who didn't have the particularly good sales strategy
26 are then managing the sales force of the company you've
27 acquired and generally one side or the other leaves and

1 you're in chaos.

2 So, we have learned that fixing the other side's
3 problems is not really a strong way to go. We've tried to
4 say that we are not going to solve problems that are on your
5 side of the house, we're not going to try and solve the
6 other side's problem when we're the house.

7 The last point I would make is one that's been
8 made repeatedly, which is that the integration is critical.
9 I'm going to tell one story and then I will turn it over for
10 Q&A.

11 Our first public deal was a company called
12 Stratcom. I can remember going to the closing dinner. We
13 spent about 45 minutes toasting the acquisition team and
14 what geniuses we were. And I can remember increasingly
15 seeing the people in the back of the room looking more and
16 more sullen because they were the integration team and they
17 recognized that there was not going to be a party to
18 celebrate the integration, there were not going to be
19 toasts, no one was going to say, hey, congratulations, the
20 systems are up and running, and meanwhile, we were toasting
21 ourselves as geniuses.

22 It was the last closing party we've held. We
23 don't do closing dinners anymore. We now look for
24 milestones to try and celebrate the integration teams and
25 bring them out of the holes and the bunkers and try and say,
26 hey, congratulations, we've hit this milestone, why don't we
27 all go out for dinner and sit down and chat. To be frank,

1 during the bubble, as the deal flow increased and we were
2 doing a deal every other week, it was harder and harder to
3 keep up and make them feel these things were genuine, here
4 we are again, another dinner, congratulations.

5 (LAUGHTER)

6 MR. SCHEINMAN: But we're trying to revive some of
7 that culture as we go forward.

8 So, for us, I think we have opportunities now that
9 we didn't have before. We have an environment that is more
10 rationale, which will allow us to, I think, increasingly do
11 the things that we do that are core to our success. At the
12 end of the day, I think we have opportunities now that we
13 did not have in the bubble, and I think you're going to see
14 that we're going to continue to leverage our strengths going
15 forward to be successful.

16 MR. BOWER: Thank you. Thank you, Dan. Thank
17 you, Bob, and thank you, Juan Pedro. It's interesting,
18 isn't it? We've tried to suggest how important specifics
19 are, but now we've got Procter & Gamble, GlaxoSmithKline and
20 Cisco, and I think you can see how very, very different are
21 many aspects of M&A, but there are many similarities. And I
22 just wondered first, does anyone on the panel want to either
23 comment on the presentations or raise questions with the
24 speakers?

25 (No response.)

26 MR. BOWER: No? Okay. Then, do we have the
27 microphone and are there questions from the floor? After

1 this question and answer, I'm tempted to say that we will
2 take a five-minute break max. I mean, we're really going to
3 just break briefly and then start again, and we will pick up
4 with negotiating the deal and then we'll pause and take
5 questions again, and then go on to the final portion.

6 Do we have questions for the speakers? Yes?
7 Please wait for the microphone. This comes from Brussels.

8 MR. PETIT: That's right. This is a question for
9 Mr. Hernandez from Procter & Gamble. You mentioned that
10 essentially value comes from revenue efficiencies. Could
11 you be more specific and explain what you mean by revenue
12 efficiencies?

13 And then one question to Mr. Ingram for
14 GlaxoSmithKline. You talked about how you increased your
15 R&D budget from "three plus one" to five, and you mentioned
16 that the transaction actually brought financial strength.
17 Could you be more specific about that? Thank you.

18 MR. HERNANDEZ: Let me address your first
19 question. What I meant to say is that our most successful
20 acquisitions have delivered revenue efficiencies, and I also
21 said that there are two sources of value creation when it
22 comes to acquisitions in our case. One is that of revenue
23 efficiencies. My three examples, Richardson-Vicks Inc.,
24 Iams, and Spinbrush essentially support and back up this
25 statement. I also said that we look at improving the
26 profitability and the cost structure of the asset(s) that we
27 acquired. So, it is not either/or, it is a combination of

1 both.

2 To reiterate, in our case, our most successful
3 acquisitions have common elements in that we are able to
4 build a brand, to expand it through our strong go-to-market
5 capability, so that we delight consumers around the world.

6 MR. BOWER: So, what you're saying then is, by
7 efficiencies, that you're able to take products, for
8 example, RVI products, and using the Procter distribution
9 system and marketing skills, drive them further into the
10 global market?

11 MR. HERNANDEZ: Yeah. We use the technology, we
12 use the equities and we use the go-to-market capabilities to
13 increase and to grow the brands that are being acquired.

14 MR. BOWER: I don't know if everybody is aware of
15 the extent to which Procter is a really remarkable
16 manufacturing company. So, when they say technology, they
17 are really at the leading edge in terms of the specialties
18 that they're dealing with. And for those of us who use
19 their products, that's a good thing.

20 MR. INGRAM: Joe, I'll be very brief. The two
21 legacy companies in R&D, in dollar terms, Glaxo was
22 investing about \$3 billion a year, SmithKline was investing
23 about \$1.2 billion a year, so the net investment was a
24 little over \$4 billion. We've taken that now to \$5 billion.
25 That was funded largely by some of the cost savings,
26 particularly cost savings that came out of the manufacturing
27 area, and cost savings that came out of the administrative

1 area. But it was also just the shear decision we made,
2 which was the heart of why we think this merger will make
3 sense, that our future is really tied to R&D productivity.
4 We knew that as a combined company, we would have an
5 increased ability to invest in R&D. We had to make that a
6 reality on day one, and it wasn't just throwing money
7 saying, we're bigger. We saw, as we aligned those six
8 centers that I spoke to, an opportunity to invest, and as
9 best as one can tell about an early stage research
10 investment, make it a good investment.

11 MR. BOWER: Thank you. Any other questions?

12 (No response.)

13 MR. BOWER: Why don't we just stop here very
14 briefly. This is not a 15-minute break. This is going to
15 be, if anything, a four-minute, five-minute break.

16 **(Whereupon, a brief recess was taken.)**

17 MR. BOWER: As we get started, our hosts have
18 suggested that we now listen to the next presentations and
19 do the Q&A at the end. What I'm going to do is ask Michael
20 Jones to speak next, and then next would be Peter, and then
21 after that, we will focus on M&A implementation with
22 Illinois Tools and Conoco, Bill Earnest.

23 **(Whereupon, there was a brief pause in the**
24 **proceedings.)**

25 MR. BOWER: Why don't you go ahead, John?

26 MR. MAYFIELD: You want me to start? All right,
27 very good.

1 I will cover three key areas here in my allotted
2 time of about 10 to 15 minutes. First of all, I'd like to
3 give you a brief introduction to Illinois Tool Works, ITW,
4 for those of you in the audience that are not familiar with
5 the company. I'll then touch on how we set price in our
6 acquisitions during the negotiation process, and then I'll
7 briefly talk about due diligence process and what we expect
8 to accomplish during that review and intelligence gathering
9 process.

10 First some background on ITW. In the past five
11 years, ITW has purchased approximately 159 companies. We do
12 not pursue the unreasonable targets (the bluefish that were
13 referred to earlier). The total purchase price paid for all
14 of those companies approximated \$6.3 billion, and if we
15 exclude one acquisition in the past two years called
16 Premark, we have purchased companies that average about \$20
17 million.

18 ITW serves the following key market segments, as we
19 define them -- residential construction, commercial
20 construction, automotive OEM, automotive tier one, and the
21 catch-all called general industry.

22 ITW is a bit different. We do not have any particular
23 department that is assigned to acquisitions or strategic
24 mergers. Our target identifications come from about 600
25 operating units. We have eight EVPs, executive vice
26 presidents, that also participate in the identification
27 process, and certainly the CEO.

1 Most of our acquisitions and ideas come from the bottom
2 up. Almost 90 percent of them come from operations. Less
3 than 5 percent are, what I would call, CEO-generated. So,
4 maybe perhaps that's a criteria for success. Since the vast
5 majority of acquisitions initially emerge from the operating
6 level, it means that the people responsible for integrating
7 and managing the operation are involved on Day 1. There is
8 no drama of a handoff from a corporate mergers and
9 acquisitions department. The operating people will know the
10 target and possess quite a bit of knowledge before we even
11 enter the due diligence phase.

12 Our due diligence process is a team concept. As I have
13 said, the operating people are involved on Day 1. They are
14 supported by a tax department, legal department, and
15 internal audit. We do outsource a number of areas in terms
16 of environmental law, and even in the Hart-Scott-Rodino
17 area.

18 We have a standard checklist that we use to gather a
19 number of standard items. For example, we would gather
20 copies of contracts, commitments, employee benefits, leases
21 and so forth. Simultaneous to this, the operating
22 management would refine the acquisition model and attempt to
23 confirm assumptions that have been used in the determination
24 of the purchase price.

25 Some prior presentations have indicated that
26 almost 50% or more of the acquisitions fail. Some of the
27 key reasons are over payment of purchase price, and

1 inability to transition the business as planned. This
2 usually means overly aggressive top line growth assumptions
3 or unsupported cost reduction assumptions.

4 ITW seems to go against this failure rate. Over 95% of
5 the acquisitions ITW makes, we term successful, and I'll
6 talk a little bit about that at the end, what we mean by
7 successful.

8 We talked during the lunch break with the panel and
9 there are some internal criteria that you would use to
10 determine whether an acquisition was successful, and there
11 are also some external criteria.

12 Let's move to the negotiation process. One of the
13 key or the most important points, I think, during the
14 negotiation process is actually setting the price. We have
15 found that when the price is not set correctly, when you
16 overpay, you begin to make some very short term, what we
17 think are incorrect decisions -- cost-cutting, reduction of
18 research and development and the like. Certainly, in the
19 long run, that is going to impact the acquisition, and in
20 the end, not only will it be a failure internally, but it
21 will be a failure to the end customers that you're actually
22 trying to serve.

23 A key aspect, when we are setting the purchase
24 price, is that we really don't proceed until we have a clear
25 fit for the acquisition. There has to be an absolutely
26 clear strategy of where it's going to fit in the
27 organization, and why we are making the purchase. We need

1 to clearly understand why we are pursuing the target. There
2 has to be a clear and logical integration plan.

3 This has been brought up by all of the panelists, earlier
4 today, that there has to be a very clear integration plan,
5 and I can't emphasize that enough. I think that's why we
6 are successful, because the operations people are involved
7 up front in setting that integration plan.

8 But assuming we get past those points, our biggest
9 question we're going to ask, as we're setting the price, is
10 whether this is going to benefit the customers. What do
11 they expect to get out of this transaction? As I mentioned,
12 we serve some traditional markets, construction and
13 automotive, and we feel, for whatever reasons, that both of
14 those markets are under-served by their suppliers. We think
15 ITW brings a number of new and innovative ideas to those
16 markets, whether its new technology, research and
17 development, or improvement in the supply chain so they can
18 be successful.

19 When we actually set the price for an acquisition,
20 we use some of the same traditional methods I think most
21 companies would use. We do look at revenue growth. We look
22 at the possibility of increasing prices, which is almost
23 non-existent in the markets that we serve. We look at
24 improvement in the cost base, whether it's the delivery of
25 the product or the actual manufacturing of it. We certainly
26 look at the working capital that's employed. We look at the
27 cash flow. Our target measure is to set a price that gives

1 us a return on invested capital anywhere within a 12 to 36-
2 month period.

3 Some factors that go into setting that price and
4 where we see the risk are whether this is a domestic or
5 international acquisition. Internationally, there are some
6 additional risks that we don't necessarily have here
7 domestically. We look at whether we're going to have to do
8 significant restructuring, which is an additional cost to
9 us.

10 The key question we ask is, "Are we going to be
11 able to retain these customers, and is this a revenue stream
12 something we can count on?" If, in fact, we are a little
13 skeptical of the revenue stream, we're going to have to
14 adjust our purchase price accordingly. The key question is,
15 "Are we going to like it when we get there?"

16 During the due diligence process, as I said, our
17 most important area that we first look at is determining the
18 revenue stream and whether that can be maintained. During
19 this process, we attempt to survey customers involved in the
20 transaction. We will look at the products they receive,
21 what they perceive as either a lack of product, lack of
22 research and development, lack of attention, or lack of
23 ability to receive product on time. If we can't confirm the
24 revenue stream and we can't talk to customers and we can't
25 develop a thorough understanding of what we're getting into,
26 then we'll either back away from the acquisition or we will
27 discount our price accordingly.

1 In traditional due diligence, we will actually
2 confirm our financial numbers through audits, internal
3 reporting, tax return data, and the like. Another
4 particular area that we look at in terms of due diligence is
5 our risk. We have entered into a number of acquisitions
6 that had plants that are not one or two years old, but, 50
7 or 60 years old. We have human resource issues in terms of
8 retaining key employees and there are also issues that deal
9 with product liability and general liability. When we are
10 conducting our due diligence, those particular areas form
11 the basis for our indemnification clauses and/or, again, a
12 price discount.

13 As I said a little bit earlier, we like to involve
14 the operating people very early on in the process of the
15 acquisition. They are going to be the individuals that will
16 be responsible for running the acquisition. We feel that by
17 having them involved in the process early on, they can hit
18 the ground running when the ink is dry on the acquisition.

19 At the completion of due diligence, we confirm our
20 price model. We make a go/no-go decision. We make any
21 purchase price adjustment necessary and then we move
22 forward. I think as we look toward success of an
23 acquisition, we measure it two ways. We can measure it from
24 an external viewpoint, the customer. We can see if
25 customers have been retained and are satisfied, whether we
26 have been able to introduce new products and improve
27 customer service. Externally, we can do surveys and perform

1 focus groups to see if our customer base has been served.

2 Internally, we look at the return on invested capital
3 and whether or not the operation is actually hitting the
4 metrics that we have set up for it. Stockholders can look
5 to our outside numbers, such as earnings per share, goodwill
6 impairment, and return on invested capital to see if we
7 behave the way those who have entrusted funds to us would
8 like us to behave. So, those are some of the ways we can
9 look at success.

10 Since we do a very large number of acquisitions,
11 we do also have experience with failures. Some of the areas
12 of failure that we've seen in the past occur due to the
13 inability to communicate our corporate philosophy to the
14 newly acquired work force. Another area is the loss of the
15 revenue stream, and as I said, that was our number one due
16 diligence concern. No matter how diligent you may be in
17 that area, losing the revenue stream can be initially
18 devastating as competitors come at you early.

19 I think that kind of covers the areas, Joe, that you
20 wanted.

21 MR. BOWER: Thank you, John. That's great.
22 Peter, do you want to pick it up from the point of view of
23 an investor group?

24 MR. BRODSKY: Sure. Let me just spend two minutes
25 talking a little bit about who Hicks, Muse is because while
26 a lot of the things that my fellow panel members said ring
27 true, we come at it from a slightly different perspective.

1 We are a private equity firm and we manage about
2 \$8 billion in assets. We've executed about 400 transactions
3 worth about \$50 billion over the last 15 years. So, our
4 firm's success really lives or dies by the success of our
5 M&A, merger and acquisitions, activity, and we really
6 measure our success in a very simple way, which is, has an
7 acquisition enhanced the value of our investment or
8 decreased the value of our investment.

9 When it's an initial platform investment, we're
10 calling capital from our investors, say \$100 million, the
11 day we invest that money, it needs to be worth more than
12 that six months later or we're not doing our job on behalf
13 of our investors. There are a variety of factors that help
14 determine whether or not our equity is, in fact, growing in
15 value or declining in value. A lot of the things that these
16 gentlemen have talked about, customer satisfaction, also
17 preservation of revenue, execution of cost savings, but at
18 the end of the day, that's the metric that we're measured by
19 and we are measured by with our investors.

20 The other thing that's slightly different is that
21 when we buy a company, our funds have a 10 to 15-year life
22 span. So, any investment that we make, we intend to exit,
23 on average, between three and seven years later. So,
24 there's a very finite period of time when the value needs to
25 be created, there's a very finite period of time when the
26 acquisition will be deemed to be a success or a failure.
27 So, in a lot of ways, it makes our job in measuring

1 ourselves simpler because it's such a finite specific target
2 that we're trying to hit.

3 Having said all that, I guess I'm talking today a
4 little bit about negotiation and also about deal
5 structuring. What we do in terms of the negotiation and the
6 deal structuring is the follow-up to what these gentlemen
7 have been talking about for the past couple of hours in
8 terms of preparing and performing due diligence in an
9 acquisition. That is, we go through a very similar process
10 where we target a company -- our criteria typically are
11 strong cash flows. We look for market leaders, we look for
12 companies that are in consolidating industries where we're
13 going to be able to put more capital to work in that company
14 and hopefully realize some cost synergies which I'll talk
15 about in a moment.

16 Having done that targeting, having done that
17 planning, really, I look at the negotiation and the
18 structuring process of the deal as a competition between the
19 buyer and seller as to who's going to take on more risk and
20 who's going to keep more up-side. And really, you can boil
21 down a negotiation to those two factors. So, for a seller,
22 the ideal structure is a stock sale where all the
23 liabilities go with the company, where the selling company
24 is getting credit for projections that are hockey stick in
25 nature, and which implies a very large multiple of current
26 year's profitability based on a very rosy picture of future
27 growth.

1 For a buyer, the ideal acquisition is an asset
2 acquisition where there's very limited liability traveling
3 with the deal based on a series of projections showing flat
4 to declining profitability, so that there's a very low
5 multiple. And one side comes to the table with one agenda
6 and the other side comes to the table with the other agenda,
7 and the negotiation ensues. A lot of time is spent
8 negotiating about whose responsibility a variety of
9 liabilities are, a variety of tax liabilities, legal
10 liabilities that you spoke about earlier is important. And
11 then to me, the key area of negotiation is the discussion
12 about who gets paid for the efficiencies that we've been
13 talking about all day today.

14 The seller's argument is always, look, I've got
15 three bidders bidding for this property. They're all going
16 to ring out the same efficiencies you're going to ring out,
17 be they cost efficiencies or revenue efficiencies, and this
18 is a competitive process. The winner is going to be the one
19 who's going to pay me for those efficiencies.

20 And the difficult challenge in our industry is to
21 maintain discipline and not pay for those synergies because
22 those synergies are highly speculative in nature and we've
23 talked a lot today about how there's a perception that
24 mergers fail and the reason for that perception is that
25 there's a lot of overpaying.

26 And I would say that overpayment really is two
27 things. One is overly rosy projections of the base

1 business, which are fully paid for up front, but even more
2 importantly, overly rosy projections of synergies, be they
3 cost or revenue, that are also paid for up front. If
4 they're paid for up front then the implementation team, that
5 the rest of the panel is going to talk about today, is
6 really in a very difficult situation because the more you
7 pay for those, the less room for error there is on the
8 implementation side. Implementation is fraught with error,
9 and sometimes it's trial and error and not everything goes
10 according to plan.

11 So, really, I view my job and my partners and
12 colleagues view our job, when we structure a deal, is to be
13 disciplined enough, while remaining competitive in a
14 process, so that our management teams have some ability to
15 fail in the implementation process and not have it be
16 devastating to the company.

17 That is particularly important in a leveraged
18 buyout. We don't do stock deals, we do cash deals financed
19 by leverage. So, the under-performance of a business
20 doesn't just cause the stock price to go down, it can send a
21 company into bankruptcy. That is -- the stakes are very,
22 very high in a leveraged buyout, which is why we try to be
23 very, very precise in how we negotiate deals.

24 So, let me talk a little bit about the different
25 kinds of efficiencies because there's a different risk
26 factor to each of these efficiencies. I've categorized them
27 into three or four buckets and then every time I created a

1 bucket, I found several sub-buckets. So, now, I'm not sure
2 how many there are, so please bear with me.

3 In a platform acquisition, which is one unlike
4 anything that these gentlemen would be doing, where we don't
5 have any operations to integrate into the business, we are
6 buying a platform. That doesn't really change the
7 competitive dynamic of the marketplace because we're just
8 becoming a new owner of a business, we're not combining two
9 businesses. There's really one kind of cost synergy, which
10 is I'm going to do it better than the current management
11 team is doing it. And those cost synergies are sometimes
12 very, very real.

13 Our biggest successes as a firm have been from
14 acquiring subsidiaries of large corporations where that
15 particular subsidiary was non-core. There's only so much
16 that a CEO of a large company can do in a day and those non-
17 core subsidiaries often are under-managed. There are very
18 meaningful cost synergies to be realized from such companies
19 and, also, revenue synergies because you put in an
20 entrepreneurial capital structure and you unleash the
21 management team or put in a new management team and there
22 can be some very meaningful growth.

23 One of our most successful deals we actually
24 bought from American Home Products was their food division.
25 It was a series of very, very solid brands, Chef Boyardee
26 and Polaner All Fruit and Jiffy Pop Popcorn, but it just
27 wasn't being managed actively because it was a tiny division

1 of a huge company that wasn't focused on food. We bought
2 that company. We paid a very high multiple of current year
3 cash flow, but there were so many cost synergies and
4 efficiencies that we could see just from putting in a more
5 entrepreneurial management team and cutting some fairly
6 bloated G&A, that we were able to bring our multiple down
7 fairly rapidly. Then we engaged in a buy and build process
8 where we added on brands onto that platform, and that's
9 where we started to see some of the synergies like we've
10 been talking about today where we were able to take brands
11 and put them through our distribution pipeline and enjoy
12 those kinds of synergies.

13 So, getting back to my original point, the first
14 one is just cost synergies, the I can do it better
15 synergies. Another kind are the kinds we've been talking
16 about today where there's actually an existing
17 infrastructure that you can put another product into, you
18 can eliminate a tremendous amount of G&A and you can also
19 drive the top line very significantly by putting that
20 product through your infrastructure.

21 And then there are the harder to calculate, harder
22 to justify revenue synergies that will come from putting two
23 companies together -- you've got Companies A and B, you can
24 sell Company B's product to Company A's customers and
25 Company A's product to Company B's customers and there
26 should be a tremendous amount of synergy. As you go along
27 the continuum of this, I can do it better through the cross

1 fertilization, cross marketing, I would say it's going to
2 get riskier and riskier. And what we try to do as we
3 negotiate and as we execute is it's okay to pay for a little
4 bit of the low-hanging fruit synergies, but if you've begun
5 to pay for every last bit of growth that you're going to see
6 out of the acquisition, you have a very, very high
7 likelihood of having overpaid for the deal when you're done.
8 That is going to be a failure in our book because our equity
9 value will decline over time.

10 So, that's really what the negotiation is,
11 particularly in a platform, and in an add-on acquisition,
12 once we have a platform. The transaction we were talking
13 about earlier would be an example where we have a platform
14 and we're adding on products or merging with another
15 company.

16 The other key negotiation point is the selection
17 of the management team. You referred earlier to how
18 challenging that can be. My experience and my firm's
19 experience is that if you aren't crisp in your selection of
20 a manager to run the process, you have a much higher
21 likelihood of failure. So, a compromise at the negotiating
22 table on a co-CEO or a co-COO or a co-implementation team
23 means that there are going to be sacred cows as the
24 integration process goes through and you can really end up
25 in a nightmare. So, I commend GlaxoSmithKline for
26 recognizing that and redoing it. And that's, I guess, the
27 third element.

1 I talked earlier about everything in negotiation
2 being a balance between who gets the liabilities and who
3 gets the up-side, and then there's also the ego factor in
4 any negotiation, and to the extent that that can be
5 mitigated, that is going to do good things for the company.

6 So, hopefully, that addresses the question, but
7 that's really what's on our mind as we seek to negotiate,
8 and then the deal structure is simply the documentation and
9 the implementation of the decision about who's getting what
10 and who's taking what risk. And then, hopefully, from
11 there, there can be a quick execution, so that the
12 implementation can begin, and that's where the real value
13 gets created.

14 MR. BOWER: Thank you very much, Peter. We now
15 turn to GE and Michael, and go on to the implementation
16 phase.

17 MR. JONES: Joe asked me to talk today about the
18 acquisition integration and implementation process. Like a
19 lot of my colleagues for GE and GE Medical Systems, the use
20 of acquisitions is a critical component of how we help the
21 business execute on a strategy faster. We've got, at any
22 given time, probably 15 or 20 different integrations going
23 on at once, and it's really kind of the engine that keeps
24 the front end of the process driving. The fastest way for a
25 business, and GE, to kind of lose its ability to acquire
26 businesses to help execute on strategy, is to fall down on
27 the integration and implementation front.

1 So, what I'm going to take you through today is
2 just some thoughts on process and people around integrations
3 and then through a tool that we actually use to manage our
4 integration process. That way you can see the things that
5 we view as important and see how we get visibility on how
6 we're actually doing it and measuring acquisitions.

7 A lot of these points have been hit on already
8 and, as seen in the slide on the bottom of the first page of
9 my handout, we kind of boiled down the integration approach
10 into three buckets; process, leadership and people. And,
11 again, probably because GE borders on being process
12 improvement junkies, we spend a lot of time focusing on
13 this. We really try to make sure that a view on integration
14 starts with the due diligence process on a business, so that
15 when it comes time for a hand-off to the business, it's a
16 seamless process.

17 It's always a tough balance, and there's really no
18 one answer to try to balance independence and culture of an
19 acquired business and the desire to try to integrate
20 quickly. You do need to make decisions quickly, but
21 respecting a culture that you're bringing into GE is also
22 very important. We also place a big emphasis on trying to
23 adopt some of the best practices of the companies we acquire
24 so that, at the end of the day, a company we acquired
25 doesn't look like GE necessarily at the end of the
26 integration period. But some of the things that made the
27 company valuable to begin with are there and in place. And

1 this really requires not just the team of people who are
2 involved in the acquisition, but kind of a broad business
3 ownership and cross functional engagement from different
4 parts of the business.

5 From a leadership perspective, commercial
6 sensitivity is really our first priority; i.e., the
7 customer. It's always on our screen, it's always an
8 important part of what we're looking at. If we lose our
9 customers at the end of the day, the business that we
10 thought we were acquiring is somewhat irrelevant. So, we
11 set clear measurements and we closely monitor each of the
12 businesses we acquire to make sure that we have early reads
13 on how we're doing on this front. While you may not know if
14 an acquisition is successful or not, at least from the
15 buyer's perspective, for several years, the first 12 to 18-
16 month period, in our experience, is really the critical one.
17 We're looking for real-time information to determine whether
18 or not what you were hoping you acquired turns out to be the
19 case and make sure you're doing the right things there.

20 Ultimately, from a leadership perspective, the
21 business leader who owns the business and where the business
22 is going to end up, owns the integration -- has dedicated
23 people working on the integration. It's the business leader
24 that has to own the integration, and, again, from the front
25 end through the integration process.

26 Finally, on people, in addition to the commercial
27 sensitivity, you've heard a number of people say today that

1 making sure you're retaining talent is absolutely critical
2 in an acquisition. And we focus on commercial and key
3 talent retention, and in our business, that's primarily
4 technical R&D type of talent. And what we're hoping for is
5 to create the right incentives in an integration plan to
6 have the key players actually give GE a chance to have us
7 prove to them that we can be a great place for them to
8 prosper, grow their careers and, hopefully, open up the
9 whole wealth of new opportunities for them.

10 Regarding integration managers, and we learned
11 this probably the hard way when we first started spending a
12 lot of time on acquisitions, you have to make sure that
13 you're not kind of underwhelming an integration by having a
14 player who's not top-notch, fully dedicated leadership, in a
15 leadership position related to the acquisition.

16 You've got to overwhelm, in many cases, from a
17 leadership perspective, who you're applying to deal with the
18 integration, and also make sure that from the acquired
19 company's perspective, they are also dedicating key
20 leadership positions as well. You're taking top people out
21 of their jobs and making sure that they're motivated,
22 compensated, incented, to make sure that you're working
23 together on what you're trying to drive as a combined
24 organization and you're doing everything in parallel.

25 We've got a tool that we call E-integration, which
26 is basically an online tool that helps bring all this
27 together, that creates clear objectives that we can then

1 track and make sure we're delivering on. I'll use the slide
2 on the top of page 2 of my handout to take you through this
3 tool.

4 This is actually a screen shot taken a little bit
5 of time ago, but essentially this is a tool that the senior
6 leadership of our business and of GE can look at on any
7 given day to see all the acquisitions we're working on or
8 the integrations that we're working on and how we're doing
9 from a performance perspective as well as from an
10 integration executive perspective. And this is really the
11 tool that the integration team works off of, GE management
12 team works off of, and also, the target employees are
13 looking at so that there's transparency and the opportunity
14 for immediate feedback on how we're doing on each of the
15 integrations.

16 The slide provides an example of a company we
17 acquired a couple years ago. The slide is segregated into
18 acquisition performance, which has a number of components,
19 integration execution, which is kind of more of a functional
20 exercise, and finally what we call customer centricity,
21 which is, again, trying to make sure that we're getting
22 feedback from the customers of the acquired company to make
23 sure that we're meeting their needs. A big part of what
24 we're doing in our acquisition strategy is to attempt to try
25 to bring a broader offering of products and services to our
26 customers and to new customer bases.

27 Everything kind of starts with the financial

1 performance. This is something that's pretty
2 straightforward and something we track and our CEO looks at
3 on a weekly basis. It's a leading indicator of how well
4 you're doing financially. At GE, hitting your numbers is
5 critically important. It's no different for acquisitions.

6 So, we look and track very closely the financial
7 impact relative to the plan that we've put forth during the
8 due diligence and the negotiations to make the case for GE
9 to invest in this business.

10 We then have what we call deal CTQs. CTQ is a GE
11 vernacular for critical to quality. Essentially, key
12 success factors. And this speaks to some of the key
13 strategies of why we acquired a business, and this may be
14 sales into a new country, into a new region, into a new
15 segment of customers. It may be the timing or the product
16 sales related to a new product introduction. We try to boil
17 it down into one or two or three, for a larger transaction,
18 five things, that from a leadership perspective and from a
19 team perspective on the integration, that you've identified
20 as being the important things, that if you do these things
21 right, you know that your tracking and your integration is
22 on a good path.

23 And then the next piece is what we call
24 operational CTQs, which are more kind of functional metrics,
25 similar to the overall strategic reasons for doing a
26 transaction, but things that are sometimes a little bit
27 softer. Some of it relates to the people side of the

1 integration, new product introductions. So, it's different
2 milestones from an operational perspective, customer
3 satisfaction, employee retention, those types of things that
4 are more operational in nature. Again, these are things
5 that you want to track that don't necessarily appear in the
6 financials of the business, but from an integration
7 perspective are absolutely critical for success.

8 We then look at integration execution, which is
9 kind of process-oriented, and really much more detailed.
10 There are almost five functional areas in the business that
11 will track how we're doing versus the integration plan in
12 terms of completion of those items. Then there's a group of
13 things we call GE non-negotiables, things that are important
14 that, again, the CEO of the business and the leadership team
15 wants to make sure that are being done and done in a timely
16 manner beyond a much more detailed integration plan.

17 There's a component of the tool that gives
18 executive updates. Our CEO and some of his leadership team
19 will review these on a weekly basis, and the integration
20 team will highlight critical issues, key wins that will
21 require leadership input, again, to make sure that issues
22 are highlighted, flagged, related to the integration and to
23 the business that we've acquired, and that we can make real-
24 time decisions on this.

25 Finally, this point called customer centricity,
26 which actually is the result of input that we're getting
27 directly from our customers -- we call it voice of the

1 customer. When we announce the acquisition of the business,
2 we will communicate with its customers, in some cases,
3 common customers to ours, and provide them a forum by which
4 they can communicate to us and let us know how we're doing,
5 whether it's around service issues, good, bad, indifferent.
6 We give them, through the web, a place to come in and tell
7 us how we're doing, provide input and make sure, again, that
8 we're maintaining the revenue base and the customer
9 satisfaction that we think is one of the most critical
10 success factors in any integration we're doing.

11 And this has been great when -- in addition to
12 providing us with real information, our customers appreciate
13 the fact that we're going out of the way to make sure the
14 process of integration, which can be a pretty tumultuous
15 time, particularly for the employees of an acquired company,
16 that we're still taking the time to listen to what the
17 customers are saying and we're trying to be responsive to
18 their needs.

19 Just some more detail on this tool. Again, I
20 highlighted some of these things, but it's drill-downs on
21 some of the live information, and then this is something
22 that we try to keep fresh and it's actually the tool that
23 the integration team is running the integration off of. We
24 will generally keep an integration on this tool for 12 to 18
25 months to make sure it's kind of well on its way to being a
26 successful platform. New businesses will track much longer
27 than this. Businesses that are more fully integrated into

1 our businesses will come off the screen more quickly.

2 But, again, the key thing that we have found is
3 the ability to have visibility into actually what's going on
4 in a relatively simple way, and accountability around these
5 actions that have to happen during the integration enables
6 us to make real-time decisions. When you're in this pretty
7 important period, initially when you acquire a business,
8 this tool enables you to make sure that something doesn't
9 drag on for several months before you can respond and make
10 the right decisions, try to correct some action that may
11 have happened as a result of the integration.

12 Finally, there is this piece on customer voice.
13 This is something that we really, really have spent a lot of
14 time on in our business. It goes all the way back to how we
15 develop products with our customers, the voice of the
16 customer in our product development activities, and then
17 ultimately into how we're doing acquisitions. It is an
18 absolutely critical component in whether or not we think
19 we're doing well from an integration perspective.

20 If we're delivering well against the financial
21 plan for an acquisition and we're not doing well from a
22 customer perspective or from an employee satisfaction
23 perspective, we wouldn't consider this a success. So, all
24 of these different factors weigh into whether or not we
25 think we're doing well. Ultimately, the voice of the
26 customer is probably the best leading indicator, we think,
27 of the ability of the business to continue on whatever

1 trajectory it's on and to deliver -- whether on revenue
2 synergies that you might have baked into your acquisition
3 analysis or into ultimately how it affects your cost
4 synergies. So, that is what I've got.

5 MR. BOWER: Great. Thank you, Mike. And, Bill?

6 MR. EARNEST: I think I might have one slide I may
7 put up in the interest of time.

8 First of all, I want to say we're still in the
9 early days at ConocoPhillips. So, to ask us to talk about
10 integration and implementation is interesting, although I do
11 think we have done a lot of things the right way. Our
12 merger of equals was announced in November 2001, and we
13 actually got regulatory approval and closed around September
14 1, 2002. So, we're just three months into our merger
15 integration.

16 A couple of things we do have going for us - one,
17 we did not pay a premium. It was a true merger of equals,
18 done "at market", meaning neither party overpaid. So, shame
19 on us if we don't make it work. The big value driver for us
20 was synergies and combining the capabilities and opportunity
21 sets of the two companies. We hired McKinsey to help us
22 with the process, and once we got the process down, we took
23 over ownership and McKinsey was gone in a matter of three or
24 four months. But they did help us put a process in place
25 that we now own.

26 Real quickly, I'll just run through the
27 integration team that we put together. First of all, we

1 established a separate team, an integration management team,
2 which worked along with the CEO's of the two companies,
3 Archie Dunham and Jim Mulva. That high level group, for the
4 first month or two after the announcement, worked on high
5 level strategies and objectives for the new organization.

6 We also picked two of the brightest and probably
7 most upwardly mobile individuals in the two companies below
8 the CEO level, Phil Fredrickson from the Conoco side and
9 John Lowe from the Phillips side, to lead the integration.
10 So, again, we were picking leaders that we thought had a
11 vested interest in making this merger work, not only in the
12 next few years, but really, in the long-term. If you were
13 to ask the people at Phillips and at Conoco, who were the
14 most likely successors to their current CEO's, these were
15 the two guys most people would mention. And so, they were
16 put in charge of integration.

17 Below that, we had seven integration teams. One
18 for upstream, which is the exploration and production part
19 of the business, and one for downstream. These are our two
20 major lines of business. Several of the functional areas,
21 such as Finance and Human Resources, also had teams, and
22 then below that, we had 64 sub-teams. So, altogether, we
23 had 500 to 600 people working integration.

24 Again, the people that led these seven sub-teams
25 didn't know exactly where they were going to land in the new
26 company. But, they were key leaders in the company and we
27 knew the people that were leading the upstream team had a

1 role in the future upstream organization. They didn't know
2 exactly where, but they had a role and a stake in making it
3 work, and also had ownership in the synergy targets.

4 One of the things I think we did extremely well
5 was getting our organization named, working with the
6 regulatory authorities, naming key people, and trying to get
7 our organization in place as early as we could. And, then
8 as we named these people into their specific positions, they
9 took over ownership of the integration process, the synergy
10 targets, and the organizational goals that had been put in
11 place at the high level.

12 These were two very proud companies with two very
13 similar backgrounds. Both, in a way, were caught up in the
14 takeover frenzy in the early '80s. Phillips fought off the
15 Boone Pickens takeover attempt, but it had a impact on the
16 company for years to come. Conoco was "rescued" by DuPont
17 in 1981 after a hostile takeover attempt by Seagrams, then
18 was spun back out as a public company in 1998. So, really,
19 we're both survivors in an industry that has seen much
20 consolidation. Both companies were not willing to do this
21 transaction unless it was a merger of equals.

22 We said we were going to take the "best of the
23 best" in people selection, and I think we did a first class
24 job of picking the best people, and keeping the strengths of
25 the two organizations in place. That did not mean that in
26 every department 50 percent of the people were Conoco
27 people, 50 percent were Phillips people. In fact, you'll

1 find that the operating side very much went Conoco's way, at
2 least at the executive level. Conoco was known for a very
3 strong operating culture, both in upstream and downstream.
4 Phillips, on the other hand, was more known for its hard-
5 nosed financial acumen, and you'll look in the finance
6 department of ConocoPhillips and you'll see senior
7 management is predominantly Phillips heritage. We did try
8 to pick the best of the best, and it just happened to come
9 out, in total, very close to a 50/50 split.

10 I guess the thing we're the most proud of is that
11 within 45 days of close, September 1st, everybody in
12 ConocoPhillips knew that they had a job and what it was, or
13 they knew they didn't have a job. So, really, by the middle
14 of October the organization was set, and that was a goal
15 that we set early on. We didn't want an organization of
16 people sitting around wondering, "where am I, where do I fit
17 in".

18 The other thing I think we did very well was the
19 hand-off. As I said, as we named executives to lead certain
20 groups, the executives basically assumed the integration
21 team responsibilities and became accountable for getting the
22 promised results.

23 What was really fortuitous for us was the fact
24 that we got approval in early September. I think had it
25 gone a few more months, we wouldn't be nearly as optimistic
26 about our ability to really make this thing work in the
27 near-term. The reason is because in the oil and gas

1 industry, the budget cycles begin usually in the summer.
2 So, you're really planning for the next year's work 12-18
3 months in advance. September was about as late as we could
4 get approval to close and still really get all of our plans,
5 our synergies, everything, built into our operating plans
6 for 2003. We have really humped it since September, to get
7 these plans in place, and, in fact, tomorrow in New York,
8 hopefully, our Board of Directors will approve the 2003
9 capital budget and operating plan for ConocoPhillips.

10 What is really important about that is that each
11 of these synergies, all these targets that we've put in
12 place, are in the operating plans. So, we have clear
13 accountability, we have a clear plan for how we're going to
14 achieve them. We will start seeing the bottom line impact
15 of that March 19, 2003.

16 You can look at this and say, well, this should be
17 pretty easy, you didn't pay a premium, you've got two
18 companies, all you have to do is get some cost savings. If
19 you look ahead a few years, I think, our real challenge is
20 going to be merging the cultures. Conoco and Phillips
21 really -- if you know anything about it, you'd look at it
22 and say, well, those are two very similar companies. But
23 what you find is really a collection of cultures as a result
24 of some of the deal activity that has occurred in both
25 companies over the last three years.

26 Conoco just did an IPO and split off from DuPont
27 at the end of 1998. In 1999, I was in this building trying

1 to convince the FTC that Conoco was a better competitor for
2 Arco Alaska than Phillips would be. Phillips had won the
3 bid from BP to buy Arco Alaska. That was a \$7 billion
4 transaction that Phillips completed in late '99, early 2000.
5 In late 2000, Conoco and Phillips got together and talked
6 about merging. It didn't happen for various reasons, mostly
7 because of some of the soft issues.

8 So, within six months of that, Conoco went out and
9 bought Gulf Canada for \$6 and a half billion in the middle
10 of 2001. Within a month of that, Phillips announced the
11 acquisition of Tosco, a \$7 billion acquisition. I don't
12 know if you want to call it an arms race or what, but -- at
13 that point, the two companies got together again and said,
14 "you know, maybe we let some things get in our way that we
15 shouldn't have", and the deal was put together rather
16 quickly about a year ago.

17 So, the big challenge for us I think is making the
18 soft side work with the cultures. We're a combination of
19 cultures. You've got Conoco, you've got Phillips, you've
20 got Tosco, you've got Arco and you've got Gulf Canada, all
21 of which have come together in the last two years. Again,
22 the reason we're very optimistic about it is we have a CEO
23 that is very financially focused, we do have all the
24 synergies from all of these deals baked into our operating
25 plans, and we are going to hold people accountable -- that's
26 how we're all going to be paid. We're very optimistic that
27 we're going to make this work.

1 That's all I have.

2 MR. BOWER: Well, first of all, this is an
3 extraordinary panel. So, I think we should thank them.

4 (APPLAUSE)

5 MR. BOWER: And now, can we take questions? We do
6 have time for questions. Yes, David?

7 MR. SCHEFFMAN: David Scheffman, FTC. Bill, could
8 you give us a better idea of what you did prior to when you
9 could close, when you passed regulatory clearance, and what
10 you didn't do?

11 MR. EARNEST: What we did prior to getting
12 approval?

13 MR. SCHEFFMAN: In terms of integration planning,
14 et cetera.

15 MR. EARNEST: We did the obvious things,
16 particularly on the upstream side where there were fewer
17 issues on the regulatory side. We knew we had obvious
18 duplication of offices in the lower 48. We had overlap in
19 the North Sea. So, we could do some planning as far as what
20 kind of organization we thought we would need. The things
21 that we were not able to do were things like exchanging non-
22 public information about our assets, which would have been
23 helpful in making strategic decisions on portfolio. We
24 tried to prepare for that by developing some templates, so
25 once we got approval we could populate the templates with
26 real data, and move quickly.

27 We knew the kind of information we'd like to

1 share. At Conoco, we knew we'd like to know all the
2 projects that Phillips was working on in the Middle East.
3 We knew the ones we were working on. We knew that Phillips
4 was probably working on some and we knew we probably
5 couldn't work on all of them when we combined. So, we
6 couldn't really share that information, but what we did was
7 have each side separately develop the same kinds of
8 information, which once we received regulatory approval, we
9 could share with each other. Through our budget process,
10 from September until now, we have been able to make some of
11 those judgment calls, but we're still not there.

12 There are still some areas where I think we haven't
13 made some of the tough calls on portfolio because we just
14 haven't had time to look at the two portfolios and
15 rationalize them. But we did as much preparation as we
16 could pulling data together after receiving regulatory
17 approval. I think the main thing we did was get our
18 organization in place, get people aligned around the
19 objectives on cost synergies, and we were able to do that
20 without really sharing any kind of non-public information.

21 MR. SCHEFFMAN: So, you did create the integration
22 team and you identified the co-leaders and had all the
23 structure in place?

24 MR. EARNEST: Yes. Actually, I think we named our
25 two integration leads, Phil Fredrickson and John Lowe, at
26 deal announcement. We said they're in charge of
27 integration. We put our teams in place and each of the

1 teams had lawyers on them. We were very careful about
2 getting their guidance and we shared what information we
3 felt that we could, and we didn't share the information we
4 didn't think we could. I was the leader of one of the
5 upstream teams and was quite frustrated, actually, in our
6 inability to share certain information. But, we did what we
7 could within regulatory and legal limits, and the rest of
8 it, we're doing on the fly. We're going to make it work.

9 MR. BOWER: Yes, Susanne?

10 MS. TRIMBATH: Susanne Trimbath with the Milken
11 Institute. I'd like to ask Daniel a question. I think
12 Robert, in particular, and maybe one of the other speakers
13 had mentioned that when they did their management
14 integration, they made it clear that it would be whoever was
15 the best person for the job. I read somewhere that one of
16 Cisco's requirements for the firms they look at is that they
17 have strong management teams already in place. In other
18 words, management is considered part and parcel to the
19 acquisition. Is that true, and if so, how important is that
20 to the success of your acquisitions?

21 MR. SCHEINMAN: The simple answer is that it's
22 more true in down markets than in up markets. In up
23 markets, we were sometimes counting as management teams if
24 we had one person we thought was strong enough to survive.
25 Today, we clearly are looking for management teams. We
26 believe that the retention of the management team in the
27 technology business is absolutely critical. We're betting

1 really on the next platform or the integration of two
2 platforms to create a third platform, and you need the
3 vision at the management level to do that. So, we really
4 have a focus on management teams.

5 The one metric, which I was looking to see that GE
6 had up, that we tracked religiously was retention,
7 particularly, of the management team.

8 MR. BOWER: Any other questions? Yes, in the
9 back?

10 MR. PIDANO: I'm Chuck Pidano, Bureau of Economics
11 at the Federal Trade Commission. As I think most of you
12 probably know, when we look at efficiencies, we're looking
13 at merger specificity, can these efficiencies be achieved
14 only through the proposed merger. One area that there's
15 probably a predilection to assume that they are not merger
16 specific is general and administrative type efficiencies.

17 I'd like to hear any of you comment on that,
18 whether some of the G&A efficiencies in the mergers you've
19 been involved with are, in your opinion, merger specific or
20 not, and to what degree.

21 MR. BRODSKY: I think it really depends. But,
22 there's always room for more G&A efficiencies. For
23 instance, take a Procter & Gamble example or, in our case, a
24 branded food example from one of our companies, you're
25 buying a specific brand. There could be a tremendous amount
26 of G&A that's currently used to manage that brand by its
27 current owner that simply isn't necessary anymore once that

1 brand or that product is owned by a different company
2 because the existing people and facilities in the company
3 have enough room to take on that additional work, or there's
4 simply enough office space or something like that.

5 So, I think very often G&A is intimately linked to
6 the acquisition.

7 MR. PIDANO: But does it have to be a competitor?
8 In other words, is Conoco going to get more G&A efficiency
9 by merging with Phillips than by merging with P&G, for
10 example? I know that's a simplistic way of saying it, but
11 that's an issue that comes up pretty frequently here.

12 MR. BRODSKY: I'd be curious to hear what everyone
13 else says, but my opinion is, yes, if Conoco and P&G merged,
14 you would probably have the need for one CEO and one CFO,
15 but below that, you would need people with very, very
16 distinct skill sets. If you're putting together two
17 companies that are in the exact same industry and simply are
18 different -- manage different products, there's people
19 further down in the G&A that can multi-task, and that
20 directly leads to a combination of businesses in like
21 industries.

22 MR. BOWER: Let me just pick up on this and go
23 back to the example I gave earlier of Snapple and Quaker.
24 The Quaker people thought for sure that Snapple would have
25 the characteristics that Peter just described, that it would
26 fit easily into their portfolio. In fact, it turned out to
27 have little to do with their portfolio. They didn't know

1 that and they couldn't see it, and they learned it, to their
2 dismay, because they nearly destroyed Snapple. It's amazing
3 to me how difficult some of these deals can turn out to be,
4 because the processes by which two firms will do the same
5 business turn out to be very, very different.

6 So, I think it's an easy assumption to make, but a
7 dangerous one. There's another one. Mike Scherer said it
8 earlier today -- the assumption that firms will get
9 administrative efficiencies just because they're available
10 is very risky.

11 I think the head of Mobil is quoted as saying that
12 almost all the efficiencies that they were going to get from
13 Exxon/Mobil could have been realized by Mobil and Exxon
14 separately, except they never would have been, because life
15 being what it was, changing arrangements was hard, -- so,
16 yes, in principle you can realize administrative
17 efficiencies, you know, "if". But if a frog had wings, it
18 wouldn't bump its bottom on the ground so much.

19 MR. PIDANO: Thank you.

20 MR. BOWER: Yes?

21 MR. SALTZMAN: I am Harold Saltzman, with the
22 Bureau of Economics at the FTC. This two part question goes
23 to various panelists. First, assume that a given
24 acquisition is expected to realize, say, \$100 in cost
25 savings. Based on your experience, would the actual cost
26 savings from that acquisition be roughly \$100? Would it be
27 less than \$100 or more than \$100? Would it be \$200 or \$500?

1 Second, whatever the cost savings ultimately ended up being,
2 how much of it would be from the original \$100 that was
3 expected?

4 MR. BRODSKY: I think there are surprises in every
5 deal. One thing I can guarantee is that it won't be 100.
6 It might be 50 and it might be 150, but I've never seen a
7 projection that actually came to fruition exactly as
8 originally projected. I think it depends on how aggressive
9 the teams are in their negotiating and it depends on how
10 much access to due diligence there was. There are varying
11 levels of access during the whole process. So,
12 unfortunately, I don't think there's a generalized answer to
13 that.

14 MR. INGRAM: I would echo what Peter said. When
15 you look at the cost savings, it isn't just eliminating
16 duplication as part of that \$100 as you said, but
17 procurement. You become a bigger buyer. You can command
18 much better discounts. We're British Air's biggest
19 corporate customer now, and we can really negotiate much
20 better discounts based on just shear volume.

21 MR. SALTZMAN: Just to follow up some. I
22 recognize that there is a lot of uncertainty, and that each
23 situation is different. But it sounds like you collectively
24 have been involved with literally hundreds of acquisitions.
25 So, I'm wondering, based on your actual experience, is it
26 very, very likely that the number that is projected as a
27 cost savings will be realized because the company wants to

1 be conservative, for example? Can you pretty much go to the
2 bank with that number because in all likelihood you will
3 reach it or exceed it? Or, is it just as likely that you
4 will fall short?

5 MR. BOWER: John Mayfield?

6 MR. MAYFIELD: Well, at ITW, due to the number of
7 acquisitions we've done, obviously, the cost savings is
8 probably the easiest area in which to be --

9 UNIDENTIFIED MALE: More certain.

10 MR. MAYFIELD: most certain. The revenue stream,
11 price increases, and customer retention, as I said, are our
12 critical issues, and by far the most difficult to try and
13 confirm prior to the acquisition. Limited access to
14 customers and pricing information during the due diligence
15 process creates a higher degree of uncertainty than
16 synergies (cost savings) that could result from the
17 acquisition. So, when we set our acquisition models, we
18 usually approach them from a synergistic basis with the
19 upside based on top line growth (volume growth, customer
20 retention and targeted price increases). Our cost savings
21 is the most certain number, and if we err on the
22 conservative side, it is top line growth. Will we get the
23 numbers in the specific areas? No. However, as the other
24 panelists have noted, cost savings can be generated from a
25 number of different sources. Buying power can be improved
26 through association with a larger enterprise. In ITW's
27 case, newly acquired companies can gain access to more

1 sophisticated research and development, which can improve
2 their product cost immediately. So, the cost savings is the
3 most certain assumption we can make and the revenue growth
4 on the top line is the least certain in determining
5 acquisition purchase price.

6 MR. BOWER: I agree. I did a study way back in
7 1973 that looked at capital budgeting and the process within
8 a company. And at that time, the mean of realized cost
9 savings to projected cost savings on capital projects, was
10 about 1.1, with a tight variance. The mean on revenue
11 projections was about 0.6 with a broader variance. The mean
12 on new product areas, essentially innovation, was zero with
13 a very wide variance.

14 (LAUGHTER)

15 MR. BOWER: That variation of uncertainty as to
16 results is important when we're talking about the outcomes
17 of deals. The results that I gave describe investments made
18 within your own company, projected by its own people, using
19 its own numbers.

20 MR. BRODSKY: It goes back to what I was saying
21 earlier, that as you're trying to negotiate for who's going
22 to reap the benefits of those savings, it's much less risky
23 to pay for the expense savings, and it's very risky to pay
24 for the revenue enhancements.

25 UNIDENTIFIED MALE: Well said.

26 UNIDENTIFIED MALE: Exactly.

27 MR. EARNEST: I suspect part of it is that there

1 is probably an inverse relationship with the premium that's
2 paid. Quite frankly, one of the analyses we do periodically
3 on all the companies that we might be interested in
4 acquiring is what kind of premium do you have to pay, and
5 then what level of synergies would you have to achieve in
6 order to make up for the value that you paid in the premium.
7 In the case of ConocoPhillips, there was no premium, so we
8 had no pressure to over-promise on a synergy number. And,
9 just a couple of weeks ago in New York, at our first
10 security analysts' meeting, we told the Street that actually
11 we're increasing our synergy target by 67 percent from what
12 we made at announcement. So, we didn't need to over-promise
13 because there was no premium. It's just a theory.

14 MR. BOWER: But I think, in general, you would
15 agree that when it's an oil company buying an oil company,
16 life is simpler. Bob Ingram said it, it's a drug company
17 buying a drug company-- they've been studying their
18 competitors for years. They talk to the competitors, they
19 know the people. Those kinds of projections are much more
20 likely to be sound. When Viacom buys Paramount, they don't
21 have a clue. They try, but it's a very, very different kind
22 of operation, and what you can see on those deals is that
23 they're totally a function of the leadership.

24 Sumner Redstone seems to be great. Mike Armstrong
25 seemed to be incapable of doing a good deal. And what can
26 you say?

27 MR. BRODSKY: We do a lot of business in media and

1 radio and television and, it's not quite once you've seen
2 one TV station, you've seen them all. But when you've been
3 around one industry for a very long time and looked at lots
4 of different stations, during your due diligence, you can
5 ask how many people do you have in your news department, how
6 many people do you have in your promotions department, how
7 many sales people do you have, how much square footage do
8 you have per person, and you can do very quick, but
9 accurate, assessments of what the cost structure should be.

10 MR. BOWER: Yes, Paul?

11 MR. PAUTLER: Paul Pautler of the FTC. I just
12 wanted to follow up on a statement that Bill just made. It
13 ought to be easy to do the calculations to figure out what
14 the savings are, but you've just increased your estimates by
15 67 percent. So, you were a little bit below.

16 Now, did you find out new information? After the
17 regulatory period stopped and you were able to move forward
18 and actually exchange information, did you find out there
19 was a lot more there or were you just conservative to start
20 with and now you're being sort of a little less
21 conservative?

22 MR. EARNEST: It was both actually. I think once
23 we were able to exchange information, we identified a lot
24 more savings in procurement. We operate in a very capital
25 intensive business, and together, we were spending \$8
26 billion a year in capital, and billions more in operating
27 costs and supplies, and what we found was a third or more of

1 our new synergy target is procurement savings. Those are
2 the kinds of savings we weren't quite as confident about a
3 year ago.

4 MR. BOWER: Yes, Susanne?

5 MS. TRIMBATH: Susanne Trimbath, Milken Institute.
6 I'll just add a comment to what you're saying there. I was
7 at the Association for Corporate Growth's M&A Finance
8 conference in Los Angeles last year when they were talking
9 about this. There are some buy-out firms who work with
10 smaller organizations, certainly not the really large ones,
11 but the smaller ones, who provide exactly this service for
12 the companies that they put into their portfolio. That is,
13 they pull together their acquisition processes to make them
14 bigger buyers for all the types of materials that they have
15 to purchase.

16 MR. BRODSKY: We do that at our firm.

17 MS. TRIMBATH: It's a great service.

18 MR. BRODSKY: Valued-added. That's terrific.
19 Because if you put all of our companies together, it's an
20 enormous amount of purchasing power, whereas individually
21 they're all relatively small.

22 MR. BOWER: Yes. From Wilmer Cutler?

23 MR. KOLASKY: I'm Bill Kolasky.

24 MR. BOWER: Bill, yes?

25 MR. KOLASKY: Following up on the discussion we
26 were just having about greater uncertainty on the revenue
27 growth projections, to what extent have failures to meet

1 those projections, in your experience, been the result of a,
2 shall we say, more vigorous response from your competitors
3 than you were expecting or from competitors adopting
4 strategies that you hadn't anticipated in response to your
5 own merger or acquisition?

6 MR. BOWER: Does someone on the panel want to pick
7 that up?

8 MR. JONES: From GE Medical's perspective, some of
9 it's related to new product introduction. So there's some
10 uncertainty looking at, what a product's going to be able to
11 do a year or two down the line until you actually have the
12 products in the marketplace. There's certainly the comments
13 we heard today about when a transaction is announced, having
14 competition all over customers, all over employees is right,
15 and I think those two, customer base and sales force, are
16 very fragile. I think it's as much not having a handle on
17 what's going to happen to the customer base and to the sales
18 force that impacts that, not necessarily the competitor
19 coming up with a new strategy. I think the strategy is
20 pretty tried and true when an acquisition is announced.

21 So, I think it's not dealing with that issue
22 effectively that creates the problem as much as some kind of
23 new unique strategy coming on board.

24 MR. BRODSKY: And it goes to the question that, I
25 think, someone asked at one of the earlier panels, which was
26 why does it matter if it takes a long time for a deal to be
27 approved.

1 UNIDENTIFIED MALE: Absolutely.

2 MR. BRODSKY: It's not just the employees that get
3 solicited, it's the customers, because it's a period of
4 uncertainty, and especially for the acquired company, their
5 constituencies don't know what's going to happen to the
6 company. In that uncertainty, there's more of a propensity
7 to change.

8 MR. BOWER: There's also an issue which Dan
9 Scheinman picked up. Sometimes when you're adding products
10 to fill into a line, what you're doing is you're dealing
11 with a problem that the product division or the sales
12 organization had created for you. And then you put that new
13 product line in an organization which is fundamentally
14 hostile to it or doesn't have the capabilities to sell it or
15 doesn't understand it, or you get into a fight and then you
16 lose your revenue projection for that kind of reason.

17 Any more other questions?

18 **(No response.)**

19 MR. BOWER: Well, then, I'm going to thank the
20 panel. I've heard a number of comments from the audience
21 and also some of the people who left. They were apologizing
22 and said, "this is just fantastic,". We really thank you.

23

24

PANEL 4

25

**HOW AND IN WHAT CONTEXT DO COST SAVINGS OF VARIOUS KINDS
AFFECT BUSINESS DECISION MAKING?**

26

27

**WHAT HAVE BEEN THE FTC AND DOJ'S EXPERIENCES WITH EFFICIENCY
CLAIMS?**

28

29

30 MR. SCHEFFMAN: All right, welcome back to the ice

1 box. It's a little warmer today, isn't it?

2 GROUP: Yes, it is.

3 MR. SCHEFFMAN: Well, they will probably fix that, so
4 don't leave your coat, all right? We're delighted you came
5 back after yesterday's very interesting session.

6 Today we're getting back more explicitly into
7 antitrust land. The first panel today deals with an issue
8 that economists have known about for decades, in fact
9 forever, which is that actual business decisions are often
10 made in part based on average costs rather than incremental
11 costs. That's been a matter of some concern to economists
12 for years. At various points, economists have done surveys
13 of businesses, where they've asked, what's the most
14 important determinant of prices? And the response has been,
15 average costs. Which is an embarrassment to economists, but
16 I think it's because economists haven't really thought about
17 what the role of costs are in business decision-making.

18 So, what we want to do today in this first session
19 is have someone put forward arguments about why businesses
20 use something other than incremental costs in decision-
21 making. The person that's going to do that is David
22 Painter. For those of you not from the Commission, David
23 Painter was at the Commission for 25 years. He was our lead
24 financial analyst. He was the internal person who actually
25 assessed efficiency claims made by parties, and now he does
26 a lot of work on the outside as a consultant putting forward
27 efficiency arguments, so he has an interesting background in

1 that regard.

2 The chair of the panel today is Andrew Dick, who's
3 Acting Chief at our sister agency, the Department of
4 Justice, Antitrust Division. Andrew will not just be a
5 moderator but will be talking a little bit about the second
6 topic of today's session. The other member of the panel is
7 Gabe Dagen, who currently is the head of our financial
8 analysts. The financial analysts at the FTC have a very
9 important role, such an important role that I stole them
10 back from the Bureau of Competition in the last year. Were
11 you ever in the Bureau of Economics, David?

12 MR. PAINTER: Not as part of the competition part of
13 it. I was with the old line of business program.

14 MR. SCHEFFMAN: Okay. Well, I think at some point,
15 many years ago certainly, when the Commission started, I
16 think there were financial analysts in what today would be
17 called the Bureau of Economics. At some point the lawyers
18 stole the financial analysts, and in the last year I stole
19 them back where they belong, with the other quantitative
20 geeks. The purpose of that was to really re-invigorate and
21 enlarge the role of financial analysis in our merger
22 investigations, and antitrust investigations generally. I'm
23 a strong believer, as a long-time MBA professor, that
24 financial analysis is very important, and we do much more
25 financial analysis than we used to in the investigation of
26 cases.

27 Gabe Dagen is the leader of a group of five

1 financial analysts that we have. We have hired several
2 within the last year, and they are all busy doing lots of
3 useful things. So, Gabe will provide some comments on
4 David's presentation on costs, how costs may affect business
5 conduct in various situations. Gabe will provide a reaction
6 in part from the point of view of how we as enforcers can or
7 should take such arguments into account in our analysis of
8 potential efficiencies.

9 Then Gabe and Andrew are going to talk about our
10 so-called chicken and egg problem, to come back to Chairman
11 Muris' comments of yesterday. That is, we actually are
12 prepared to assess efficiencies, but we don't actually see
13 substantial credible efficiency claims generally. There
14 seems to be a problem that the private bar advises their
15 clients that it isn't worth it, and as the Chairman
16 indicated, that's not true. As he also indicated, in the
17 majority of the cases, it's probably not worth it, but in
18 some cases it is, and we're not seeing it. So, Gabe and
19 Andrew are going to speak a little bit from the point of
20 view of the two agencies, about what we see and what we
21 don't see in terms of efficiencies analyses.

22 So, I'll turn it over to you, Andrew. Thank you.

23 MR. DICK: I should start with a disclaimer, and Gabe
24 asked me to include him in this disclaimer. I'm not going
25 to be speaking as a representative of the Department of
26 Justice, and Gabe won't be speaking as a representative of
27 the FTC or its Commissioners.

1 As David indicated, there are two questions, and
2 they are going to seem distinct, but hopefully as we get
3 into the discussions, we'll see how they relate to one
4 another..

5 The first question, which David Painter will speak
6 to presently, is how and in what context do cost savings of
7 various kinds affect business decision-making? The second
8 question that the panel will discuss is what has been the
9 experience of the agencies and private parties in presenting
10 and evaluating efficiency claims? What do the agencies
11 usually receive from merging parties by way of efficiency
12 arguments and supporting evidence, and equally importantly,
13 what should parties provide to make their arguments and
14 evidence as compelling as possible?

15 David previously introduced the two panelists, but
16 let me just add one or two more words about them. David
17 Painter is a Director at the Law and Economics Consulting
18 Group (LECG). He specializes in antitrust, finance and
19 damage estimation. Formerly, he was the Chief Accountant at
20 the FTC where he had responsibilities for accounting and
21 financial issues in a wide range of merger and non-merger
22 investigations.

23 To his right is Gabe Dagen, who is the Assistant
24 Director of the Accounting and Financial Analyst group at
25 the FTC. Gabe has been with the FTC for four years and has
26 performed efficiency, valuation, and viability analyses in a
27 wide range of investigations.

1 And as David mentioned, I'm the Acting Chief of the
2 Competition Policy section at the Department of Justice.
3 I'm also an economist, and so hopefully, among the three of
4 us, we'll bring some perspective from a number of different
5 experiences.

6 I'm going to ask David to begin. Again, his topic
7 is how and in what context do different types of cost
8 savings affect decision-making by businesses?

9 MR. PAINTER: I appreciate the opportunity to be
10 here. It's good to see old faces and it's good to see new
11 faces here. I wanted to carve out sort of a narrow aspect
12 of efficiencies. It's narrow in the sense that it's a
13 discrete area, it's not narrow, however, in terms of its
14 importance. I'm going to address the importance, as I see
15 it, of fixed cost savings in antitrust efficiency analyses.
16 I'm not going to be touching on variable cost savings. I
17 think everybody acknowledges and the Guidelines speak fairly
18 clearly to the importance of variable cost savings and the
19 potential for those savings to have a direct impact on
20 prices. But I think that fixed cost savings may present
21 some of the very same benefits that variable cost savings
22 present and maybe more, so that's going to be the area of my
23 focus.

24 I've been asked to speak about the potential
25 consumer benefits that fixed cost savings from a merger
26 might create or might contribute to. It is an area, I
27 think, that merits greater attention and credit by the

1 antitrust agencies. More and more, I confront experienced
2 antitrust counsel, and antitrust consultants who are very
3 reluctant to assert fixed cost savings as an efficiency of
4 the proposed merger based on the advice of antitrust counsel
5 and consultants. I am not one of those consultants who
6 shares this view. The merging parties are frequently
7 unwilling to bear the cost required to properly identify,
8 substantiate and measure cognizable fixed cost savings of
9 the merger. Why is this the case?

10 It's largely because many antitrust practitioners
11 perceive that fixed cost savings will be accorded little or
12 no credit in the antitrust assessment of the merger, and
13 worse, will be used more as evidence against the merger than
14 as a pro-competitive benefit in the Government's evaluation.
15 In their experience, fixed cost savings have been
16 acknowledged by the antitrust authorities only to
17 demonstrate the existence of high entry barriers and not
18 consumer benefits.

19 As David pointed out, however, I think, in recent
20 months and maybe the recent year, antitrust enforcement
21 officials have gone to great lengths to re-affirm that fixed
22 cost savings, and indeed all efficiencies, are acknowledged
23 as potential consumer benefits under the DOJ/FTC Horizontal
24 Merger Guidelines, and are going to be given much more
25 credit and attention by the authorities.

26 With that said, that is the reason why I'm here, to
27 sort of speak to the potential benefits of fixed cost

1 savings.

2 As seen on the slide at the bottom of the first
3 page of my handout, I want to make four points today.
4 First, I want to make it clear that the Merger Guidelines do
5 acknowledge the potential importance of fixed cost savings
6 as consumer benefits. The second point I want to make is
7 that fixed cost savings can provide direct price-related
8 consumer benefits. Third, fixed cost savings can contribute
9 to important non-price consumer benefits. And fourth, it is
10 my opinion that the importance of fixed cost savings needs
11 to be assessed on a case-by-case basis. That is somewhat
12 dissimilar to variable cost savings, which, I think, almost
13 across the board one would acknowledge are going to have the
14 potential to reduce prices.

15 First, how do the Merger Guidelines acknowledge the
16 importance of fixed cost savings? As shown in the slide on
17 the top of p. 2 of my handout, they do so by identifying a
18 variety of consumer benefits that could potentially arise
19 from merger or acquisition. One, lower prices, first and
20 foremost. There's no question that the FTC and DOJ prefer
21 merger benefits in the form of price reductions. That
22 preference is understandable to me and to others, in that
23 efficiencies become less certain, both in terms of their
24 achievability and their merger specificity, and are less
25 able to offset the more immediate potential competitive
26 harm, the more distant their realization is into the future.

27 Nonetheless, the Merger Guidelines do point out the

1 potential for benefits even when price is not immediately
2 and directly affected, and some of these areas actually fall
3 into the fixed cost savings consumer benefit area. Mergers
4 may lead to new and improved products, enhanced service,
5 increased output and may change for the better the
6 incentives of companies to compete. And with respect to all
7 of these non-price consumer benefits, fixed cost savings can
8 contribute to the financial and economic justification of
9 them, as well as serve as a ready source of capital for the
10 funding of these investments.

11 First, let me talk about price-related consumer
12 benefits. Fixed cost savings clearly have the potential to
13 provide direct consumer price benefits. In many
14 circumstances, as David Scheffman pointed out, fixed costs
15 figure directly into pricing policies, methodologies and
16 practices. I want to point you to an article that was
17 published in the 1997 Journal of Management Accounting
18 Research, it was called "The Full Cost Price and the
19 Illusion of Satisficing." I actually sent in a variety of
20 studies attached to a bullet point presentation that, I
21 think, may be available as part of handouts, but this is one
22 of those studies.

23 In any case, this study refers to two previous
24 studies of corporate pricing practices, both of which
25 concluded that fixed costs are taken into account far more
26 often than not in setting prices. Let me identify the
27 specific studies, which are referenced in the slide on the

1 bottom of p.2 of my handout. One of them is
2 Govindarajan and Anthony, titled "How Firms Use Cost Data in
3 Price Decisions." This was published in July of 1983 in the
4 Journal of Management Accounting. The other is Shim and
5 Sudit, "How Manufacturers Price Products," published in
6 1995.

7 The first study, a 1983 survey of the pricing
8 practices of the Fortune 1000 industrial companies, made a
9 number of startling conclusions at the time, as shown in the
10 slide on the top of p. 3 of my handout. It found that 41
11 percent of the 501 responding companies -- 501 out of the
12 1000 surveyed, a very high response rate -- based their
13 prices on total costs, that is, both fixed and variable
14 production and non-production costs. Another 41 percent
15 based prices on total production costs, which contains an
16 element of fixed costs, fixed overhead, plus some variable
17 non-manufacturing costs. Only 17 percent actually used
18 variable cost pricing.

19 The reasons cited generally for deviating in actual
20 practice from profit-maximizing pricing models included the
21 lack of time, the lack of resources and very much the lack
22 of information that was needed by managers in order to set
23 the optimum pricing model. The authors of this 1983 study
24 concluded three points. Two of them are quoted in the slide
25 on the bottom of p. 3 of my handout.

26 First, "in the real world, most large companies use
27 full costs rather than variable costs" in their pricing

1 decisions. Second, the results of the survey -- and this
2 is a quote -- "unequivocally destroy [...] the myth that
3 full costs, and especially allocated costs, are irrelevant
4 as a basis for pricing decisions." The third point was that
5 the apparent conflict between actual pricing practice and
6 economic pricing theory was a sign, in the view of the
7 authors, that something was wrong with the theory.

8 As seen in the slide on the top of p. 4 of my
9 handout, the more recent 1995 study, surveyed 600 large
10 industrial companies. That survey found that 70 percent of
11 large manufacturing companies set prices by marking up some
12 version of full costs; that is, a combination of fixed and
13 variable costs. When I say fixed and variable costs, I'm
14 also including allocated costs. Only 12 percent of the 141
15 respondents to this survey reported using a form of variable
16 cost pricing, and only 18 percent professed to set prices
17 based upon market conditions or competitive conditions.

18 The studies were 12 years apart, but the
19 conclusions of the studies are very consistent with one
20 another. Both studies acknowledge that, as we all know,
21 there may be instances where it makes good business sense to
22 take orders at less than normal prices, as well as
23 situations that permit you to take orders at much higher
24 than normal prices. But these were considered in both
25 studies to be departures from the normal situation of
26 pricing to cover all costs and to earn a satisfactory return
27 on investment. Also, both the studies suggested an apparent

1 conflict between economic theory and actual practice in
2 setting prices.

3 These are just illustrative examples supporting the
4 proposition that fixed cost savings have the potential to
5 directly lower prices, and certainly not exhaustive of such
6 situations. As shown in the slide on the bottom of p. 4 of
7 my handout, there are numerous other examples of instances
8 in which fixed cost savings can lead to lower prices. For
9 example, pricing may be tied to cost-based contracts and
10 contracts that allow for cost audits, and either of these
11 kinds of contracts could cause prices to be reduced if fixed
12 costs are reduced.

13 Also, there are many firms that submit bid
14 proposals that reflect on a line-by-line basis a variety of
15 costs and expenses, many of which are fixed, and in these
16 instances obviously reducing fixed costs could affect the
17 bids. There's also a very common situation that I've seen
18 employed on the outside, in terms of setting prices for
19 simplicity sake, which is where the pricing decision is tied
20 to a specific gross profit threshold. That is, we'll take
21 on this business and we'll price it in such a way that we
22 have to earn at least 20 percent gross profit. And the
23 reason for employing a gross profit threshold for setting
24 prices is that the firm needs to cover other costs and
25 expenses that may not be built directly into the pricing
26 model, a lot of those costs and expenses being fixed or
27 allocated costs. Obviously, as one is able to reduce some

1 of that group of costs, then it may well be that pricing can
2 be tied to a lower threshold.

3 There are other situations such as where power
4 buyers or very knowledgeable buyers will learn fixed cost
5 reductions that their suppliers are realizing, either
6 through merger or on a stand-alone basis, and they can,
7 based on that knowledge, perhaps force a lower price.

8 I want to also bring up one other situation,
9 referred in the slide on the top of p. 5 of my handout. I
10 will admit that it's speculative, and I haven't found
11 empirical studies that sort of go to it. But, I think,
12 fixed cost savings have the potential to provide management,
13 particularly management of public companies, the latitude to
14 undertake price-cutting that have short-term earnings
15 consequences but offer the potential for long-term growth
16 and long-term earnings enhancement. Public companies are
17 under close scrutiny on a day-to-day basis and week-to-week
18 basis, and short-term earnings is something that oftentimes
19 is the primary focus of management.

20 With respect to these companies, variable cost
21 savings and fixed cost savings have equal footing. They
22 both contribute to profits equally. And to the extent that
23 fixed cost savings that might be achievable through a merger
24 can somehow help satisfy stockholder expectations or market
25 expectations, it may provide the comfort level to management
26 to undertake price cutting and a variety of things that may
27 have some adverse consequences in the short term but

1 positive benefits in the long term.

2 The slide on the bottom of p. 5 of my handout
3 identifies another area where fixed cost savings can have a
4 very positive effect on prices, and it's a very common area,
5 I think. There are situations where managers, people that
6 are actually responsible for setting prices, are held
7 accountable for obtaining a target level of profitability
8 that includes or reflects both fixed and allocated costs.
9 Brand managers, product managers are often a part of this
10 management group. They typically operate their businesses
11 as a profit center, as contrasted, for example, to maybe a
12 manufacturing operation, which is typically treated as a
13 cost center. They often will not have knowledge of the
14 breakdown between fixed and variable costs. They may be
15 dealing with costs that are imposed on them in terms of
16 marketing costs, R&D costs, allocated corporate overhead
17 costs and so forth, and they are held accountable to make
18 sure that their products and brands earn a profit to cover
19 those costs.

20 Typically the costs that they are held accountable
21 for would include, for example, an allocation of corporate
22 charges for services and functions that are performed at the
23 corporate level on behalf of not only their product area but
24 a variety of other business areas. Obviously, as one is
25 able to reduce the group of costs that typically gets
26 allocated back to product managers and brand managers, then
27 one might be able to see the beneficial effect on pricing of

1 having a reduction in the fixed costs comprising that group
2 of allocated costs.

3 I just want to remind you again of one of the
4 studies that I referred to earlier. The study concludes,
5 and, I think, it's consistent with brand managers and a
6 variety of other managers that are responsible for the
7 businesses that they supervise, that people often lack the
8 time, they lack the resources, and more importantly, they
9 lack the information particularly on demand side kinds of
10 things that will allow them to really set optimal price.
11 They know that they're going to be evaluated based upon the
12 target profits that are imposed on them, the P&Ls that are
13 imposed on them, the pro formas that are imposed on them,
14 and for that sake and for other reasons, they, in setting
15 prices, will often take account of fixed costs and allocated
16 costs.

17 Even managers that have access to the breakdown
18 between fixed and variable costs in my experience don't
19 necessarily use them in the calculations of what prices to
20 set. Many companies keep their books and records in a way
21 that balances off the trade-off of the cost associated with
22 fine tuning your costs -- determining exactly how much is
23 fixed and how much is variable over various ranges of output
24 -- with making it workable, making the accounting system
25 workable for the people that need to work with it. For that
26 reason, the definitions of fixed and variable often are not
27 precise within the books and records of a company, and the

1 company's managers acknowledge that and are aware of that.

2 Another situation where fixed cost savings can lead
3 to lower prices is in transfer pricing; that is, transfers
4 between business units of a corporation, goods and services
5 that are being provided from one unit to another. These
6 transactions will usually lack the arm's length bargaining
7 and the influence of market forces as a basis for what the
8 pricing will be. The ability of a merger, for example, to
9 reduce the fixed costs of one of the business units that's
10 transferring some good or service to another unit can well
11 affect the transfer price and ultimately the final price of
12 the finished product.

13 Let's move on. I wanted to put together what I
14 thought to be a typical brand manager P&L to further
15 emphasize some of the points that I've already made. The
16 slide on the top of p. 6 of my handout is intended to be
17 such a typical P&L. You can see that various line items are
18 reflected which include fixed or allocated costs, and any of
19 these particular costs could potentially be reduced through
20 fixed cost savings.

21 For example, one line item is fixed manufacturing
22 costs, which generally are taken into account in a brand
23 manager's P&L. If the product obviously shares
24 manufacturing operations with other products, this overhead
25 component is an allocation to the brand manager.

26 Marketing and R&D costs are also areas of
27 responsibility for the brand manager, and these are

1 typically fixed in nature. Reductions in these costs, for
2 example, through mass media efficiencies or infrastructure
3 cost reductions that are possible through a merger could
4 reduce the amount that gets charged or allocated back to the
5 brand manager and may affect the price which the brand
6 manager sets for the product.

7 I want to use this opportunity actually to refer to
8 something that I'm going to discuss in more detail in just a
9 few minutes, and that is new product development and the
10 importance that fixed cost savings potentially can have on
11 new product development. The pro formas that are prepared
12 for new products often will contain some of these same cost
13 elements in the brand manager's P&L, including, for example,
14 allocated costs, marketing expenses and research and
15 development expenses. A variety of these and other costs
16 are fixed, and, obviously, to the extent that fixed costs or
17 infrastructure costs can be reduced as a result of a merger,
18 it may well impact the pro forma P&L for which the product
19 manager is responsible, as well as the financial viability,
20 the financial justification of undertaking new product
21 development.

22 And for this, I just want to refer you to a well-
23 known text, Cotler's text, Marketing Management Analysis:
24 Planning, Implementation and Control. In one of the
25 chapters dealing with new product development, a pro forma
26 P&L is presented, and it includes both fixed and allocated
27 costs that must be covered by sales of the proposed new

1 product. To that end, fixed cost savings might reduce some
2 of the pro forma costs that must be covered by the new
3 product.

4 I want to point out another area that can benefit
5 from fixed cost savings, because we see it so often. I saw
6 it very often at the Commission and on the outside I see it
7 often. Companies engage in price wars that frequently
8 result in competitive pricing which falls below average
9 total cost. In instances like this, reductions in fixed
10 costs can potentially affect the duration of below-cost
11 pricing and also affect other consumer benefits, as shown in
12 the slide on the bottom of p. 6 of my handout. We all know
13 that firms have to cover all of their costs in the longer
14 term, and the lower the fixed costs that the company has,
15 there may well be a correlation between how long it's able
16 to sustain or willing to sustain below full cost pricing in
17 such a competitive environment.

18 There are also studies that support my next point
19 in the slide at the bottom of p. 6 of my handout. Fixed
20 cost savings may well enable a firm that's engaged in
21 intensive below cost pricing to maintain non-price consumer
22 benefits, such as R&D, new product development, product
23 improvements, customer-oriented services, and a variety of
24 other such consumer benefits. Commentators have noted that
25 firms that face aggressive pricing from their rivals over
26 extended periods often will adjust to the new profit level
27 or loss level through non-price responses, such as reducing

1 R&D, advertising, customer service and product variety.

2 For this I refer you to another study, Goodlock and
3 Guiltinon, and it's called "A Marketing Perspective on
4 Predatory Pricing." It was published in the Antitrust
5 Bulletin, fall-winter of '98. This study amplifies the
6 consumer loss that possibly would result from this. It
7 concludes that a loss in such non-price competitive efforts
8 by competitors actually reduces pressure on the price leader
9 to maintain below-cost prices or to continue to offer those
10 same non-price consumer benefits, thereby compounding the
11 consumer loss.

12 The study also concludes that at least some firms
13 that have pared costs in this manner to remain in the market
14 become unlikely to be aggressive competitors on either a
15 price or a non-price basis in the future. Finally, the
16 study concludes that extended pricing below average total
17 cost may then lead firms to retreat to the most profitable
18 channels and distribution areas that they service.

19 I've actually been involved fairly recently in a
20 merger in which one of the merging parties had already
21 started eliminating the least profitable customer accounts
22 and the least profitable products, in an effort to try to
23 remain profitable or viable in the face of a fairly
24 prolonged price war. Obviously, to the extent that you
25 achieve fixed cost savings, there may be products that then
26 can continue to be maintained and customers that might
27 continue to be serviced, resulting in greater product and

1 supplier choice for customers.

2 Let me just summarize some of these remaining
3 points on price-related consumer benefits quickly and move
4 on to non-price consumer benefits that can result from fixed
5 cost savings. For the same reasons fixed cost savings can
6 help extend or intensify price and non-price competition
7 during a period of below-cost pricing, it may also delay or
8 reduce the risk of exit by competitors during those periods.
9 As shown in the slide on the top of p. 7 of my handout, the
10 result of many price wars is a relegation of losers to niche
11 markets or an exit entirely from the market. Again, the
12 prior study I mentioned confirms this happening, although, I
13 think, we can observe this virtually every day if we read
14 the newspaper, the Wall Street Journal in today's market
15 economy. That's the Goodlock and Guiltinon study.

16 Let me make one last point on this. Fixed cost
17 savings can also intensify below-cost pricing. Dell has
18 continually touted that it has a cost structure that's half
19 that of Hewlett-Packard as a percentage of revenues.
20 Clearly, you know, we get the benefit of some tremendous
21 pricing in the personal computer area. Nonetheless, Dell
22 makes very large profits. If Hewlett-Packard and any of the
23 other computer manufacturers were able to reduce their fixed
24 cost infrastructure, to a level that more approximated that
25 of Dell, you might see even lower prices.

26 Similarly, Delta -- we can see it with United as
27 well -- has publicly announced that it isn't able to compete

1 against Southwest on price because of its very high fixed
2 cost infrastructure. It has recently announced that it's
3 going to consider starting up another airline, a completely
4 new airline, that could then establish a very low-cost
5 infrastructure enabling it to compete more effectively with
6 Southwest. But the point is that if Delta were able to
7 reduce in a significant way its own fixed cost
8 infrastructure, that might, again, be the basis for being
9 able to offer lower prices on its own.

10 The last point I want to make on this, and then I
11 am going to truly leave it for the non-price consumer
12 benefits, is that incremental investments can be made
13 possible by fixed cost savings. The cost of capital can be
14 reduced, hurdle rates can be reduced, and, as shown in the
15 slide on the top of p. 7 of my handout, incremental
16 investments made possible by lower cost of capital and lower
17 hurdle rates can, in and of themselves, lead to lower
18 variable costs. And those lower variable costs in turn,
19 can, as we all know, lead to lower prices.

20 Lastly, make/buy decisions can be enhanced by fixed
21 cost savings. You can convert something that's being out-
22 sourced into something whose production is brought in-house.
23 That alone changes the cost structure for the firm from one
24 that is generally 100 percent variable cost, the out-
25 sourcing, to one that's a combination of fixed and variable
26 costs, again leading to the possibility that maybe they
27 could take that into account in pricing.

1 Okay, we're on to non-price consumer benefits.
2 Let me start first by addressing what I think is a
3 misconception held by many government antitrust enforcers.
4 I have been confronted with this in presenting merger cases,
5 but I admit that I probably was guilty of it myself when I
6 was at the Commission. It is the perception that fixed cost
7 savings benefit shareholders exclusively. It's erroneous,
8 and let me refer you to the slide on the bottom of p. 7 of
9 my handout. The fact is that the profit rationale behind
10 most mergers is not to retain all fixed cost savings in
11 order to distribute them as dividends, but rather, to
12 maximize firm and shareholder value by investing these
13 savings further in the business. As you know, fixed cost
14 savings contribute to added cash flow and thus contribute to
15 the level of investment made in the business.

16 There are numerous studies that show this to be the
17 case. Dividend rates as well as the percentage of firms
18 that are paying dividends have declined substantially over
19 the last five to ten years, even as earnings have gone up,
20 as shown in the slide on the top of p. 8 of my handout. For
21 example, dividend yields have fallen from 5 to 6 percent in
22 the mid-1970s to just a little over 1 percent in 2001. The
23 dividend payout of earnings has fallen from 60 to 70 percent
24 in 1991 to less than 40 percent in 2001. And this trend is
25 true whether one uses 2000 as the cut-off or extends it into
26 2002 during the period where the economy has not performed
27 well.

1 Similarly, the proportion of firms that pay cash
2 dividends has fallen from 66 percent to 21 percent, roughly,
3 from 1978 to 1999.

4 Importantly, also, I want to point out that studies
5 actually indicate that the propensity to pay dividends has
6 declined for firms with actual and anticipated high
7 investment outlays. There's an inverse relationship between
8 dividend ratios and expected investment outlays, as
9 indicated in the slide at the bottom of p. 8 of my handout.

10 Okay, now let's talk about some of the specific
11 non-price consumer benefits made possible or enhanced by
12 fixed cost savings. Non-price consumer benefits flow from
13 reduced financial leverage, as shown in the slide on the top
14 of p. 9 of my handout. There are a lot of highly leveraged
15 firms in the economy. Fixed cost savings can enable a
16 highly leveraged firm to reduce its debt levels. As we all
17 know, debt levels establish cash flow requirements and
18 restrictions that in turn limit the amount of cash that can
19 be invested in the business. High leverage limits marginal
20 investments, those that approximate the company's cost of
21 capital, and often can limit quite profitable investments,
22 those that could substantially exceed the company's cost of
23 capital.

24 Fixed cost savings can represent additional cash
25 flow for use in reducing existing debt levels, or additional
26 cash flow that can serve as a cushion against very
27 restrictive financial covenants in these debt facilities,

1 either of which can enable a firm to undertake investments
2 that it otherwise would not be able to undertake. This is
3 not simply speculation. Fairly recently, I worked on a
4 merger between AmeriSource and Bergen in which one of those
5 two companies faced this very dilemma. The Commission
6 ultimately decided to allow that merger to proceed, and one
7 of the reasons, I'm certain, was that that merger was going
8 to lead to substantial fixed cost savings that a lot of
9 evidence showed would lead to improved financial leverage,
10 lower cost of capital and greater investment in the
11 business.

12 I won't go over all of the items listed in the
13 slide on the bottom of p. 9 of my handout, except to say
14 that SEC filings routinely point out the types of operating
15 limitations that are imposed by high leverage.

16 Finally, as I have said, fixed cost savings from a
17 merger can lead to a lower cost of capital for the merged
18 firm over the pre-merger levels of the combining firms. As
19 we know, credit ratings are driven by forecasts of cash
20 flows and the related ability of the firm to meet financial
21 commitments and to grow the business. The expectation that
22 the merger will enable the merged firm to achieve greater
23 cash flow due to fixed cost savings can well affect the
24 credit rating of the merged firm and allow it to borrow at
25 lower interest rates, as shown in the slide on the top of p.
26 10 of my handout.

27 Chairman Muris of the Federal Trade Commission and

1 others acknowledge the importance of capital savings
2 efficiencies, citing empirical studies that show that large
3 firms of a billion dollars or more enjoy borrowing rates 6
4 percent lower than firms of \$200 million or so (e.g., about
5 7.0% versus 7.5%). And the courts have also acknowledged
6 the benefits to competition and to consumers of capital
7 savings efficiencies. This is just one that I'm citing, but
8 International Harvester found that the acquired firm was at
9 a competitive disadvantage because its financial condition
10 forced it to pay more for capital, and it held that the
11 merger would lead to a capital efficiency because it would
12 improve the acquired firm's cost of capital.

13 Finally, as shown in the slide on the bottom of p.
14 10 of my handout, fixed cost savings can provide an internal
15 source of readily accessible capital. Funds generated from
16 internal operations are the primary source of capital for
17 funding the day-to-day operations of the business. There
18 are transaction costs and often very long lead times
19 associated with obtaining capital through external sources,
20 such as debt and equity, and often this will make internal
21 capital a preferred source of funding.

22 Because internally generated funds are readily
23 available, fixed cost savings may allow funding of consumer
24 benefits to take place more quickly. In any event, I think
25 it's important to point out that fixed cost savings can help
26 establish an adequate profit and cash flow from operations,
27 which can serve as the basis for being able to obtain

1 external capital.

2 Let me move on to one of the more important non-
3 price consumer benefits that can flow out of or be enhanced
4 by fixed cost savings. It's in the new product development
5 area, referred to in the slide on the top of p. 11 of my
6 handout. There are so many industries now that are driven
7 by new product development, the food industry, consumer
8 electronics, and so many others. As a consequence, every
9 industry has effectively been required to come up with new
10 product introductions much more frequently than they had
11 historically. Product life cycles are getting so much
12 shorter.

13 As I mentioned earlier, the decision to undertake
14 new product development has associated with it a set of pro
15 forma financial and operating statements projected three,
16 four, five years out, which effectively show what the likely
17 return is going to be by undertaking the new product
18 development. Often these pro formas will contain items that
19 represent fixed costs or that represent allocated costs from
20 outside the actual business unit responsible for the new
21 product development. The ability to achieve fixed cost
22 reductions can help enhance the pro forma financial
23 statements and the investment decision to undertake this new
24 product development.

25 I think that so much of this is intuitive or
26 obvious. For the sake of time, I'm going to skip over some
27 of these points on new product development. I think the

1 most important point is to know that fixed cost savings can
2 enhance the ability and the willingness of a company to
3 undertake new product development.

4 The next slide on the bottom of p. 11 of my handout
5 identifies a variety of industries, but certainly is not an
6 exhaustive list, where new product development has become
7 critically important.

8 Bill McLeod made a presentation to the Commission
9 as part of the global hearings that were held at the
10 Commission four, five, six years ago. He was representing a
11 food manufacturer, and he gave some astounding statistics
12 with respect to the food manufacturing industry as to how
13 many products that were on the shelves had been developed in
14 the prior three to five years. My recollection is that 50
15 percent or more of all the revenues of a variety of
16 different food manufacturers were represented by new
17 products. So again, new product development is quite
18 important to competition and to the competitive viability of
19 a firm.

20 There also have been studies that have established
21 a correlation between firms in these and other similar
22 industries and the need to invest proportionally higher sums
23 in R&D each year. Again, fixed cost savings can contribute
24 needed funds as well as help justify the investment in new
25 product development.

26 Fixed cost savings can certainly help improve the
27 success rate for new products. I'm going to skip over the

1 slide on the top of p. 12 of my handout, which addresses
2 that. Instead, moving to the slide on the bottom of p. 12
3 of my handout, fixed cost savings can help bring new
4 products to market quicker. That is becoming critically
5 important, because the window of opportunity for recouping
6 the investment in new product development is becoming
7 shorter and shorter as product life cycles are becoming
8 shorter. So, the justification for new product development
9 is becoming that much more difficult.

10 There are studies that point out that where new
11 products are becoming more and more important, companies are
12 investing proportionally larger sums. Let me just refer you
13 to one of them. It's VonGlinno and Mormon, "Managing
14 Complexity in High Technology Organizations." There are
15 others. Again, I've tried to cite some of these studies in
16 my handout.

17 Before I shift to the final point on the non-price
18 consumer benefits, let me add that fixed cost savings
19 provide funds for increased advertising, product promotion,
20 and customer service --some of this is obvious. But let me
21 go now to the last point made on non-price consumer
22 benefits, the diffusion theory, which is in the slide on the
23 top of p. 13 of my handout. Gary Roberts and Steve Sallop
24 have written an article titled "Efficiencies in Dynamic
25 Merger Analysis," published in 1996, in which they point out
26 very clearly that price reductions made by a company tend to
27 diffuse throughout the market. This diffusion has a

1 multiplying kind of effect, and the authors acknowledge
2 that, similarly, non-price consumer benefits can have the
3 same kind of multiplier effect through diffusion in the
4 marketplace.

5 I've spoken a lot now about the importance of fixed
6 cost savings. The key question remaining is, when do they
7 count? As shown in the slide on the bottom of p. 13 of my
8 handout, I think the obvious answer is that one has to
9 decide for each specific merger. It's a little different
10 from variable cost savings, which are important in virtually
11 every merger. There are going to be some industries in
12 which fixed cost savings are going to be more important, and
13 some industries or markets in which fixed cost savings will
14 be less important. There are a number of factors that one
15 might consider in judging the importance, to include the
16 following:

17 First, judge the potential impact of fixed cost
18 savings on prices within the market. Next, judge the weight
19 to be given to potential non-price consumer benefits by
20 assessing the value of such benefits within the particular
21 market. For example, there are some markets that are driven
22 by non-price factors. In consumer electronics, a reduction
23 in variable costs might not be considered so important. The
24 development of a new technical concept underlying consumer
25 electronics, however, might be deemed very important.

26 To continue, as shown in the slide on the top of p.
27 14 of my handout, fixed cost savings should receive much

1 more credit in markets where there are other competitors
2 having a more efficient cost structure. The fact is that
3 there are many mergers that involve markets where the target
4 company is unable to compete against the more cost-efficient
5 market leaders. I think in instances where the merging
6 companies are less efficient, it's easy to place a value on
7 fixed cost savings, because in these instances, fixed cost
8 savings are highly likely to be used in ways that lead to
9 consumer benefits.

10 Next, one should assess the effect of fixed cost
11 savings to the merged firm's cost of capital or to its
12 internal business decisions and its internal hurdle rates.
13 If fixed cost savings are sufficiently large to measurably
14 reduce the cost of capital of the firm or to positively
15 affect credit ratings, you can feel certain that there are
16 going to be new investments undertaken that wouldn't have
17 otherwise been undertaken.

18 I certainly encourage companies I'm representing to
19 be very specific in terms of consumer benefits from fixed
20 cost savings, and hopefully, most merging parties will do
21 that and try to identify very specific projects and the
22 consumer benefits that would arise from a lower cost of
23 capital.

24 I think you should judge the intent of the merged
25 firm to use the fixed cost savings to grow the business.
26 There are a whole slew of things that one could look for in
27 this area. First, are the post-merger business plans

1 projecting greater growth than the combined stand-alone
2 plans predict, for reasons other than price increases? Look
3 for evidence of intended new product development, greater
4 investment in R&D, proposed market expansions after the
5 merger. Look for evidence of pre-merger capital
6 constraints, rejected investment opportunities, any trends
7 of either of the merging companies toward competing only
8 within niche markets relative to the other competitors in
9 the market.

10 Also you may see mergers that are proposing, and
11 you've judged them to be true, very qualitative kinds of
12 synergies and complementarities that would allow you to
13 conclude that possible new products or more efficient
14 manufacturing processes could come out of the merger. In
15 those instances, I think it's fair to say fixed cost savings
16 are far more likely to be used in ways that benefit
17 consumers.

18 Finally, I think you should try to assess whether
19 past mergers or stand-alone fixed cost savings have been
20 used to further consumer benefits. Establishing such a
21 linkage between historical cash flows and consumer benefits
22 would go a long way toward allowing the authorities to give
23 credit for fixed cost savings.

24 Let me just finish up very quickly, referring to
25 the slide on the bottom of p. 14 of my handout. I've
26 mentioned AmeriSource/Bergen as an example where the
27 responsibility for demonstrating consumer benefits rested

1 primarily with the merging parties. I think they did an
2 outstanding job of demonstrating that there were not just
3 assertions and unverifiable representations being made, but
4 rather there was absolute evidence provided on virtually
5 every one of their assertions. In addition, they provided
6 empirical studies showing that highly leveraged companies
7 grow their business at a slower rate and typically have
8 higher prices than other companies within the same industry
9 that are better capitalized.

10 I have tried to identify just some of the
11 information that one should look for in trying to assess the
12 importance of fixed cost savings in a particular merger. I
13 will not go further into them except to note that these are
14 just some of many ways of trying to discern the importance
15 of fixed cost savings. And let me just say in conclusion, I
16 do believe that fixed cost savings historically have been
17 given less attention and less credit than they deserve. At
18 the same time, I think there is a move afoot by the agencies
19 to give them the credit that they merit.

20 However, with that said, I do believe that the
21 primary responsibility for demonstrating consumer benefits
22 rests with the merging parties, not with the Federal Trade
23 Commission or DOJ to go in there and prove your case for
24 you. I am not advocating, when I talk about fixed cost
25 savings, any looser standard for demonstrating cognizable
26 efficiencies. They still must be merger-specific, they need
27 to be verifiable, they cannot be the result of anti-

1 competitive reductions of output or service, and, with rare
2 exception, they still have to fall within the problematic
3 market.

4 With that said, I have appreciated this
5 opportunity, and I think I've taken a little longer than I
6 should have. Thank you.

7 MR. DICK: I found David's talk quite persuasive on
8 the point that we sometimes take too static a view of cost
9 savings and efficiencies, and that we should be looking for
10 cost savings that might come about over time through fixed
11 cost savings, through R&D stimulation and other sources that
12 may take a little bit longer to show up in prices and profit
13 statements.

14 I'd like to pose one question to David first, and
15 then I'll invite others to add their thoughts. One of your
16 slides towards the end, David, said that credit should be
17 accorded on a case-by-case basis to fixed cost savings.
18 Specifically, you said that we should judge the potential
19 impact of fixed cost savings on prices in the market.
20 Should parties be prepared, in your view, to come in and
21 say, look, in the last year, here's some very specific items
22 on our balance sheet, or on our P&L statement that look like
23 they're fixed costs, but here's how we have actually
24 translated them into our pricing decisions? Should this be
25 very company-specific? Is there a company-specific evidence
26 hurdle that says we know that R&D has to be paid for
27 somehow, and this is a very R&D intensive industry, and so

1 you should give us some credit for the fact that we're
2 likely to be able to achieve some fixed cost savings in the
3 following cost categories?

4 What is the level of evidence, what is the level of
5 specificity that you think companies need to make in order
6 to persuade the agencies that their fixed cost savings
7 really should be credited as a consumer benefit?

8 MR. PAINTER: I think that if you rely simply on
9 studies, it becomes a battle of studies, I'm sure there are
10 studies out there that will say something contrary to what
11 some of the studies I cited say, and I think that without
12 very specific evidence, it just simply becomes a matter of
13 assertion and representation to the agency.

14 With that said, I advocate a practice that requires
15 the merging firms to prove their point. If a merging firm
16 wants to get credit for fixed cost savings with respect to
17 pricing, then I think it behooves them to come in, and in
18 every which way they can, either by using pro forma P&Ls
19 that pricing managers rely on or by pointing the agency to
20 pricing models that implicitly or explicitly take account of
21 fixed cost savings, prove their point. Literally, when I
22 say case-by-case, I think it has to be that.

23 I'll go one step further on this point. I believe
24 that in demonstrating non-price consumer benefits - I
25 probably will wish I hadn't said this - that you not only
26 have to demonstrate that fixed cost savings are going to be
27 used in a way that can enhance non-price consumer benefits,

1 but I think you have to show that it makes a difference,
2 that what is going to happen as a result of the fixed cost
3 savings would not have happened without the fixed cost
4 savings. I think that this goes beyond simply a yes/no
5 answer, and would include showing that new products are
6 brought to market sooner or they are brought to market at a
7 lower cost through the merger. It's got to be something
8 different happening with the fixed cost savings than would
9 have happened without the fixed cost savings.

10 MR. DICK: Let me ask one follow-up question and
11 then open it to the audience. One of your last slides also
12 indicated that you thought that responsibility for
13 demonstrating consumer benefits should rest primarily with
14 the merging parties. I wondered whether that was a
15 statement about the fairly obvious point that the parties
16 are going to be best situated to have information about
17 efficiencies, about whether they are fixed or variable cost
18 savings that they're claiming, as compared to other economic
19 issues that the agencies have to evaluate, such as market
20 definition, competitive effects, entry. There are lots of
21 different market participants that we can go to ask about
22 how easy or difficult entry is, or whether some product is
23 in the market or out of the market, but merging parties are
24 particularly well situated to providing us information about
25 efficiencies.

26 So, were you meaning responsibility in that sense,
27 that they have a burden or responsibility to provide

1 information, or were you going one step further to say that
2 the burden of proof is on the parties to convince us that
3 these efficiency claims are credible?

4 MR. PAINTER: Maybe it's a combination, but clearly
5 one of the things that has impressed me since I left the
6 Commission in 1997, based on the work that I've done since
7 that time, is the amount of information that people on the
8 outside, consultants, attorneys and the business people
9 themselves, have access to that truly can be beneficial and
10 help them present their case. Linked to that, it still
11 amazes me how good a job the antitrust enforcement people do
12 in trying to uncover that information through second
13 requests and depositions and so forth.

14 I've been on cases where at first glance and in
15 first interviews with business people, the response is, we
16 don't have that; we know it's true, we rely on this guy for
17 these kinds of things, so when he says that the fixed cost
18 savings are going to be such and such, we know it's true.
19 But subsequently, when push comes to shove, it is amazing
20 how much information one can put together to raise the
21 comfort level and the credibility of that assertion to a
22 skeptical audience like the Commission and DOJ, an audience
23 that really does need to be convinced of it.

24 There's a tremendous amount of historical
25 information available within a company that literally will
26 go to virtually every single efficiency point that I think
27 can conceivably be identified with respect to a merger.

1 MR. DICK: Let me ask if there are questions from
2 the audience. Yes?

3 MR. FINKELSTEIN: My name is Neal Finkelstein from
4 Blake Castles in Toronto. I'm interested in the proposition
5 that lower fixed costs can lead to lower prices, and I'm
6 interested in the regulator's view of it. I was lead
7 counsel to Superior Propane in the Superior Propane case,
8 and I can tell you that in the Competition Tribunal, neither
9 our economists nor the Competition Bureau's economists would
10 accept that proposition, notwithstanding my best efforts.
11 I'm wondering, number one, whether that proposition is
12 acceptable to American regulators, and if it is, what kinds
13 of evidence you look at?

14 MR. DAGEN: I guess that was addressed to me. I'm
15 going to discuss that a little bit in my presentation, but
16 the short answer is, I agree with most of what Dave has said
17 in his presentation. Having come from industry, I know that
18 fixed costs are involved in pricing decisions. Total costs
19 are involved in pricing decisions. If you price for an
20 extended period of time below total costs, you're going to
21 be out of business. So, they are, in fact, considered.

22 I think from our perspective, regulatory
23 perspective, in looking at fixed costs within the agency, we
24 don't see a lot of them presented to us, so we haven't made
25 a lot of decisions based on fixed costs. I think prior to
26 my arrival here, there were some cases - Commission memos
27 and/or in litigation scenarios - where we argued that fixed

1 costs don't matter. But I think it's incumbent upon the
2 parties to demonstrate that their fixed cost reductions
3 will, in fact, have an impact somehow or another on their
4 competitive aspects of their business.

5 MR. FINKELSTEIN: But by using what kinds of
6 evidence?

7 MR. DAGEN: Some of the evidence I'm going to talk
8 about that they can use is how they have historically
9 managed their business. Almost every company has cost
10 savings programs within their business: ongoing total
11 quality management programs, Sigma 6, numerous state-of-the-
12 art cost reduction programs as they have progressed through
13 the years et cetera. They have internally documented how
14 these cost savings have benefited them in competition with
15 their competitors. Companies should provide evidence of how
16 they have historically been able to use their fixed cost
17 reductions to promote price reductions, new product
18 introductions, cost of capital reductions; any of those
19 historical achievements from the merger; and tie them into
20 the kinds of future pricing or other consumer benefits that
21 may be achieved. This would be an adequate presentation
22 that would allow us to evaluate fixed cost reductions.

23 MR. DICK: Bill?

24 MR. KOLASKY: Bill Kolasky from Wilmer, Cutler &
25 Pickering. I just wanted to comment on David's comment that
26 there's a conflict between what the surveys show as to
27 actual business practice and what economic theory teaches,

1 because there actually have been a couple of recent more
2 theoretical works by economists that I think help to solve
3 that apparent paradox.

4 There's a new book by William Baumal, for example,
5 entitled The Free Market Innovation Machine which uses
6 contestability theory to show that in markets where you have
7 substantial recurring R&D costs and other substantial common
8 costs, you need to be able to price-discriminate in order to
9 stay in business, and therefore, very few customers, as you
10 point out, pay prices that are equal to marginal costs.
11 Most of the customers are infra-marginal, and the companies
12 charge higher prices to those customers, which include an
13 element of those common costs, and what constrains them from
14 charging even higher prices is if they raise prices any
15 more, that would attract entry from their rivals and drive
16 the prices back down.

17 So, they are price-takers. They don't have market
18 power, but they are charging discriminatory prices, and they
19 need to do so in order to be able to stay in business. If
20 they were not doing so, they would not be able to stay in
21 business, and, obviously, in those circumstances, savings in
22 those common costs, recurring R&D and even some G&A expenses
23 will directly benefit customers by reducing the prices
24 charged to the infra-marginal customers. There's also an
25 article by Michael Levine in the Journal of Regulation that
26 makes the same point.

27 The other thing I just wanted to comment on is

1 again for David -- I think that one needs to be careful in
2 using the term "fixed cost," because whether or not costs
3 are fixed depends on what the competitive decision that
4 you're making is. In the case of airlines, which is the
5 classic example, obviously, the cost of each seat is the
6 marginal cost and may be close to zero. But if you're
7 deciding whether or not to add an airplane then it's the
8 cost of flying the airplane. So I think that you may be
9 better served by talking about incremental costs and common
10 costs rather than just the blanket term "fixed costs."

11 MR. DICK: Time for one more question.

12 MS. TRIMBATH: Susanne Trimbath, Milken Institute.
13 I'll just add a little bit to what David said in terms of
14 the cost savings potential. I showed some of my research
15 results yesterday but certainly there wasn't time to do
16 everything. The research I did is covered in the book that
17 we talked about, Mergers and Efficiencies. Basically, I did
18 find some evidence that the cost savings were coming from
19 SG&A and not from cost of goods sold. I didn't really focus
20 in on it because I didn't realize at the time how important
21 it is. I'm very surprised to hear that the FTC is not
22 seeing a lot of claims of cost savings, in particular fixed
23 cost savings, because it seems to me that the SG&A savings
24 are the most obvious and the easiest ones to find.

25 In order to actually change manufacturing costs,
26 you would have to be looking at a firm that somehow had
27 fallen behind its industry in the manufacturing processes,

1 so that you could update their equipment, for instance. I
2 think in the steel industry, there was a situation where
3 they were updating the manufacturing process itself through
4 mergers. That was actually affecting what would amount to
5 the fixed part of costs of goods sold. Frank Lichtenberg's
6 study of manufacturing plant change of ownership reflected
7 great savings from overhead. So, the cost savings are
8 certainly there, and it's very surprising that they're not
9 being shown to the FTC in the pre-merger review documents.

10 Another thing that I'll mention that David talked
11 about was the effect of leverage. We found that the most
12 aggressive cost cutters, ex post, were those that had higher
13 levels of debt. Now, whether it's cause and effect, I'm not
14 sure. I can't look into the minds of the people doing the
15 mergers. Whether they cut costs more aggressively in order
16 to service the debt or whether they used the debt to do some
17 sort of changes, for instance, in equipment that would make
18 them more efficient, can't be discerned in a large sample
19 study. But there certainly is evidence that there are more
20 cost savings associated with merged firms who have the
21 higher levels of debt in place.

22 Just to put this in the form of a question,
23 yesterday some of the consultants said that one of the key
24 elements of success in a merger was to have a detailed
25 integration plan. I'm wondering if the FTC is not seeing
26 the evidence presented up front because the merging firms
27 have not gone sufficiently deep into their integration plan

1 to be able to say, "yes, we'll need fewer people in human
2 resources," "we'll only have one computer system," something
3 of that nature, and that's why they're unable to present it.
4 If any of you could comment on that, I'd appreciate hearing
5 it.

6 MR. DICK: If I can use my role as moderator to hold
7 that question in abeyance, I think it's going to feed into
8 some of the things that Gabe's going to talk about, and I
9 want to make sure we have time. It seems like a natural
10 segue into the very practical nature of what the agency sees
11 and what it needs to see in evaluating efficiency claims.

12 MR. DAGEN: Good morning, and thank you, Dave and
13 Andrew.

14 Yesterday, we heard a number of esteemed speakers
15 talk about the factors involved in achieving a successful
16 merger and achieving cost savings, synergies or
17 efficiencies, and there were some questions yesterday about
18 what the appropriate definitions of those were, and they're
19 all slightly different. But those were some of the key
20 factors that made a merger successful. Standing here today,
21 I would say that I agree with most of the assessments made
22 yesterday.

23 Stock price review gives mixed results of merger
24 success. Efficiencies are often competed away.
25 Efficiencies or cost savings are achieved in most cases.
26 The magnitude is dependent upon the integration planning and
27 successful achievement of the plan that's put into place. I

1 also wholeheartedly agree that cost savings are usually
2 achieved in the magnitude claimed by the merging parties.

3 I also agree with Dr. Scherer's assessment that a
4 large portion of the savings claimed can be achieved without
5 this particular merger or without any merger. This is where
6 the synergy and efficiency analysis that the agency does
7 diverges from the synergy or cost savings analysis that the
8 corporations do in preparation for either their offering or
9 their takeover bid.

10 What I plan to do today is talk about some
11 efficiency claims experience that the agency has seen, and
12 I'm going to go over some of the Merger Guidelines that
13 specifically address some of the topics Dave was talking
14 about -- how they play into the divergence between corporate
15 cost savings and the analysis that we perform.
16 Specifically, as seen in the slide on the top of p. 1 of my
17 handout, I will talk about merger specificity, verifiability
18 and the cognizability of efficiencies. Then I will briefly
19 mention what we would like to see. I'm going to go into a
20 little bit of detail about the kinds of things that we
21 actually do see submitted to us. Then I'm going to talk a
22 little bit about how merging parties can provide the
23 information that we would like to see.

24 The first area that I want to talk about is
25 cognizable efficiencies. As seen in the slide on the bottom
26 of p. 1 of my handout, by cognizable efficiencies we mean
27 efficiencies that are merger-specific, that have been

1 verified and do not arise from anticompetitive reductions in
2 output or service. To begin, I want to talk about merger
3 specificity as it relates to cognizability. As seen in the
4 slide on the top of p. 2 of my handout, efficiencies are
5 merger specific if they are "likely to be accomplished with
6 the proposed merger and unlikely to be accomplished in the
7 absence of either the proposed merger or another means
8 having comparable anticompetitive effects". That's one of
9 the criteria for the agency to recognize the efficiencies as
10 cognizable.

11 The second area that needs to be achieved is that
12 the efficiencies have to be verifiable. Verifiability isn't
13 really explained in the Guidelines, and there's a little
14 leeway there. It's very difficult for merging parties to
15 submit data that's verifiable to us, because we're talking
16 about an act that's going to take place in the future.

17 So, what I propose, and the way I suspect that
18 would benefit merging parties the best, would be to submit
19 data that is supported by company documents. It could be
20 business plans. It could be balance sheets, income
21 statements. It could be trial balances, expense ledgers,
22 capacity reports, product profitability reports, whatever
23 documents they have that have substantiated past savings and
24 that will tie into what they're reporting to be future
25 savings.

26 We understand that the identification of
27 efficiencies and the magnitude of these efficiencies require

1 some guesswork and some estimates, but it's important that
2 the parties, in fact, take this upon themselves to do, and
3 do it in as accurate and supportable a way as possible.
4 It's very unlikely that the merging parties have access to
5 one another's records. They're not available in large part
6 because of what's going to be talked about later, which is
7 the gun-jumping issue in a merger analysis. But if a deal
8 is being done, enough should be known so that it is possible
9 to make a reasonable attempt at quantifying the
10 efficiencies.

11 As discussed extensively yesterday, pre-merger
12 planning is a key to success in integrating a merger. So,
13 you have to plan it, you have to know where the efficiencies
14 are coming from, and you have to be able to establish what
15 you're going to do after the merger. We would like to see
16 that analysis that's being done by the corporations. If
17 it's not being done, it makes a pretty good case for the
18 fact that the companies may not be able to achieve all the
19 efficiencies that they're submitting to us.

20 I want to address what we receive from parties and
21 how we analyze what we receive. Efficiencies are generally
22 grouped and itemized to us in the following manner. We get
23 efficiencies that are corporate overhead savings. We get
24 efficiencies that are divisional overhead savings. We get
25 R&D savings; procurement savings; distribution savings;
26 production savings; and sales, general and administrative
27 savings. Those are the main categories that the savings we

1 see fall into.

2 I'd like to tell you a little bit about how we
3 analyze those groupings. To start with, corporate overhead
4 would, for the most part, fall into what Dave would classify
5 as fixed overhead. Now, corporate overhead would also fall
6 into the category, for the most part, at least historically
7 within the agency, of savings that are likely to be achieved
8 with the merger but unlikely to be cognizable under the
9 Merger Guidelines. They can very well be very substantial,
10 and in some cases, there may be an argument made so that
11 they are cognizable and merger-specific; however, there's
12 usually an alternative opportunity for merger that would
13 allow the same corporate overhead reductions to be achieved.

14 The other portion of the analysis with corporate
15 overhead that we see quite frequently is that when
16 submissions are made, we see one of the two companies'
17 entire corporate overhead eliminated in their projected cost
18 savings, and this clearly can't be the case. In some cases,
19 when it's a big firm taking over a small firm, it may, in
20 fact, occur. But if it's two firms of relatively equal
21 size, for instance, a corporate audit department won't be
22 able to be completely eliminated. In fact, it's probably
23 going to have to stay proportionally the same size as it was
24 before the merger. Legal expenses to a large extent and
25 possibly even human resources may fit it this category.

26 So, the analysis has to be pretty concise for us to
27 accept the corporate overhead savings, as well as give us an

1 indication that they are, in fact, merger-specific.

2 Divisional overhead is the next area that I
3 mentioned, and it's probably more likely to be merger-
4 specific. The divisional overheads for two companies that
5 are merging probably have a lot of duplicative resources
6 that can be eliminated with the merger. They are likely to
7 be achieved, and the analysis that's submitted should be
8 detailed enough to substantiate them. The divisional
9 overhead savings may, therefore, be considered to be a
10 cognizable efficiency.

11 R&D savings are not usually considered cognizable
12 under the Merger Guidelines, because they usually result in
13 a reduction of output. R&D cost savings submitted from a
14 merger are usually a result of personnel reduction such as
15 researchers, not managers. The savings would likely result
16 in a reduction of output. If however, infrastructure was
17 eliminated, and the costs to run the R&D department were
18 reduced, they might qualify as a cognizable efficiency.

19 Procurement is another area that we almost always
20 see in a submission of cost savings and efficiencies, and I
21 think there is agreement that procurement savings are
22 likely; however, the position taken is that procurement
23 savings are pecuniary and that it's just a transfer of
24 profits from the supplier's pocket into the buyer's pocket
25 through a bit of buyer's market power and fear of loss of
26 business from the supplier. Nevertheless, there could be
27 savings that are cognizable. Increased capacity utilization

1 at suppliers post merger, resulting in reduced production
2 costs which are passed through to the merged firm, would be
3 an example.

4 Distribution savings are frequently presented in
5 consumer and business product mergers. Usually in
6 distribution, there are a lot of variable cost savings, and
7 we, obviously, acknowledge those. As Bill mentioned
8 earlier, we shouldn't be talking about fixed and variable -
9 - the fixed cost savings in a distribution environment
10 aren't really fixed. They're fixed to the extent that you
11 have equal monthly payments or equal depreciation on a
12 business, but the business, in fact, is distribution, and as
13 you gear up or increase volume running through that
14 distribution center, your costs to run it on a per-unit
15 basis are actually variable. If a merger doubles the volume
16 that's taking place at a distribution center, the product
17 costs don't change, but the distribution expense, which is
18 your cost of goods sold, so to speak, of running the
19 business do, in fact, change.

20 For production efficiencies, we look at fixed and
21 variable cost savings. Consolidation of manufacturing
22 between facilities of the acquirer and acquired, insourcing
23 from more expensive contract manufacturers, and utilization
24 of more efficient production processes would all be analyzed
25 for cognizability.

26 Submissions of SG&A savings are frequently lumped
27 together as one cost saving. The G&A portion of these

1 savings are usually corporate overhead and I have already
2 discussed these. The sales savings, however, may be
3 cognizable and we would look to determine whether they are
4 merger specific and verifiable.

5 Now, I'd like to talk a little bit about what we
6 actually receive from the parties in the way of submissions.
7 To begin with, the big cost savings numbers that you see in
8 press releases are usually the numbers that appear in the
9 initial investment banker's analysis of the deal. This is
10 often the number that's calculated to help the parties
11 determine the premium to be paid on the deal. It may have
12 been arrived at through analysis of comparable deals. As we
13 all know, each deal is different and every company's
14 operations are different. While calculated to justify the
15 deal price, these savings rarely have any relationship to
16 cognizable efficiencies.

17 Companies can usually achieve cost
18 savings significantly greater than the cognizable
19 efficiencies recognized in the Merger Guidelines. However,
20 the achievable cost savings are the cost savings that are
21 usually reported to us. The shortcoming of reporting these
22 is that the merging parties haven't met their burden of
23 providing cognizable efficiencies to the agencies, which is
24 something Dave mentioned earlier. We get efficiency studies
25 that really are cost-saving studies, and they are not done
26 on a micro enough level from the parties' standpoint to
27 present cognizable efficiencies to us. We then dig into

1 them and try to figure out which ones are merger-specific
2 and which ones aren't. This leads us to identifying non-
3 merger-specific efficiencies. It reduces the number that is
4 reported, and then the number that's reported becomes less
5 reliable to us.

6 As the cognizable savings decrease from the
7 reported savings, the reliability of the efficiency claims
8 tends to decrease. This may pose some risk for the parties
9 when the efficiencies are examined as a defense to effects.
10 This could be either at the Commission or at a Preliminary
11 Injunction hearing.

12 I want to give you some specific examples of some
13 of the specific efficiencies that we've received recently.
14 We had a merger recently between two parties, they were
15 international companies, and we were looking at North
16 American efficiencies. Each company owned two factories in
17 the United States, and to protect the innocent or guilty,
18 I'm not going to use any names in any of these cases.

19 One of the companies (call it Company A) was
20 running each of its two plants at 85 percent capacity, and
21 the other company (call it Company B) was running each of
22 its two plants at approximately 35 percent of capacity. The
23 efficiency claimed was based on the plants of Company B
24 combining. The merged firm was going to consolidate both
25 Company B plants into one plant. They were to shut down one
26 and increase the capacity utilization to 70% for the
27 remaining plant. Well, obviously, that would result in cost

1 savings, and, obviously, it could have been done without a
2 merger.

3 Another recent merger consisted of two companies
4 that manufactured large industrial products. Company A was
5 the low cost producer in some product markets and Company B
6 was the low cost producer in other product markets. Both
7 companies competed in all of the product markets. The lower
8 cost producer usually achieved a significantly higher market
9 share.

10 The parties claimed that the merger would result in
11 significant savings by transferring the best practices
12 methods of the lower cost producer to the other firm. They
13 first calculated how many total projects each company
14 completed annually prior to the merger. For example,
15 Company A, prior to the merger, built 96 Industrial
16 Structures and Company B, in direct competition, built only
17 4. Company A could build these structures for \$100,000
18 while it cost Company B \$120,000 to build their version. As
19 can be seen by this example, if the merged firm adopted
20 Company A's methodology, it would achieve a savings of
21 \$80,000 (4 projects times \$20,000 per project). However,
22 the parties insisted that they would achieve \$2 million in
23 savings because after the merger they would be building 100
24 Industrial Structures at a savings of \$20,000 each. Clearly
25 there were no savings achieved by using Company A's
26 methodology to build the 96 projects they would have built
27 using the same methodology without the merger.

1 Another claim submitted by merging parties had to
2 do with consolidation of operations. Prior to the merger,
3 there were three operating divisions in the one company, and
4 they were going to merge a similar type of company into
5 their operations and set up a new division. The
6 savings that were calculated encompassed not only the
7 savings from incorporating the new division, but
8 incorporated the savings of merging the three divisions that
9 were in existence prior to the merger. A substantial
10 portion of the savings were for the operations that were in
11 existence prior to the merger. Again, savings like this
12 tend to make other savings that maybe are achievable and
13 cognizable look less reliable.

14 And the final example I want to give is, again, a
15 recent case where one company had underutilized
16 manufacturing operations, and it was merging with a company
17 that produced product as well as toll-manufactured the
18 product. After the merger, the underutilized manufacturing
19 operation was going to manufacture the product that was
20 toll-manufactured. While this would generally be
21 cognizable, there was significant evidence that the products
22 produced were so different that their engineers weren't sure
23 that they could be manufactured in the same facility without
24 a major investment. There was also some evidence that even
25 if they could manufacture it in that facility, that the toll
26 manufacturer was a lower cost producer than what could have
27 been achieved in-house after the merger.

1 These are some examples of the efficiencies we see
2 submitted to us that are probably conceived and considered
3 at a high level in the merging parties' organizations. As
4 these examples indicate, when integration planning and
5 efficiency claims aren't well thought out prior to coming to
6 us, they tend to be considered non- cognizable by the
7 agency.

8 Now, here's what we would like to see. It's
9 pretty simple. We would like to see a submission of
10 cognizable efficiencies presented to us in a verifiable
11 manner. The first question I think we addressed earlier is,
12 does this include fixed costs such as the ones David spoke
13 about. As shown in the slide on the bottom of p. 2 of my
14 handout, the Merger Guidelines state that "efficiencies...,
15 which enable the merging firms to reduce the marginal cost
16 of production, are more likely to be [cognizable]."

17 Variable costs are used as a proxy for marginal
18 costs in a lot of the economic analysis. As David
19 mentioned, there are a lot of gray areas. I won't go into
20 detail but fixed costs should be considered in situations
21 where fixed costs may not really be fixed. Distribution was
22 an example that I gave earlier.

23 As seen in the slide on the top of p. 3 of my
24 handout, there's another part of the Merger Guidelines that
25 states, I quote, "The Agency also will consider the effects
26 of cognizable efficiencies with no short-term, direct effect
27 on prices in the relevant market." You can infer from this

1 that if it's a cognizable efficiency and it doesn't have
2 short-term direct effect on prices, it may be what we've
3 been talking about as fixed costs. So, the Guidelines may
4 leave open consideration of fixed costs.

5 And this last slide on the bottom of p. 3 of my
6 handout tells us how savings, both fixed and variable,
7 including overhead, may relate to pricing or capital
8 reduction. The Merger Guidelines state that "the merging
9 firms must substantiate efficiency claims so that the agency
10 can verify by reasonable means the likelihood and magnitude
11 of each asserted efficiency, how and when each would be
12 achieved and any costs of doing so, and how each would
13 enhance the merged firm's ability and incentive to compete."
14 I think that's important, and it doesn't say reduce price,
15 it says enhance the merged firm's ability and incentive to
16 compete.

17 It's important to recognize that it's incumbent
18 upon the merging parties to let us know how efficiencies are
19 going to be used, not have us try to infer how they may
20 happen, and why each one of those would be merger-specific.

21 Just to put all this into perspective, over the
22 last five years, the agencies have received anywhere from
23 2000 to 5000 HSR filings. Only about 2-3 percent of these
24 filings have a second request issued. Approximately 80
25 percent of those where a second request is issued either we
26 allowed to proceed without challenge or have a remedy and
27 are fixed with a consent order, which usually requires

1 divestiture, and only about 0.1 percent of all the filings
2 are litigated. These numbers reflect the fact that
3 achievable efficiencies are preserved in almost all mergers
4 filed with the agencies. Furthermore, even when divestiture
5 is required, the parties are likely to still achieve
6 efficiencies from combining their non divested assets.

7 Claimed efficiencies play a large role in
8 determining whether to challenge a merger, carve out a
9 divestiture or let the transaction occur without
10 modifications. I'd say that in an HSR filing where the vast
11 majority of cases just run through the agency, there's
12 probably no benefit to doing an efficiency analysis. But if
13 we're talking about the 2-3 percent where a second request
14 is issued, there's probably some benefits to providing a
15 detailed efficiency analysis.

16 So, just to wrap up, what we'd like to see is a
17 cognizable efficiency presentation to us that includes both
18 fixed and variable cost savings with a detailed explanation
19 of how these savings will be achieved and how they're going
20 to affect the competitive environment that the parties are
21 operating in.

22 MR. DICK: Thanks very much, Gabe, for your
23 practical discussion about what we do see and what we'd like
24 to see.

25 I'd like to make just a couple of short
26 observations. As you point out correctly, very few cases
27 eventually are litigated or turn on efficiency claims in

1 litigation. But I don't think that should let us lose sight
2 of the importance of an efficiency story and hearing that up
3 front. It's extremely important, particularly during the
4 first 30 days of an investigation, for the parties to
5 provide the rationale for the deal, and that frequently is
6 framed in terms of the efficiencies that might come from the
7 deal.

8 Obviously, they can't do that or frequently won't
9 be able to do that with the same degree of specificity and
10 detail and backup that we would eventually like to see if,
11 in fact, efficiencies really turn out to be the decisive
12 issue. But that shouldn't dissuade and in my experience
13 frequently doesn't dissuade parties from explaining up front
14 the rationale for the deal and the efficiencies, the
15 synergies that they anticipate. Of course, some of those
16 may not be specific to the deal, but they're presenting the
17 deal that they're presenting. They're coming forth with
18 this particular merger, not some other merger or some other
19 joint venture, and so it's natural in the first 30 days for
20 them to adopt something less than a merger-specificity
21 standard when they're explaining the rationale. But that's
22 extremely important, because it helps to frame the rest of
23 the investigation.

24 The second observation that I would like to make is
25 that parties ought to take advantage of the full range of
26 types of information that they can provide to us. Gabe
27 picked up on this point in his remarks in part. It's

1 extremely helpful to provide information on efficiency
2 claims from a number of different angles. Admittedly,
3 sometimes that information will be a little bit
4 contradictory or it will simply reflect an updating, a
5 natural updating that the parties will go through as they
6 get more information themselves, as the second and third-
7 level managers in the company start talking with one another
8 or they start sharpening their pencils a little bit more.
9 But the fact that there may be contradictions, the fact that
10 the efficiency numbers may bounce around during the
11 presentations to the division or to the FTC hopefully
12 shouldn't dissuade them from bringing in those people from
13 within the company or providing the documentation, providing
14 the analysis, because that's extremely helpful to the
15 agencies.

16 It's also, obviously, very helpful if there is an
17 historical record of past mergers involving the same
18 companies or other forms of integration short of merger that
19 generated efficiencies. So we can sort of test what has
20 been the track record of this company in terms of actually
21 meeting its claimed efficiencies. That can often be
22 extremely helpful to evaluating current efficiency claims.

23 Let me pose some questions to Gabe. How specific
24 do the parties need to be at different stages of their
25 presentation? What types of evidence do they need to be
26 bringing in? Do they need to be providing a complete
27 efficiencies story, do they need to be providing the

1 analysis or do the agencies really just want to see the hard
2 facts and numbers and we'll crunch them ourselves? What
3 type of balance between providing the story, providing the
4 analysis, and providing the backup information is the FTC
5 looking for?

6 MR. DAGEN: I think we look for all three. I think
7 we want the story as to how the efficiencies are, in fact,
8 going to be generated. We'd like the parties to do the
9 analysis. They're the ones that have the data. We don't
10 have the data, and we'd like them to point us in the
11 direction of the data and supply us with the backup that, in
12 fact, their analysis is based on.

13 One of the key issues that we see here quite
14 frequently is that one company is doing the efficiency
15 analysis and they're doing it without data from the second
16 company. The first company makes assumptions on the data of
17 the second company, and as long as the assumptions are
18 somewhat based in historical data, we can verify the other
19 company's data and see if, in fact, some of the savings that
20 are being anticipated are being calculated correctly.

21 Problems may arise, however, when a company, for
22 example, bases its efficiencies claims on best practice
23 savings. Although some can be quantified, it's hard to
24 quantify best practice savings. In attempting to quantify
25 best practice savings, the first company may say, well, we
26 do this process so much better than the other company. But
27 in deposition testimony, the other company claims to be just

1 as efficient as the first company, so some of the savings
2 maybe are unrealized. Therefore, it's important for us to
3 be able to verify, in fact, the savings that are being
4 claimed by the party submitting the efficiencies. By them
5 supplying backup and the second company also supplying the
6 information that's requested, we're able to do a test check
7 on whether or not the efficiencies claimed are cognizable.

8 MR. DICK: Do we have maybe one quick question?

9 MR. SCHEFFMAN: I'm going to have to take over,
10 because we are going to run late. There may be questions,
11 and Gabe and David will be around if you want to ask them
12 questions.

13 Let me just say, because we have many people from
14 agencies outside the U.S., Gabe's job, as all of our jobs as
15 enforcers, is to be skeptical about efficiencies claims, and
16 he's good at doing that. That doesn't mean that we don't
17 seriously consider efficiency claims.

18 I think a problem on the outside is that outside
19 counsel are quite willing to be advocates on competition
20 issues, and that's fine, that's their right. We don't give
21 those any credibility, of course. Now, on efficiencies,
22 you have a duty of good faith, because we have to rely on
23 you a lot, and we need corroboration and documents and other
24 things, so that's a problem. If you stretch your efficiency
25 claim, it's going to disappear, because we rely on good
26 faith.

27 Second, I think there's a problem of not involving

1 financial analysts in developing efficiencies. When I did
2 work on the outside and on efficiencies, I always had a
3 financial analyst involved, because an economist is not a
4 substitute for a financial analyst. In efficiencies, you
5 get into these issues about how costs are allocated and
6 other sorts of things, and you really need financial
7 expertise in doing that. You're usually not going to be
8 able to use your internal business people, because they
9 don't really understand the sort of analyses we are going to
10 have.

11 But to go back to what Chairman Muris said, we
12 think efficiencies of all kinds are important. We would
13 like to see better presentations. We don't think, as the
14 Chairman said, that there are many cases where efficiencies
15 are going to make the difference, but there are some. There
16 are more of them than we see, and I thank the panel for very
17 interesting presentations, which will be available on the
18 website. We also will get a bibliography of the articles
19 David Painter cited, and that will be available. The next
20 session won't start until 11:00, so thank you very much.

21

22 **PANEL 5**
23 **PRE-CONSUMMATION INFORMATION EXCHANGE AND INTEGRATION**
24 **PLANNING**
25

26 MR. SCHEFFMAN: We're coming to the last session
27 before we end, and we're running a little late. I want to
28 thank Paul Pautler, who created this whole conference, and

1 his secretary, Chrystal, who made a lot of the arrangements.
2 Stefano, up here, has orchestrated lots of things, the
3 Commission's IT folks, that have made everything work. So,
4 we appreciate the hard work of all the people and, again, of
5 all the panelists who have contributed all their knowledge.

6 There are a couple of things I want to achieve from
7 this final panel on gun-jumping. We learn from the business
8 literature, and you can look at Paul Pautler's paper, that
9 merger implementation is very important to success.
10 Obviously, there's a trade-off between implementation and
11 gun-jumping issues. I would like people to talk about that
12 trade-off so we understand it better.

13 Second, my experience as an outside consultant
14 working with a lot of law firms and companies convinced me
15 that outside lawyers and companies have very different views
16 about where the line actually is. Also, different agency
17 personnel have very different views as to where the line is.
18 Maybe I'm wrong about that. But if I'm right, I would hope
19 that this panel creates a record that would be a
20 stimulus which would move the two agencies to speaking with
21 greater clarity about where the line really is, and we get
22 more consistency across legal staffers of the two agencies
23 in identifying to people where the line is.

24 With that said, Alice Detwiler, one of our first-
25 rate lawyers from the Bureau of Competition, is the chair
26 of this panel. I'll turn things over to her.

27 MS. DETWILER: Thank you, Dave.

1 Good morning. As Dave mentioned, this is an area
2 where we as regulators have -- perhaps as great as any other
3 area -- a role in defining what the guidelines are and what
4 the constraints are. Therefore, it's especially useful for
5 us to hear from counsel who are involved in antitrust -- as
6 to their experience with real transactions and their
7 experience with the advice that they have been giving.

8 In the panels yesterday, a number of speakers
9 emphasized the role of integration planning as a key factor
10 enabling companies to realize their anticipated synergies.
11 In fact, several speakers went so far as to say that the
12 speed of integration planning and the number of crucial
13 decisions made in the early weeks after the announcement of
14 the merger would make or break the success of the merger.

15 Of course, in the business world, it's always
16 important to have fast, accurate decision-making, but our
17 panelists believed that this was especially important in the
18 post-announcement environment. Some of the top reasons they
19 gave were the need to retain human capital, competitors are
20 trying to pick off the top talent, and human capital
21 dissipates in the face of uncertainty. Customers are not
22 dealing well with uncertainty, and competitors are trying to
23 pick off the customers as well. The sheer number of
24 decisions that must be made requires that the merging party
25 use every day efficiently.

26 So, the business people have every reason to want
27 to proceed quickly and accurately, which they can't do

1 without information and participation from the other side.
2 Also, as we heard this morning, they may need to share
3 information and make decisions in order to back up their
4 efficiencies claims. Enter the antitrust laws.

5 As long as the merging parties are separate
6 entities, the Hart-Scott-Rodino Act, the Sherman and FTC
7 Acts and the Clayton Act each restrict the amount of
8 information that companies can share, the way they can plan
9 for integration and the joint decisions they can make.
10 These constraints are real, and one of the major jobs of
11 antitrust counsel during the pre/post period is to make sure
12 that their clients steer clear of conduct that could spark a
13 gun-jumping investigation. Hence, the need for today's
14 panel.

15 Some of the questions our panelists will address
16 include what are the legitimate needs of merging parties to
17 exchange information and plan for integration prior to
18 closing?

19 How should regulators distinguish between
20 legitimate and illegitimate exchanges of information and
21 integration planning activities, also known as gun-jumping?

22 What are the merging parties' incentives to share
23 or withhold information and how do those differ from
24 regulators' concerns?

25 What practical steps have companies taken to guard
26 against excessive information exchange and with what
27 results?

1 How does the need to avoid gun-jumping impact the
2 ability of the merging parties to realize their anticipated
3 synergies?

4 And how can regulators reduce uncertainty as to
5 where the line is?

6 Our panel today consists of antitrust and corporate
7 counsel, both inside and outside counsel, each of whom has
8 substantial experience with mergers and integration
9 planning. First we'll hear from Howard Morse, a partner at
10 Drinker, Biddle & Reath and co-chair of that firm's
11 antitrust group. He previously served as an as Assistant
12 Director in the Bureau of Competition here at the FTC. MR.
13 Morse's recent article on gun-jumping should be available
14 outside. He will lay the ground work for our discussion
15 with a short overview for this topic.

16 James Morphy is the managing partner of the M&A
17 group of the law firm of Sullivan & Cromwell. He has served
18 as outside counsel to buyers, sellers and financial advisers
19 in a large number of acquisitions. He will give us a
20 corporate lawyer's perspective on integration planning,
21 trying to get the deal done and capture synergies within the
22 constraints of antitrust law.

23 Paul Bonanto is corporate counsel for M&A at
24 DuPont. He has been at DuPont since 1974, and for the last
25 eight years, he's headed the M&A core team of DuPont's legal
26 department. Having been involved in integration planning
27 from the inside, he will share with us his experience with

1 actual mergers and the impact of gun-jumping constraints.

2 Mark Whitener is antitrust counsel for General
3 Electric Company, a position he assumed in 1997 after four
4 years as Deputy Director of the Bureau of Competition here
5 at the FTC. Although he assures me that his time at the FTC
6 was the most fun he's ever had in a job, he actually
7 accomplished a number of things while he was here as well,
8 including helping to develop federal antitrust guidelines
9 for mergers, intellectual property and international
10 enforcement. While at GE, he's been involved in a number of
11 acquisitions, and he will discuss the challenges of due
12 diligence and integration planning in that context.

13 Finally, we will hear from Bill Kolasky. He's the
14 co-chair of the antitrust and competition practice group at
15 Wilmer, Cutler & Pickering. He recently returned to private
16 practice after a time as Deputy Assistant Attorney General
17 at the Department of Justice. He will discuss some of the
18 inherent tensions between the needs of merging parties and
19 the concerns of antitrust regulators, and he will highlight
20 some open issues in the guidance that is available on gun-
21 jumping.

22 This topic really lends itself to discussion, so
23 after the presentations, I will have a few questions for the
24 panelists, and I hope the audience will have questions as
25 well.

26 MR. MORSE: Thank you and good morning. I want to
27 thank the organizers of the event, but particularly Dave

1 Scheffman and Sean Royall for inviting me to participate.
2 It's an honor to be back at the FTC. I spent ten years
3 here, often in this room, sitting up at the table over there
4 trying to convince the commissioners to take enforcement
5 action. Now that I'm in the private sector, I still do
6 believe that occasionally enforcement action is appropriate,
7 just not when it involves my clients.

8 Seriously, I do appreciate probably more than when
9 I was here, the need for the government to send a clear
10 message in order to provide guidance to people in the
11 private sector. I hope that what we are doing today will
12 help the government to move in the direction of providing
13 greater clarity.

14 I've been asked to provide an overview and to set
15 the stage for the discussion to follow. For those of you
16 who want more detail, I refer you to my article published
17 earlier this year in The Business Lawyer [Mergers and
18 Acquisitions: Antitrust Limitations on Conduct Before
19 Closing, 57 Bus. Lawyer 1463 (2002)].

20 I want to start by noting two critical distinctions,
21 set forth on slide number two of the handout, that both
22 enforcers and practitioners need to keep in mind when
23 looking at this area. Confusion arises when these
24 distinctions are ignored.

25 The first distinction is between, gun-jumping and
26 exchanges of information. The term "gun-jumping" is used to
27 refer to premature integration, taking control, or

1 integrating before closing, before the Hart-Scott-Rodino
2 waiting period has expired. Exchanges of information may
3 take place for purposes of due diligence or other purposes.
4 Some people occasionally use the term gun jumping in talking
5 about information exchanges, and in my view at least, that
6 can cause confusion. Anticompetitive concerns may or may
7 not flow from the exchange of information, but it's
8 important to focus on it as exchange of information.

9 The second distinction is on the legal front,
10 between Hart-Scott-Rodino Act and Sherman Act or FTC Act
11 limitations. Different legal rules flow from the distinct
12 laws. They apply at different times. The HSR Act applies
13 only through the statutory waiting period, not up until
14 closing, and applies regardless of whether companies are
15 competitors. The Sherman Act, on the other hand, applies up
16 until the day of closing.

17 The Hart-Scott-Rodino Act, as slide number 3 of the
18 handout notes, establishes a pre-merger notification scheme
19 that allows the Government to investigate transactions
20 before they are consummated, avoiding the difficult task of
21 "unscrambling the eggs." That was the problem that the
22 Government faced before the Act was adopted in 1976 when the
23 government often found itself challenging closed
24 transactions.

25 The starting point for understanding the HSR Act, of
26 course, is the language of the statute, which is on slide
27 number 3. That Act provides that no person shall acquire,

1 directly or indirectly, any voting securities or assets
2 without filing and observing the required waiting period.

3 The problem that we all face in interpreting that
4 language is neither the statute nor the HSR rules
5 implementing the statute define the term "acquire," which is
6 what the statute says you are not allowed to do.

7 The HSR rules do give us some insight and help the
8 analysis through a somewhat circuitous route. As noted in
9 slide number 4, the filing obligation is imposed on an
10 "acquiring person," defined as a person who will "hold"
11 voting securities or assets. "Hold" in turn is defined in
12 terms of beneficial ownership. And that is the standard
13 that the agencies have looked to in enforcing the Act.

14 We have to go one step further to look at the
15 Statement of Basis and Purpose, which is the notice issued
16 when the HSR rules were first adopted.

17 In advising clients, one has to look to the source
18 of government statements in a sort of hierarchy, and
19 evaluate how much guidance one can get out of particular
20 statements. Some sources have a longer half-life. We go
21 from the statute to the rules, decisions of courts or the
22 agencies, and the statement of basis and purpose, which is a
23 formal announcement of agency policy, to consent orders,
24 complaints, and analyses to aid public comment and
25 competitive impact statements which accompany proposed
26 consent orders. Analyses to aid public comment don't even
27 end up in the FTC reports. They just sort of disappear into

1 the ether. Private counselors of course also carefully read
2 the speeches of senior agency officials, but they of course
3 carry the disclaimer that they don't represent the views of
4 the agency. As you go down that list, the precedential
5 value declines. To put it bluntly, a speech may be helpful
6 in understanding a current enforcer's thinking, but has
7 little impact after that official leaves office. Sometimes,
8 of course, that is a good thing, when you don't like what
9 has been said in a speech. If the agency wants to provide
10 lasting guidance, officials must do more than give speeches.
11 They need to consider issuing official interpretations or
12 modifying the HSR rules.

13 The Statement of Basis and Purpose, which is quoted
14 in slide number 4, tells us that the existence of beneficial
15 ownership is to be determined on a case by case basis,
16 focusing on what it says are indicia of beneficial
17 ownership. These include the right to obtain any increase
18 in value, the risk of loss of loss, the right to vote, and
19 investment discretion or the right to dispose of assets.

20 The early enforcement actions that the agency
21 brought largely focused on these issues. Those are the
22 Arco/Union Carbide and Arco/Sunseeds cases, involving
23 devices to shift antitrust risk. Those cases examined who
24 had the right to obtain increases in value, who held the
25 risk of loss, who got dividends, and the like.

26 More recent cases addressing gun-jumping still use
27 the language of beneficial ownership, but the real focus

1 seems to be on operational control. As reflected in slide
2 number 5, DOJ officials gave speeches addressing local
3 marketing agreements and time brokerage agreements used in
4 the radio industry. The DOJ said that if such management
5 contracts are adopted in connection with an acquisition,
6 there could be an HSR violation, but if companies enter such
7 agreements outside the context of an acquisition, no HSR
8 report is necessary.

9 In 1996, the FTC brought a case against Titan
10 Wheel, referenced on the same slide, where the agreement
11 transferred possession and operational control immediately
12 to the buyer with the effect, according to the complaint, of
13 transferring beneficial ownership.

14 That brings us to the FTC's Input/Output case,
15 referenced on slide number 6 of the handout, which is
16 perhaps not quite as clear-cut. The acquirer there didn't
17 take contractual control, but according to the complaint
18 integrated the personnel and operations and held out the
19 company as being integrated to the public. The complaint
20 details conduct such as personnel moving offices, using new
21 e-mail addresses and business cards, essentially holding
22 themselves out as being a single company which seems to be
23 what attracted scrutiny.

24 One of the difficulties in giving advice is that
25 when you look at some of these cases, some of the conduct
26 alleged to be problematic seems innocuous. The last line on
27 slide 6 says personnel consulted on other possible

1 transactions. It is not clear to me whether that standing
2 alone is something that the agencies should consider
3 problematic. The idea that you might consult with a company
4 that you are about to buy about another transaction you are
5 thinking about isn't necessarily that crazy of an idea.

6 The Computer Associates case, discussed in slide 7
7 of the handout, is the case that has attracted attention to
8 the gun jumping issue. It included both HSR and Sherman Act
9 counts. Focusing on the HSR claim, here the elements of
10 control were arguably simply aimed at preserving the value
11 of the company. One could argue they weren't integrating
12 and holding themselves out to the public as a single
13 company. But DOJ alleged Computer Associates exercised
14 unlawful control over Platinum, the company to be acquired.
15 The Justice Department said an acquiring company cannot
16 exercise operational or management control over the company
17 to be acquired without stepping over the bounds of the HSR
18 Act.

19 On the other hand, DOJ's Competitive Impact
20 Statement in the Computer Associates matter tells us that
21 customary provisions restricting actions that are reasonable
22 and necessary to protect the value of a transaction do not
23 violate the HSR Act. Unfortunately, what is reasonable,
24 what is necessary, and what is customary is a bit vague.
25 Justice gives us a list of certain things that are not
26 problems, restrictions on declaring dividends, mortgaging
27 property, things of that sort, but also things like

1 restrictions on new large capital expenditures. That, of
2 course, requires one to decide what is large.

3 Part of the problem may be trying to fit a square
4 peg in a round hole, as reflected in the quote from one FTC
5 speech, shown on slide 8 of the handout. The cases and this
6 quote use the language of beneficial ownership, because that
7 is the language in the rules, but the concern is on
8 operational control or control over key competitive
9 decision-making, which has nothing to do with who has the
10 right to obtain an increase in value or the risk of loss.

11 I want to turn now from the HSR Act to the Sherman
12 Act and the FTC Act and start again with the language of the
13 statutes, on slide 9 of the handout. Contracts,
14 combinations or conspiracies in restraint of trade, and
15 unfair methods of competition are illegal. Under these
16 laws, naked price-fixing, market division, and customer
17 allocations are per se illegal. But what if companies about
18 to merge engage in such conduct?

19 Slide 10 of the handout outlines the agencies'
20 positions. The Department of Justice, in Computer
21 Associates, took the position that the pendency of a
22 proposed merger does not excuse the parties of their
23 obligations to compete independently. The FTC, in speeches,
24 has said the same thing. Until competitors consummate their
25 transactions, they are separate economic actors who are
26 bound by the competition laws.

27 But the case law is a little bit less clear. The

1 Eighth Circuit in the International Travel Arrangers case
2 rejected the view that only formal consummation of the
3 merger precludes application of Section 1 of the Sherman
4 Act. The court left it to the jury to decide whether the
5 parties lacked an independent economic consciousness.

6 Two government enforcement actions that predate the
7 Computer Associates case are noted in slide 11 of the
8 handout. The Torrington case alleged one of the companies
9 refused to quote a customer in order to, as an official put
10 it, speed up the consolidation. That was challenged by the
11 FTC as a per se illegal customer allocation.

12 The Commonwealth Land Title Insurance case involved
13 an allegation of price-fixing, where there was a formal
14 agreement between companies to set prices pending a
15 transaction that had not yet taken place.

16 Slide 12 of the handout returns to the Computer
17 Associates case, which has attracted the attention at least
18 of corporate lawyers because it attacked conduct of business
19 covenants under the Sherman Act. There, DOJ alleged
20 covenants restricting conduct pre-closing violated the
21 Sherman Act. DOJ said agreements to operate in the ordinary
22 course consistent with past practice or general agreements
23 restricting conduct that would cause a material adverse
24 change are okay, but agreements on price, agreements
25 allowing one firm to approve the other's contracts or the
26 like are prohibited.

27 I will turn now to pre-merger information exchange,

1 which as I said at the outset must be analyzed separate from
2 gun jumping. Exchange of information does not implicate
3 beneficial ownership or operational control, and is not
4 considered per se illegal.

5 Three legitimate competitive concerns that have been
6 expressed about gun jumping are spelled out in slide 13 of
7 the handout. First is that companies that have no intention
8 of merging engage in sham negotiations. Some companies may
9 exchange information under the guise of merger negotiations
10 in order to collude. Second, one firm may be engaged in
11 predatory conduct and engage in merger negotiations just to
12 get information from the other. Those are legitimate
13 concerns, but they are very rare, and to establish rules
14 based on those concerns will inhibit procompetitive merger
15 discussions. The third concern is the one that seems to
16 drive the analysis, and that is that legitimate merger
17 discussions may lead to coordinated interaction if the
18 proposed transaction is not completed.

19 As seen in slide 14, the Supreme Court precedents
20 instruct that the rule of reason applies to information
21 exchanges, recognizing that there is a useful purpose to
22 such conduct, and therefore, one has to look at the
23 structure of the industry and the nature of the information
24 exchanged to decide whether it is OK. It is safer to
25 exchange historic information than to talk about current
26 conditions. One time exchanges are generally safer than
27 ongoing exchanges.

1 It is critical to recognize two legitimate business
2 justifications for information exchange pre-merger. One is
3 due diligence, both to determine and confirm the value.
4 That doesn't end on the day that a contract is signed, but
5 may continue up until closing. A second legitimate function
6 is planning efficient integration.

7 I used to think this was only important to my
8 clients in the computer industry who insist that they need
9 to be able to move quickly after the deal is consummated,
10 but it is now clear to me that companies in all industries
11 consider integration planning important. They are concerned
12 that uncertainty leads to personnel leaving the company and
13 business being lost to competitors, and are concerned that
14 delay will reduce projected efficiencies.

15 One of the key issues in the rule of reason balance
16 ought to be whether the firms have implemented precautions
17 and safeguards to reduce the risk of anticompetitive
18 consequences from information exchanges. These are spelled
19 out in slide 15 of the handout. A firm may restrict
20 distribution and use of competitively sensitive information,
21 who is going to get it, and what they can use it for. Firms
22 may also aggregate competitively sensitive information.
23 They also may delay the exchange of the most sensitive
24 information until late in the process when the transaction
25 is more certain.

26 One has to consider these sorts of precautions and
27 safeguards as well as the strength of competitive concerns

1 based on market structure in the rule of reason balance.

2 Slide 16 summarizes recent enforcement action
3 challenging information exchanges in the merger and
4 acquisition context. The Insilco case involved exchange of
5 customer-specific information, current and future pricing
6 plans, and pricing formulas. The FTC alleged in that case
7 that the transfer of such competitively sensitive
8 information in highly concentrated markets was illegal. I
9 am troubled by language in the analysis to aid public
10 comment that suggests that this kind of information exchange
11 would likely harm competition in any market. Under the rule
12 of reason analysis, market conditions are an important
13 factor. It is also noteworthy that there is no discussion
14 in Insilco of any safeguards. Presumably there were no
15 safeguards in place. Notably, while prohibiting direct
16 exchanges of information, the FTC consent order in that
17 matter allows the companies to use independent agents to
18 aggregate sensitive information.

19 Finally, as shown in slide 17, we are left with the
20 question as to whether the mere exchange of information can
21 violate the HSR Act? The quote here is one that I find
22 troubling. It suggests that exchange of information for
23 purposes of due diligence is permissible, but it rejects
24 planning integration as a legitimate grounds for exchanging
25 information. Therefore, it suggests that if an acquired
26 firm can not show that it would have provided information to
27 a firm other than the acquiring firm, then that might be

1 unlawful.

2 I hope that this overview of the law and recent
3 government enforcement actions sets the stage for comments
4 and what I know will be worthwhile insights from the other
5 panelists. Thanks very much.

6 MS. DETWILER: Thank you. James?

7 MR. MORPHY: Good morning. As Alice said, I am
8 neither a regulator nor an antitrust lawyer. I'm one of the
9 guys that tries to get the deal signed and then leaves the
10 mess for everybody in this room to try and figure out what
11 to do with it. So it's probably appropriate that my remarks
12 will be brief.

13 As an M&A lawyer, I am not particularly troubled by
14 where we currently are with respect to the so-called "gun-
15 jumping" issue. The enforcement actions that have been
16 taken by the regulators, some of the cases that have been
17 mentioned previously, don't surprise or shock me. In fact,
18 when I look at the facts in those cases, I understand why
19 regulators did what they did under the circumstances. So,
20 I'm not troubled by what I see.

21 Sometimes what I hear, if it is indicative of
22 future actions, does trouble me. General remarks and
23 speeches by agency officials sometimes go further than what
24 I think the regulatory agencies have done in the specific
25 cases. I think as long as we all accept the "rule of
26 reason" approach and remember the purpose of the acts and
27 rules that you are enforcing, we can find common ground and

1 ways in which the objectives of the statutes and the
2 objectives of the business people and their lawyers can be
3 met.

4 The "gun-jumping" problem can be broken into two
5 basic areas: there is, first, the problems that can arise
6 in connection with the information exchange between
7 potential merger partners, and second, the post-signing and
8 pre-closing interactions between the companies.

9 I think most lawyers in this area would agree that
10 the procedures to be followed before exchanging information
11 are fairly standardized: everybody getting information has
12 to sign a confidentiality agreement. That's the first step
13 of the process. Speaking from the sell side, generally a
14 data room is created with documents that you would
15 anticipate the buyer would want to see. The data room is
16 gone over in advance by lawyers on our team. I would always
17 have an antitrust lawyer involved, but, in the beginning the
18 data room is mostly public information and not competitively
19 sensitive information. To the extent there are contracts
20 that we know somebody is going to want to see, they would be
21 redacted to the extent that they contain price-sensitive
22 information or other information that we don't believe that
23 they should have. So, that's how the process starts.

24 Starting off with a "clean" data room has the
25 advantage of eliminating an awful lot of the concerns about
26 who can see what, when, et cetera, early in the process.
27 You can allow a lot of people to see information relatively

1 quickly. You're not terribly troubled by what they're going
2 to have their hands on. A number of people may come through
3 and want to kick tires. At the end of the day, some are not
4 terribly serious, but they haven't learned very much from a
5 competitive perspective, and you haven't wasted a lot of
6 time. Obviously, as the process progresses, and you get
7 more serious with one or two buyers, and if you're lucky,
8 maybe more than two, the demands for detailed information
9 increase. At this point, logic and an appreciation for
10 antitrust sensitivities come into play from a corporate
11 perspective. When I hear from my client that Buyer A needs
12 to be provided with certain types of information, my first
13 series of questions is always, well, why do they need it?
14 What is it that they need to learn from that information
15 that is going to help you and this process? And do you
16 accept their explanation of what it is they need and why, or
17 are they just "mining" for information?

18 Then I ask, if you give the information to them and
19 this transaction falls apart, would you regret it? Usually
20 when you start to analyze things in those terms, the
21 businessmen almost always start to decide how to handle this
22 process for themselves, and you will find that they become
23 very much an ally. If it is decided that the request is
24 legitimate but we don't want to give them exactly what they
25 are asking for, the third question is generally, so how do
26 we go about giving them a substitute for this information?
27 Can we give them a proxy for it without divulging

1 information that you wouldn't want in their hands?
2 Generally a way is found to thread the needle. Aggregation
3 of data is one well recognized way to go about it. Coding
4 things and hiding names and changing information in a way
5 that still provides a sense of what the basic underlying
6 data is without giving them the underlying data, all of
7 these things are possible.

8 The other tension, though, that I throw out is, at
9 the end of the day, the seller also is trying to maximize
10 value. He or she is hearing from the buyer that without
11 this specific information I'm not sure that I can price this
12 appropriately or I'm not sure I can get you more value. So
13 undeniably there is a tension. It isn't easy simply to say,
14 forget it, you don't need this information. You do need to
15 work through a process. And, obviously, the nature of the
16 information, who is going to get it and when they're going
17 to get it all play into what we ultimately decide is the
18 right path.

19 There are transactions in which we have required
20 buyers to enter into "ring fence" agreements, where they
21 agree that only a certain group of select people within an
22 organization will be entitled to see the information. We
23 have each of those individuals sign a very explicit
24 confidentiality agreement that states what the purposes of
25 the agreement are and that they are not to use this
26 information for any purpose (or provide it to anyone else)
27 other than for purposes of analyzing the transaction.

1 Obviously, the positions of those people is terribly
2 important. Typically, they are not involved in operations,
3 in marketing, et cetera.

4 It is an iterative process and one in which you
5 work very hard to try to accommodate the need for
6 information balanced against the objectives of not providing
7 competitively sensitive information that can be used in a
8 way that regulators here would find objectionable.

9 So that's a snapshot of the pre-signing process
10 from my perspective. The post-signing/pre-closing
11 interaction process is one, as everyone knows, where deals
12 take a while to close -- sometimes thanks to the help of
13 some of the people in this room. Therefore, the buyer wants
14 some assurance that the value that it's agreeing to pay on
15 day one, and is agreeing to deliver 90 or 180 days later,
16 will be in exchange for an enterprise that is still as
17 valuable as he or she originally thought it was. Therefore,
18 restrictive covenants are written into the definitive
19 agreement, which are perfectly legitimate, and as long as
20 some sort of ordinary course business exceptions are
21 accepted as a way to allow this process to take place, I
22 think that's a fair compromise.

23 There are places, however, where the ordinary
24 course exceptions can bump up a little bit against some
25 issues. Let's assume a company, for example, has a capital
26 expenditures budget that the buyer has a look at and says,
27 gee, we really don't want you to do that. That's when you

1 must be alert to the issues.

2 I will pose three examples for the group which may
3 inspire some conversation or questions. In the first one,
4 for example, let's assume the seller is about to enter into
5 a long-term lease for its corporate headquarters, but it's
6 anticipated that one of the synergies of the deal is that
7 the seller's corporate headquarters is going to close, and
8 G&A is going to be reduced dramatically. People are going
9 to be consolidated into the headquarters of the buyer. In
10 that case, it makes no sense for the seller company to enter
11 into a long-term lease, and therefore, the buyer quite
12 naturally would not want them to do that.

13 I must say, and I will pose it and move on and see
14 if other folks have a view, that doesn't particularly
15 trouble me if I step back and look at the purposes of the
16 antitrust laws and what we're trying to achieve. Delaying
17 the decision to enter into a long-term lease for office
18 space doesn't seem to be something that should create an
19 issue. But let me go a little further and, assume the
20 capital expenditure budget of the seller calls for it to
21 spend \$5 or \$10 million to renovate a plant. Assume there's
22 surplus capacity, and it is anticipated that plant in
23 particular -- which, obviously if they're renovating it
24 isn't as efficient as it should be -- is one of the plants
25 that the two parties would close. Well, is it fine if the
26 buyer says, I don't want you to start to spend the money to
27 renovate that plant since we both agree that it's going to

1 be closed in 90 days? I have an answer for that. I'm
2 wondering what others will say.

3 The third scenario is one in which you have a
4 company that leases airplanes, and they are about to bid to
5 buy five Boeing 767s, and five Airbuses, if that's the right
6 term, and the buyer at the end of the day doesn't need or
7 want ten more airplanes. Is that an appropriate place for
8 the buyer to say, I don't want you to bid for those
9 airplanes. As I said, a little more trouble as we go up the
10 ladder here.

11 So, those are the places where I think you start to
12 see tension in terms of the buyer having legitimate
13 expectations about how the deal will unfold, what will be a
14 synergy and what will not be a synergy, -- all of which can
15 affect price for the seller and its stockholders. Questions
16 arise regarding the logic of continuing to go down a path,
17 if you assume the deal is going to close, doing something
18 that could be considered in some ways economically wasteful.
19

20 Every deal is different, every company is
21 different, and others here may have a different view. But,
22 in my experience, information systems are an area, in
23 particular, where if you can't put those things together and
24 have things up and running when a merger closes, you run
25 into tremendous problems for the business people trying to
26 integrate these businesses and make them work. So, I think
27 there are places, again, where there should be the ability

1 to allow integration planning to take place without
2 necessarily running into the "gun-jumping" issues that have
3 been raised as problems in this area. Clean teams are
4 something that people have used, with varying degrees of
5 success.

6 But at the end of the day, the antitrust rules are
7 going to prevent certain information from being able to pass
8 from one company to the other. At least in my experience,
9 most companies are able to live within those parameters, as
10 long as, again, it's a process of give and take, as long as
11 the regulators understand that there are also legitimate
12 needs for businessmen to be able to talk and to plan, and to
13 look at the specific facts under a rule of reason and say
14 that's acceptable "good faith" conduct, and we understand
15 why you did it the way you did.

16 So, from my perspective, I guess I would be happy
17 if we all just stayed where we are. The world, at least
18 this corner of it, seems to be working pretty much the way
19 it should. Thank you.

20 MS. DETWILER: Thank you, James. Now we will hear
21 from Paul, an inside counsel.

22 MR. BONANTO: First of all, to David and everyone,
23 thank you for the opportunity to come down and give a bit of
24 a business perspective, although you might wonder about
25 that. And of course, a preliminary comment, these views do
26 not necessarily reflect the views of DuPont, but they are
27 not my views either. This presentation, obviously, appeared

1 on my computer, and I'm just using it.

2 I think Howard already covered this distinction,
3 but just to set it up, what I am going to be focusing on
4 from our point of view are really three pre-closing
5 activities between the parties when competitive issues
6 exist. These are things we work with. As shown in the
7 slide on the top of the first page of my handout, these
8 categories are (1) exchange of information, (2) covenants
9 and provisions in the agreement of sale -- clearly Computer
10 Associates has gotten people focused on this if they weren't
11 before, but, as a practitioner you do worry about those
12 covenants -- and (3) preparation for startup (closing) and
13 integration.

14 What are some business needs at least that we would
15 like you to be thinking about? As seen in the slide on the
16 bottom of the first page of my handout, once announced, the
17 deal ought to go through. Embarrassment is a big driver for
18 corporate CEOs, along with other things, and when they
19 announce a deal, they want it to close. Just so you know,
20 this is even more important from the seller's point of view.
21 If we're in a competitive situation and we've announced that
22 we're selling business X and that deal doesn't close, there
23 is some inevitable competitive harm to that business.
24 People don't view you as committed to it. They don't view
25 you as reliable as a supplier. There are some inevitable
26 business issues that can't be avoided. So, if I'm a seller,
27 for sure, as well as a buyer, I want the deal to go through.

1 Second, values need to be maintained in the interim
2 period but also captured, and again, I would think from a
3 regulatory point of view, that's reasonably important to
4 you. Third, startup should be smooth, effective. I've
5 lived through some startups that were not effective, and
6 they are really, really horrible. As you can imagine, when
7 we announce, oh, there's going to be a merger, and gee,
8 customers, there's going to be all kinds of great things,
9 aren't you really happy? And they're all sitting back, boy,
10 here we go again. They're going to lose my order, and they
11 won't know what they're doing. The customers are very
12 concerned about it.

13 So, if you don't start up well, that's another
14 thing that it's very, very hard to recover from. If you
15 call me up and ask where's the order, and I tell you, gee,
16 we have to call so and so and find out about it, that's not
17 comforting. So, the startup, especially the first 30 days,
18 is very, very critical. From our perspective in business,
19 it's essential to make the startup happen the way you want
20 it to happen, which is effectively.

21 Let's talk about the first of the three we
22 mentioned, due diligence and integration. As indicated in
23 the slide on the top of p. 2 of my handout, the process of
24 due diligence (value confirmation) and integration (value
25 capture) is really one continuous process. That's the way
26 we plan for it; that's the way we implement it. The team
27 that is doing due diligence is also the integration team.

1 They are in there initially to confirm value, but they are
2 also identifying what needs to be done for a successful
3 startup and integration. Isn't that logical? If I'm Joe or
4 Sally and I'm finding out about this for this purpose, I'm
5 also thinking about, how are we going to make this company
6 run together after closing? You don't have two separate
7 teams. So, it is an integrated process. It continues until
8 closing. Obviously, the emphasis shifts from value
9 confirmation to value capture. My point is, and it's been
10 made already, a buyer's need for information continues until
11 closing, and in fact, in my experience after closing.
12 You're always learning more, but it's very, very important.
13 The due diligence, the integration, the planning, the value
14 capture, it's all one process.

15 Okay, with that background, how do we look at these
16 three issues? First of all, exchange of information. As
17 shown in the slide on the bottom of p. 2 of my handout, yes,
18 traditional rule of reason applies. My experience is that
19 practitioners are comfortable and experienced in dealing
20 with these issues, both as a buyer, and as a seller --
21 everyone sees it about the same way. Yes, this is
22 information you can have, yes, this needs to wait until
23 later, this maybe has to go to a special group, this will be
24 done differently, this needs to be redacted.

25 From my experience, this is something that is done
26 pretty well. People almost always see the same issues, and
27 they deal with them in a similar way. So far, I've never

1 had a question from either agency, the Department of Justice
2 or FTC, looking at a transaction saying, gee, what were you
3 doing here? That doesn't mean we're perfect, but I think we
4 see it pretty well. I don't think it's an area where
5 guidance is needed, again, with that caveat we talked about.
6 I think people are dealing with it reasonably well.

7 Now, you have your own perspective, which I can't
8 comment on, but this is what I have seen. People understand
9 these issues, because we deal with them in a lot of areas
10 other than mergers. Maybe you want to do a joint
11 development agreement with someone. There's all sorts of
12 competitive issues that arise under the Sherman Act, and
13 we're used to dealing with information. So, I think there's
14 a fair amount of experience out there.

15 The second one, covenants and provisions in the
16 agreement of sale, is referenced in the slide on the top of
17 p. 3 of my handout. I'll give you a few perspectives. I
18 told you the seller especially wants to know that the deal
19 is going to go through for a lot of reasons, not just
20 because of the competitive harm if it doesn't. Maybe the
21 chairman has called up Ellen and said, Ellen, I really want
22 this money in the second quarter, I am going to get it,
23 aren't I? And that can be pretty powerful living within a
24 company. It should be important for the same reason to you
25 all, that a deal that's approved closes. If you say, yes,
26 overall this should close, then you wonder why if it doesn't
27 close. If there's competitive harm, dislocation -- that's

1 a negative from your point of view as well. So, for the
2 seller, the agency, depending on your point of view, closing
3 is a positive. You should want it to happen.

4 Looking at Computer Associates and recognizing that
5 the seller wants certainty, I would say, first of all, an
6 ordinary course of business covenant doesn't do it for us,
7 because it's not very clear. Remember, Ellen has been told,
8 you have got to get this thing closed, and so anything
9 unusual that happens, what do they do? They call me up.
10 They say, Paul, if we do this, are we going to close?
11 That's a nice thing to have to answer day to day, isn't it?
12 You have got a pretty good argument, et cetera, et cetera.

13 The other I guess safe harbor talked about in that
14 case, is if it won't have material adverse effect. This
15 may not be clear, depending on how you define it. You know,
16 conditions of closing are not a substitute. You can go to
17 the other extreme and say, seller, you run your business
18 however you want until closing, and then I, buyer, can take
19 a look, and if it's changed in a way I don't like, then I
20 won't close. Well, again, that shouldn't meet your needs or
21 the seller's either.

22 My point is lack of specific covenants may cause
23 less competitive vigor rather than more. Now, this is only
24 a hypothetical. I'm certainly not recommending it, but
25 suppose you said, you seller can cut your prices 10 percent
26 below list but no more, but as long as you're only doing it
27 that much, that's not going to foul up closing. We'll

1 consider it in the ordinary course. We won't consider it a
2 material adverse effect. Now, Ellen wants to cut prices 8
3 percent. Hey, Paul, is this okay? No problem. Suppose you
4 don't have that provision and she says, hey, what happens if
5 I cut it 8 percent, well, there may be an issue. Well, I'm
6 not going to do it.

7 So, I'm just saying a lack of certainty does not
8 necessarily lead to competitive vigor on the part of the
9 seller, depending on their motivation. I'm not trying to
10 dig a hole for myself, but that's just the reality. That's
11 where they're living. So, to some extent, certainty or a
12 little more specificity in covenants can be pro-competitive,
13 it just depends. I'm not advocating that one. That's an
14 example.

15 So, I'm just urging the Government to consider the
16 underlying business reality. Those covenants very often,
17 certainly if it's against someone such as this panel, are
18 heavily negotiated. Sellers and buyers don't have a
19 unanimity of interest, so they really are arm's length.

20 The starting point should not be, I wonder what
21 these turkeys are up to. Just say, this represents two
22 thoughtful people on different sides of the fence trying to
23 come up with something. Let's at least look at it from a
24 neutral point of view and see what we think. Certainly I
25 would think at a minimum, if we're going to go to a safe
26 harbor, and that's a question for you guys, we ought to at
27 least say that the material adverse effect could have a

1 quantity specified, so that, if it doesn't change in an
2 amount exceeding X, a set dollar value, then it would be all
3 right.

4 Now, at a minimum, the seller is going to need some
5 basis to evaluate it meaningfully as to what it might do to
6 closing.

7 Preparation for startup is addressed in the next
8 slide, on the bottom of p. 3 of my handout. Some people
9 have touched on this, but I think activities prior to
10 closing to facilitate an effective startup should be allowed
11 unless they raise real anti-competitive issues.

12 I recognize we do have the jurisdictional
13 imperative of Hart-Scott-Rodino and you can't give up your
14 rights to have all this sort of stuff taken care of. The
15 pivotal case, which my colleague touched on, is Information
16 Systems. But suppose on day one, we now have the merger,
17 and somebody is calling up, Joe Blow, a real customer, and
18 he says, I want to order something. How do you place it on
19 the plan? How do the computer systems talk to each other?
20 How do you cut an invoice? Can you really track it when he
21 calls up a week later and says, when am I going to get it?
22 They want to know that they are going to get it in the next
23 week, what day, what hour, when is it coming in? What
24 train's it on? When is it going to arrive? Those things
25 you won't be able to do unless you have done a heck of a lot
26 of planning ahead of time. That means in due diligence in
27 this area, for example, you find out what computer system

1 they have, what software they have, what licenses they have,
2 and does it run well? Also, how is that system and yours
3 going to be integrated? How on day one is it really going
4 to work? And if you don't start until after it closes, you
5 will have a nightmare, an absolute nightmare. How are you
6 going to have shipping and tracking? You have got railroad
7 interfaces between the parties. Without going into the
8 litany list, it's just a whole host of pragmatic issues, few
9 of which are tremendously right in the heart of anti-
10 competitive concerns, that need to be done.

11 Clearly I'm not advocating that we share pricing at
12 individual accounts and have the sales reps talk to each
13 other a month before closing. But in many of these other
14 areas, there's an awful lot of pragmatic cases such as
15 information systems, plant operations, purchasing and how
16 you're going to get the raw materials in a more effective
17 way, et cetera, that I would just say is a positive that
18 should be allowed. And again, as we talked about, if you
19 have a very bad startup, there is some actual economic loss
20 that in our experience is never going to be made up. So,
21 that's just a few perspectives from our point of view.

22 Thank you.

23 MS. DETWILER: Thank you Paul. Now we will hear
24 from Mark, an inside counsel.

25 MR. WHITENER: Good morning. Nice to be back.
26 When I was at the FTC, I was present at the creation of some
27 of the cases that Howard talked about, so not surprisingly,

1 I'm not going to spend too much time criticizing any of the
2 actual cases the FTC brought. I do think some of the
3 guidance, some of the speeches that have followed have
4 complicated things a little bit, although I find myself
5 largely in agreement with James and Paul, especially on the
6 bottom line, which is that I don't see a crisis here. I
7 think that as Paul said, people who counsel in this area
8 have figured out how to accomplish virtually all of the
9 legitimate business needs. But I think there is at the
10 margin some hyper-caution in the guidance that comes from
11 the ambiguity that's been introduced by some comments made
12 outside the context of the actual enforcement actions.

13 So, I'll address that and try to give you my
14 perspective, especially from my last five years at GE, in
15 terms of what we actually try to do, how we do it, and how
16 we interpret the cases and the guidance that come out of the
17 agencies.

18 The first slide of my handout lists the main points
19 that I will make today. First, the business environment
20 that we and other companies operate in today is making all
21 of these issues we are talking about even more important.
22 That is to say, all business activities are under even
23 greater scrutiny, certainly including merger and acquisition
24 activity -- which deals are selected, at what price, and
25 whether they are ultimately successful.

26 For a company like GE that does a fair number of
27 deals, the marketplace is evaluating us, and it's important

1 that we be able to say, credibly -- to the marketplace, to
2 investors, to regulators -- that we have a track record for
3 choosing deals well and for actually implementing them
4 effectively.

5 The second point, which I think everybody agrees
6 with in principle, is that there are legitimate business
7 needs here -- for thorough due diligence, rapid deal
8 integration, and preservation of the seller's business in
9 the interim between signing and closing. These legitimate
10 business needs have to inform the regulatory analysis, and I
11 think they do, but the more that we focus on the details of
12 these business considerations, the better informed the
13 regulatory analysis will be.

14 The third point is that when we talk about planning
15 for effective post-closing integration -- Paul made this
16 point, and I believe others did yesterday in the efficiency
17 discussion -- we are not talking about getting a jump, in
18 some sense, on closing. It's not about, "well, we think
19 it's a good deal, so it must be good to integrate it sooner,
20 before we're cleared and closed."

21 Clearly that's not the legal and regulatory
22 environment. You can't actually integrate the business
23 until you've been cleared and closed the deal. The point
24 here is simply that deals succeed or fail based in large
25 part on whether they're effectively integrated, and
26 effective integration requires fast integration. It
27 requires, as others have said, that a lot of things happen

1 in the first hours, days, weeks and months after the deal is
2 actually consummated.

3 The next point -- and again, I'm echoing what
4 others have said - is that the current regulatory
5 environment works reasonably well. People have found ways
6 to structure due diligence, integration planning and
7 ordinary course contract provisions so that businesses can
8 do most of what they need to do. But I will talk about some
9 of the ambiguity at the margins of the agencies'
10 articulation of the policy in this area that might be
11 effectively addressed.

12 What can the agencies do differently? I think it's
13 a question of how you interpret and explain the policy and
14 the enforcement actions you take. Again, I don't have much
15 to quibble about in terms of case selection. The question
16 is what is the gloss on that case selection, and what is the
17 proper legal analysis under Section 1 and Section 7A, which
18 I think have to be viewed as distinct analyses, as I will
19 discuss.

20 Then finally, I don't want to give practitioners --
21 outside or inside counsel -- a complete pass on this. Some
22 people give very good and practical advice. But some
23 practitioners resort to a cookbook approach. You can get
24 very simple guidance, and it can be over-restrictive. Or
25 you can spend all day every day, as I'm sure Paul has found,
26 answering specific questions on a case-by-case basis. You
27 have to find something in between where you can guide the

1 process without spending 24 hours a day on it, and without
2 resorting to categorical do's and don'ts that might miss the
3 mark in some cases.

4 I put the legitimate pre-closing needs of
5 businesses that are parties to a deal agreement in three
6 categories. First, let's talk about due diligence, which is
7 referenced in the slide on the top of page 2 of my handout.
8 The fundamental premise that good information is vital to
9 deal evaluation and integration planning is not something
10 people would disagree with. Efficient markets require good,
11 timely information. M&A markets are no different. But
12 sometimes the counseling in this area unduly restrict the
13 information to what's "necessary" or "reasonably necessary"
14 in order to accomplish a business objective. That's
15 probably a good working concept, but the problem is that I
16 often find that I'm looking at information where I can
17 clearly see that there is a legitimate reason for the
18 information to flow from the seller to the buyer, even if
19 some of information may be competitively sensitive. That's
20 really the problem -- some of that information could well
21 have a legitimate pre-closing purpose, and it may be hard to
22 draw a clear line around what is "necessary." And of
23 course, it can be hard to draw a clear line around what is
24 competitively sensitive.

25 But the next point I think is something that's
26 important to say, which is that this line-drawing is
27 typically not a big problem in the current regulatory

1 environment. It's understood in the antitrust legal
2 community, at least, and I think in the M&A legal community
3 generally, that you have to take steps to keep competitively
4 sensitive information out of the hands of the wrong people.
5 Through a process of identifying the information, and
6 identifying the people, you establish processes to make sure
7 that if there's a need to know, you know *who* needs to know
8 it, and you prevent the information from flowing to
9 operational people in the buyer's organization who compete
10 with the seller. Those are steps that can be and typically
11 are taken, and I think that these steps are fairly simple
12 and widely used.

13 But in the due diligence area, I think it's
14 important to confine the analysis -- as noted in Howard's
15 terrific article and looking at the cases and speeches -- to
16 Section 1. It's a Section 1 rule of reason issue. There's
17 an established legal analysis for that. It's not the
18 clearest legal analysis in the antitrust world, but there is
19 one. It's not a 7A analysis. When I come back to
20 integration planning in a moment, I will talk about that a
21 bit more.

22 The rule of reason really is the proper approach to
23 information sharing, setting aside the sham situation, which
24 as Howard said and which in my observation is extremely
25 rare. I have never seen deal discussions that I thought
26 either party was entering into in order to mine competitive
27 information without a legitimate interest in doing a deal.

1 I'm not saying it's never happened; I've just never seen it.

2 The second legitimate need is integration planning,
3 which is discussed in the slide on the bottom of page 2 of
4 my handout. I've already made the first point, which is
5 that the business need is not about getting started with
6 actually integrating the acquired business before closing.
7 It's about being ready to quickly take the vast majority of
8 integration steps within the first 30 to 60 days after the
9 deal is closed. Keep in mind that for most deals, before
10 they are signed and announced, there's a fairly small group
11 of people in both organizations who know about the deal.
12 Often there are very strong legal and practical reasons to
13 do it that way. So, the buyer and seller organizations may
14 have hundreds or thousands of employees, but most of those
15 people are completely separate from the deal process until
16 the day that it's announced.

17 So, there's a hell of a lot to do at closing --
18 Paul made that point. My view is there's a lot of
19 preparation that can be done pre-closing, as long as
20 competitively sensitive information isn't shared among the
21 wrong people, so that at closing, we can come as close as
22 possible to pushing a button and having the IT systems
23 integrated, for example. Now, anybody that knows about IT
24 systems would laugh at that, because they know that that's
25 almost never possible, even with smaller integrations, much
26 less large ones. But that's the goal, and that's a good
27 example, I think, of a fairly competitively benign area

1 where there are business imperatives.

2 The next point is that there are difficult
3 questions about information flow, often related to the
4 integration planning process. When antitrust lawyers think
5 about this issue, we typically begin by thinking about due
6 diligence and sharing information, what kind of information
7 needs to be shared for valuation purposes, et cetera. Then
8 we think about integration planning as largely a gun-jumping
9 issue. Did the buyer exercise improper control over the
10 seller? Did they get in there and operate the business
11 prematurely?

12 But to me, one of the key areas and sometimes one
13 of the most challenging areas is a combination of the two
14 issues: What is the information flow necessary for
15 integration planning? Paul made a number of very useful
16 observations, one of which was that due diligence and
17 integration planning are not really two operations, they're
18 one. The information flow that is supporting due diligence
19 also needs to be plugged into the integration planning
20 process. And often there's even more of a legitimate need
21 for operational business people from the buyer's
22 organization to be involved in the integration planning
23 process, because they are the ones who are knowledgeable
24 about the businesses to be integrated.

25 When you're talking about pre-signing due
26 diligence, you can do some of that with non-operational
27 business people. Obviously, you may include operational

1 people for some purposes, but you can reasonably segment
2 them from a lot of the information. When you talk about
3 integration planning, by definition, you're talking about
4 how business X and business Y fit together, and that has to
5 involve, to a significant degree, operational people from
6 the buyer's organization.

7 So, it's a little more difficult at that point to
8 say, well, we'll take all the necessary information in, but
9 we'll just keep it within this deal team that is limited to
10 outside consultants and finance people and lawyers and
11 business development people. You have to include some of
12 the buyer's business people in the integration planning
13 process, so you have to then be more rigorous about keeping
14 from them competitively sensitive information from the
15 seller that they shouldn't have. That is something that we
16 focus on a lot.

17 Again, I'm not arguing here for a different policy
18 or different guidance from the agencies. I'm just trying to
19 convey the business context. If the agencies encounter an
20 example where somebody is seeking to justify information
21 flow on the grounds that it was needed for integration
22 planning purposes, I don't think you should say, well, wait
23 a minute, we look at information flow as a due diligence
24 issue. I don't think it's quite that simple.

25 The final point on this slide is that when any
26 responsible antitrust counselor is trying to help their
27 client get a deal done, the ultimate goal is to get it done

1 quickly and effectively. The overhang here, if you will, is
2 some of the more aggressive speeches by agency officials
3 about what constitutes gun-jumping. The reality, which is
4 much clearer to me since leaving the FTC and going to GE, is
5 that if you're well counseled you will try to avoid getting
6 anywhere near the gun-jumping line, because the last thing
7 you want is for your deal to be held up when the litigation
8 staff decides that they've got to focus on a 7A issue in
9 addition to the core Section 7 clearance issues.

10 It's a failure, by definition, if your deal review
11 is delayed by weeks or months because somebody thought you
12 went too close to the line on a gun-jumping issue. So,
13 there's a cautionary cushion that's often built into the
14 advice in this area, and I just think it makes it more
15 important that the agency guidance not be too aggressive,
16 because when that happens some efficient business practices
17 can unnecessarily be deterred.

18 Ordinary course conduct provisions in deal
19 agreements, discussed in the slide on the top of page 3 of
20 my handout, is really the interesting issue these days, I
21 think, because of the Computer Associates case. Effective
22 contracting requires that key terms be reduced to writing,
23 be fixed as clearly as possible, and one of those key terms
24 is the value of what's being acquired.

25 There are a lot of contractual ways to deal with
26 changes in the value of a seller between signing and
27 closing. Ordinary course operation clauses are not the only

1 way to do that, but they are an effective way to address the
2 issue. The important point here is the second one on the
3 slide, and that is that there are clearly some reasons why
4 sellers and their employees might act differently after a
5 deal is signed than they ordinarily would behave. There
6 really are reasons that don't have anything to do with
7 limiting competition why a contract may legitimately need to
8 deal with the fact that the seller's incentives and conduct
9 may change after the deal agreement is signed.

10 People may have an incentive to make themselves
11 look better in the eyes of their prospective buyer by
12 artificially pumping up their apparent sales revenues
13 through non-competitive or unprofitable transactions, where
14 the profitability of those sales is difficult to discern
15 until well after the deal is closed. Employees may seek to
16 ingratiate themselves with managers, customers or others in
17 a manner that they would not do but for the pending merger.
18 They may have incentives to act in a way that they wouldn't
19 act in a normal competitive situation.

20 So while it's widely recognized that ordinary
21 course contract provisions are common and legitimate,
22 James's triage of issues was very interesting to me. One
23 issue I would add is the one at the bottom of this slide,
24 which is a question I've asked a few people, some of whom
25 are in this room. What if the Computer Associates' facts
26 were different than alleged? What if the facts were that
27 the seller's discounting was far in excess of anything that

1 the seller had ever done before? What if a provision were
2 chosen for the contract that built in a cushion and said,
3 okay, the seller's ordinary discounting is 10 percent, and
4 the maximum discount the seller has ever granted is 30
5 percent, so discounting in excess of 50 or 60 percent will
6 be regarded as outside the ordinary course and therefore
7 will not be permitted.

8 There are some legitimate justifications for that
9 provision under those facts. I understand that there are
10 also some legitimate concerns about provisions in a deal
11 agreement between competitors that relate directly to
12 competitive pricing. But I don't think you can fully assess
13 that kind of provision under those different facts without
14 considering the fact that there is a legitimate reason to
15 allow the buyer to agree to acquire, at a fixed price, a
16 business that's operated in a certain way, and for the buyer
17 to be able to require that the seller maintain its business
18 as is for a period of time while the deal is being cleared
19 and then closed.

20 The slide on the bottom of page 3 of my handout
21 deals with current guidance from the agencies. The point
22 here is simply that while the enforcement actions have I
23 think been largely well chosen, and seem reasonable on their
24 face, as Howard noted there has been a tendency to blur the
25 analysis between Section 1 and Section 7. For example, some
26 have described information exchange as a 7A issue, which I
27 think is pretty aggressive.

1 Another question is, where does the burden lie? Is
2 it essentially on the parties to justify why they did
3 anything differently from how they would have done it absent
4 a deal agreement? Is that the baseline? I don't think it
5 should be.

6 Or is the proper way to proceed to ask, what are
7 the specific elements of a Section 1 violation? What are
8 the elements of a 7A violation? If those elements exist in
9 a given case, then the public interest requires that you
10 take some action. But if they don't, we should try to keep
11 this from becoming an overly regulatory process in which
12 conduct that is not unlawful is discouraged, but rather one
13 that is focused on whether there is evidence of a discrete
14 law violation.

15 I don't want to finish without coming back to the
16 role of practitioners. Most of the advice that I get, and
17 that I hope I give, is something in between the second and
18 third items listed in the slide on the top of page 4 of my
19 handout. It's not simple do's and don'ts, although
20 businesses constantly clamor for that. Sometimes I think
21 bad advice results from giving the client exactly what they
22 ask for, which is often "just tell me exactly what I can do
23 and not do." If that's the question, then the advice is
24 going to be somewhat more conservative than it would be if
25 you took the time to ask the client, well, what is it
26 exactly that you want to do, and why, and let's take the
27 time to look into it.

1 So, as indicated in the slide on the bottom of page
2 4 of my handout, there is no crisis in this area. I think
3 it's very useful that you're having this session to think
4 about these issues. And I agree with Paul, I don't think
5 it's a question of needing more guidance. I think it would
6 be useful for everyone to stick to the principles that have
7 been articulated in the enforcement actions and in the law.

8
9 In particular, I think that Section 1 rule of
10 reason cases should be evaluated under a real rule of reason
11 competitive analysis, not a kind of regulatory, scale
12 analysis that I think has crept into some of the speeches.

13 And then, in Section 7A, the analysis should focus
14 clearly on the beneficial ownership question. I don't see
15 this as a huge issue for businesses, because I don't think
16 we have an interest we need to vindicate to go out and start
17 influencing sellers pre-closing. But I also think the legal
18 analysis gets muddy when you start talking about "influence"
19 over the seller's business amounting to beneficial
20 ownership. So, it might be useful to focus more on what the
21 HSR Statement of Basis and Purpose says about what it really
22 means to "acquire" or exercise beneficial ownership over a
23 target before consummation.

24 Thank you very much.

25 MS. DETWILER: Okay, Bill.

26 MR. KOLASKY: Good afternoon. I don't have any
27 slides.

1 I am going to start off just with respect to due
2 diligence and integration planning, echoing what I think all
3 of the other speakers have said. I do not think that this
4 is an area where we have a particular problem right now. I
5 think that there are two main lessons that could be gleaned
6 from the cases that have been brought, and they're the same
7 lessons that others have already mentioned, and that is that
8 neither Section 1 nor Section 7A, as they have been applied
9 to date, should interfere with legitimate due diligence and
10 integration planning, and I don't think they have.

11 The enforcement actions that have been brought to
12 date have all involved conduct that goes well beyond
13 ordinary due diligence and integration planning. To the
14 extent there's any problem at all, it arises, as others have
15 said, from some of the more absolutist positions taken by
16 some former FTC officials in speeches. But I don't think
17 that those speeches reflect actual agency practice. I do
18 think it might be helpful to clarify that in future
19 speeches.

20 Second, I think with respect to due diligence and
21 integration planning, as you can tell from the presentations
22 that have already been made, the general guidelines are very
23 well understood. But I would also agree with Mark that
24 companies need good antitrust counsel for specific questions
25 of the type that he and James Morphy identified. My
26 experience, when I was back in private practice, is that
27 there is a great deal of nervousness on the part of in-house

1 counsel with respect to how the Section 1 and Section 7A
2 will be applied to due diligence and integration planning,
3 and that there are lots of questions that come up in the
4 course of a period prior to closing of a merger.

5 What I want to talk about today is something that I
6 think the other speakers really have not focused on very
7 much, and that is what some of the companies that are not as
8 well counseled as GE and DuPont have tried to get away with
9 in this area, and the type of conduct that I think does
10 violate Section 1 or Section 7A.

11 In particular, I want to talk about what I think is
12 perhaps the single most difficult issue, and that is to what
13 extent does the pendency of a merger agreement constrain
14 joint conduct in the market of a kind that might be engaged
15 in even absent the merger. That's something that's received
16 very little attention in public speeches by the enforcement
17 agencies since the radio merger wave several years ago, but
18 is the focus of some pending investigations. Obviously, I
19 don't want to talk about those investigations, but it is a
20 matter of some legitimate concern.

21 The other thing I want to mention before I turn to
22 those issues is that there are some other legitimate reasons
23 I believe for exchanging information during the pre-closing
24 period that I don't think the other speakers touched on.
25 The most important one is, of course, securing regulatory
26 clearance. In addition to due diligence and integration
27 planning, the other thing the merging parties are focused on

1 during the pre-closing period is how to get clearance for
2 their transaction.

3 That in itself requires sharing a great deal of
4 potentially competitively sensitive business information.
5 Obviously, information on sales in order to calculate market
6 shares, information on prices and margins sometimes in order
7 to do critical loss analyses or other types of econometric
8 work, and detailed information that allows one to put
9 together a verifiable efficiency story. But again, I think
10 that those who counsel in this area have developed a good
11 understanding of what safeguards need to be in place with
12 respect to the exchange of that type of information, the
13 need to go primarily to outside consultants and lawyers, and
14 to have the number of people in the two companies who are
15 involved in that process limited and subject to
16 nondisclosure agreements.

17 So, I don't think the issues are any different from
18 those raised by due diligence or integration planning, but I
19 think it's something that's worth keeping in mind as we
20 think about what the legitimate reasons for exchanging
21 information are.

22 Turning then to the areas where I think companies
23 have in the past stepped over the line and where I think the
24 agencies have legitimate concerns. The first is, of course,
25 the area of operational control, cases like Computer
26 Associates, where the buyer had veto power over certain
27 customer contracts and discounts beyond a certain point. I

1 think Mark raises a very good point as to whether or not
2 that would have been a violation had the discount level been
3 set at a level beyond what was ordinary course of business.

4 A second thing which, obviously, comes up in some
5 of the cases that have been brought, is occupying premises
6 of the other company, taking possession, starting to
7 exercise control. That might be done, for example, through
8 a management contract, and that's where the LMA, Local
9 Marketing Agreement, situation that I alluded to earlier
10 with respect to the radio merger several years ago came up.
11 The reason why a management agreement that might not be
12 unlawful absent a merger agreement would become unlawful in
13 the presence of a merger agreement is, as I think one of the
14 other speakers mentioned, that the merger agreement itself
15 transfers some of the indicia of beneficial ownership. The
16 management agreement then serves to transfer additional
17 indicia of beneficial ownership, thereby taking you over the
18 line and creating a Section 7A violation.

19 Another more subtle way of exercising operational
20 control is not by physically occupying the premises, but by
21 basically exercising influence through e-mails and telephone
22 calls and the like, where the two parties to the merger
23 actually start talking with each other on an ongoing basis
24 about current business decisions. I think all of us would
25 recognize that that's a violation, and yet some companies do
26 that.

27 Another one would be having the executives of the

1 buyer attend business planning meetings of the target.
2 Believe it or not, I have had clients ask me whether they
3 can do that. So, there are clearly ways in which companies
4 can try to exercise operational control prior to closing
5 that would step over the line and generate enforcement
6 interest.

7 The second area where companies have stepped over
8 the line, and where the agencies have legitimate concerns,
9 is with respect to coordinating marketing activities pre-
10 closing. There are some legitimate reasons why companies
11 might want to exchange information about their current
12 customers and perhaps even plan which party is going to
13 approach which customers in order to tell them about the
14 benefits of the merger and get them on board to support the
15 merger itself. The danger is when it goes beyond that and
16 the parties begin actually coordinating their marketing or
17 sales efforts, and this is something that we've seen in some
18 of our investigations.

19 One example would be where the companies actually
20 allocate customers and decide which company will pursue
21 which customers during the period prior to closing of the
22 merger. Even short of that, though, you can imagine
23 situations where one company's salespeople may represent,
24 even if it's not true, that the other company's salespeople
25 are going to be serving a particular group of customers or a
26 particular sector of the market post-closing and that,
27 therefore, the customer should do business with them rather

1 than with the other party to the merger. Even if there is
2 no such agreement, making such representations to customers,
3 obviously, creates the appearance that there is.

4 Another related activity that plainly I think goes
5 over the line would be for the parties pre-closing to
6 discuss the terms that they are going to offer to customers
7 post-closing, prices and other material terms of doing
8 business. There, there would clearly be a spill-over
9 concern that might affect the terms that they're currently
10 offering to customers. Even more egregious, of course,
11 would be if the parties to a merger did, in fact, start
12 talking about what terms they were going to offer customers
13 during the interim prior to the closing of the merger.

14 That then brings us to the difficult situation of
15 when there may be legitimate reasons to engage in some joint
16 commercial activity pre-closing. One situation is joint
17 bidding where you quite often have the situation where one
18 of the reasons why the parties are merging is that they
19 don't feel that either of them has critical mass sufficient
20 to be able to win particularly large and complex contracts.

21 In those circumstances pre-merger, there may be a
22 legitimate business reason for the companies to team in
23 order to pursue those particular contracts. I think the
24 antitrust analysis there would be basically a Section 1
25 analysis, where you would look at, A, has the fact of the
26 teaming arrangement been fully disclosed to the customer, B,
27 is there a legitimate need for the parties to team in order

1 to pursue that contract, and, C, does their teaming actually
2 lessen competition or enhance competition by giving them a
3 better chance to compete for a contract that they
4 individually would not have been able to compete for
5 effectively?

6 A similar situation is joint purchasing. We heard
7 this morning that one of the efficiencies that parties have
8 often expected to realize through mergers are procurement
9 efficiencies or procurement savings. There's a debate
10 about whether these are efficiencies or just pecuniary
11 savings, but again, I have seen situations where parties to
12 a merger have agreed to engage in some joint purchasing
13 activity prior to the closing of the merger, and I would
14 say, again, that the analysis that one engages in those
15 circumstances ought to be the standard Section 1 analysis
16 where you ask whether the joint purchasing would be lawful
17 absent the merger, and if it would be, it's hard to see why
18 the pendency of the merger should constrain the ability of
19 the parties to engage in otherwise lawful conduct.

20 More generally, the parties may have other types of
21 competitive collaborations that they would like to engage in
22 during the period prior to closing. One example might be
23 where you have two parties whose motivation for merging is
24 that they have mutually blocking IP, intellectual property,
25 positions, and they want to capture the efficiencies they
26 expect to realize from the merger by entering into, say, an
27 interim cross-license agreement so that they can begin

1 marketing a combined product that they wouldn't be able to
2 have marketed absent that cross-licensing agreement.

3 There, too, I think you'd apply the standard
4 Section 1 analysis, look at whether there was any
5 justification for the facially competitive collaboration.
6 If there is a facial justification, then you look to see
7 whether it's likely to cause competitive injury, and if it's
8 likely to cause competitive injury, then you have to look at
9 whether it's reasonably necessary to achieve the legitimate
10 objectives.

11 Here, I think the role of counsel becomes
12 absolutely critical, because one of the things that counsel
13 needs to do is to look at whether or not there are less
14 restrictive alternatives that would serve the same benefits
15 and accomplish the same objectives with less anti-
16 competitive injury.

17 The final area I want to touch on, and again, it's
18 one that the other speakers have not mentioned, are stock
19 purchases. Now that the thresholds have been raised to \$50
20 million, I think this is going to be less of a problem than
21 it might have been in the past, but one way in which a party
22 may sometimes jump the gun, if you will, is when it is
23 contemplating an acquisition, especially if it may be an
24 unfriendly takeover, it might want to accumulate a sizeable
25 stock position in the company prior to starting the hostile
26 takeover.

27 I think both agencies, but particularly the FTC,

1 has provided very clear guidance over the last dozen years
2 or so that in those circumstances, the company does not
3 qualify for the investment-only exemption, that if you are
4 seriously contemplating a possible acquisition of the
5 target, especially if the target is a competitor, you do not
6 qualify solely for purposes of investment exemption,
7 because, obviously, you're not making the acquisition solely
8 for purposes of investment. You're making it in order to
9 gain an advantage with respect to a possible takeover.

10 I would emphasize, of course, that we're not
11 talking about somebody waking up in the middle of the night
12 and saying, gee, it would be nice to acquire Joe. We're
13 talking about a situation where the company is actually
14 seriously contemplating a possible acquisition and perhaps
15 takes some affirmative steps to pursue it.

16 But, again, these are some of the areas that I
17 think the other speakers didn't touch on where companies do
18 step over the lines, but, obviously, not the companies
19 counseled by my fellow panelists. Thank you.

20 MS. DETWILER: Thank you, Bill. So, I'm glad to
21 hear that the agencies have spoken with one voice and
22 everything is crystal clear to practitioners.

23 Just to start off with the list of conduct that
24 Bill mentioned, which was a fairly specific list, did
25 anything on that list strike anyone else on the panel or in
26 the audience as a close call or was there any disagreement?

27 MR. MORSE: I'll jump in on that one, at least a

1 little bit. I think as Bill was talking, we all had in mind
2 situations where there is a competitive overlap between two
3 companies, and the concern is can a company do these things
4 when it is about to merge with its competitor? But what do
5 we do in the situation in which there is no overlap? I
6 think this comes back to needing to be careful to
7 distinguish the rules under the Sherman Act and under the
8 Hart-Scott-Rodino Act, because if Chase Manhattan Bank is
9 funding a management buy-out by someone and filing under the
10 Hart-Scott-Rodino Act, assuming it does not already have an
11 interest in other companies in the same business, I'm not
12 sure that I have a problem with Chase Manhattan Bank sitting
13 in on a business planning meeting or sitting down and
14 discussing post-closing prices, but Bill said you can't do
15 that.

16 MR. KOLASKY: Howard, I think you're absolutely
17 right, and I should have been clear about that, that I'm
18 talking about situations of horizontal acquisitions.

19 MS. DETWILER: Another thing that struck me, I must
20 have heard the word "reasonable" any number of times during
21 the presentation. But it also occurs to me that there are
22 situations where the rule of reason would not apply, and
23 some of the conduct that we were discussing would involve
24 discussions between buyer and seller, and there you would
25 have an agreement, and could we be in per se territory? Is
26 there any uncertainty as to when the rule of reason applies
27 versus when the per se Section 1 territory would apply?

1 MR. WHITENER: Well, I addressed that point a bit.
2 I think the per se situations would be quite hard to imagine
3 -- obviously, it's possible that parties could decide to fix
4 prices or allocate customers in the meantime, but it was a
5 bit unclear as to how that would have been pleaded in court
6 in Insilco. Howard pointed to the part of the analysis that
7 said this would be a problem "in any industry" or something
8 along those lines, but I don't think there is much in this
9 area that would be potentially per se.

10 My point was, you will typically have sufficient
11 business justifications for whatever it is we're looking at,
12 to take the conduct out of a per se analysis. Certainly the
13 vast majority of what's been discussed today were activities
14 in which I think you'd start off with an efficiency baseline
15 that would take you out of the per se rule. One could, of
16 course, imagine huge screw-ups where you're dealing with per
17 se behavior, but I don't think that has a lot to do with
18 what we're talking about today.

19 MR. MORSE: I think the Commission allegations in
20 the Torrington case I mentioned are essentially a per se
21 allegation, where the companies had a discussion and
22 essentially said, during this interim period, one would not
23 sell or quote to customer X. Again, I think there may be
24 some uncertainty in the law as to whether the mere existence
25 of a merger agreement arguably may take that out of the per
26 se category, but I think in dealing with cases at the
27 Commission or at the Justice Department, that you can expect

1 per se treatment to a mere market allocation agreement pre-
2 closing.

3 MR. KOLASKY: If I could add just one thing to
4 that, I would agree with what both Howard and Mark said,
5 that it's very unlikely that even an agreement between the
6 parties to a merger as to which ones will sell to which
7 customers pre-closing would be per se unlawful. You might
8 be able to construct a sufficiently facial justification
9 that you would get yourself out of the per se doctrine. But
10 I do think that if the evidence were to show that the
11 justification the lawyers advanced post hoc was a
12 pretextual one, that you might be able to attack the
13 agreement as per se unlawful. But even if it does not fall
14 within the per se category, I think this is a category where
15 the quick look approach to the rule of reason has a great
16 deal of merit. Well, obviously, the type of information
17 exchange that you have for due diligence or integrational
18 planning deserves a full rule of reason analysis.

19 There are other types of conduct during the pre-
20 closing period that I think could be, as Phil Areeda would
21 say, found to be unlawful in the twinkling of an eye,
22 because the anti-competitive effects are so obvious and the
23 proper justification so weak.

24 MS. DETWILER: Were there any reactions or
25 questions from the audience?

26 MR. MORSE: Can I jump in and make one comment
27 before we turn to the audience, particularly given the fact

1 that, as I understand it, a number of people in the audience
2 are from foreign countries. I want to mention one issue
3 that we have not discussed today. I've been on a number of
4 conference calls with my client and lawyers in various
5 countries around the world in which we discuss what can be
6 done during this pre-closing waiting period. I know some
7 of the other people up here have more experience than I do
8 on international deals, but in my experience the rule of the
9 most restrictive standard is what most companies will
10 permit, because if the U.S. says one thing is OK and the EU
11 says something else and Canada says something else, you are
12 going to be cautious to do the least which you can do
13 without getting in trouble, at least with those countries.

14 I'm not really too scared about rules from those
15 countries, but we've also seen merger filing schemes in lots
16 of other countries. I have a fear on a going-forward basis
17 that there are countries around the world that will read
18 some of the loose language that we have been talking about
19 and come up with rules and say you violated our gun-jumping
20 rule by doing X, and therefore, you owe us a \$3 million
21 fine.

22 So, as we talk about this issue, and as we've said
23 the rules are generally reasonable in the United States, we
24 also have to think about the implications on a worldwide
25 basis. I'd like to throw that out and see if based on the
26 other panelists' experience they agree or disagree.

27 MR. KOLASKY: I've talked enough.

1 MR. WHITENER: Me too.

2 MR. BONANTO: I think from at least DuPont's
3 perspective, fortunately or unfortunately, we have legal
4 offices around the world. Sometimes we have to follow due
5 diligence differently in different parts of the world, we
6 have to do integration differently in different parts of the
7 world. As you know, under the community directives, EC,
8 European Commission, privacy is a different issue than it is
9 in the United States.

10 What data can actually lawfully be made available
11 to the buyer in Europe is different from what can be made
12 available in the United States. So, I think you probably
13 have a good point there. There is a lot of complexity. I
14 suppose as a practitioner we can look at that as an
15 opportunity for us, but it is a challenge. I would say that
16 we would look at certainly the EC practice and the U.S.
17 practice as complementary but not always the same, and we
18 would try and deal with them appropriately when we need to.

19 MS. DETWILER: Questions from the audience?

20 NEW SPEAKER: Something from the European
21 Commission. You know, I just wanted to follow up on what
22 Bill Kolasky mentioned about securing international
23 clearance, because I think that's a situation we have
24 sometimes in the EU where parties tell us we have difficulty
25 gathering the information you are asking us. I wanted to
26 ask you in concrete examples what kind of difficulty you may
27 have faced in the past and what kind of problem this gun-

1 jumping issue may raise? For instance, will you be
2 incapable of presenting arguments to the regulators, in
3 particular, in relation to efficiencies claims?

4 MR. WHITENER: I'll take that one first. When Bill
5 said that, it registered with me that that was an issue we
6 hadn't touched on and probably should have. My other
7 thought was that I haven't viewed that issue as a particular
8 problem. That clearance process is and has to be guided by
9 counsel, and so if it's done right, there won't be an
10 inadvertent mistake.

11 To me it's just a question of proper management,
12 and as long as it's managed by counsel, it shouldn't be
13 difficult to decide what is it that the business people
14 really have to know.

15 They can probably frame arguments pretty
16 effectively without having the current competitive details
17 of the other business that many of you in this room would be
18 uncomfortable with them having. Frequently, when there are
19 meetings with the agency staff, sometimes you want both
20 companies there. A lot of times you don't. And the typical
21 deal agreement will provide for the companies to cooperate,
22 but it's always done in a way that's sensitive to these
23 issues. So, I haven't had a particular problem with this,
24 because I think that fundamentally it's something that's
25 managed by antitrust lawyers.

26 MR. KOLASKY: If I can just add a couple of
27 thoughts to that, the way we typically manage this in the

1 United States is by having, in addition to the standard
2 nondisclosure/confidentiality agreement between the parties,
3 a joint defense agreement which the parties and the lawyers
4 sign. Obviously, the retainer agreements with outside
5 economic consultants and accountants have similar
6 confidentiality provisions in them.

7 We will quite often have levels of confidentiality
8 so that there's some information that you can share with a
9 small group of employees of the company who are working with
10 you on the regulatory presentations, but there may be a
11 higher level of confidentiality of information that can only
12 go to the outside advisers and not to people within the
13 company.

14 What I haven't thought very hard about is to what
15 extent a problem exists in Europe where the Commission has
16 taken the position that in-house counsel are not entitled to
17 assert the attorney-client privilege, because as an outside
18 lawyer, I would find it nearly impossible to navigate the
19 regulatory clearance process without being able to share a
20 great deal of confidential information with the in-house
21 counsel.

22 MR. BONANTO: Let me just say briefly, I think with
23 the development of Form CO, DuPont's practice changed. As
24 you know, just to over-simplify, in the United States, you
25 make a rather limited filing initially, and if there's not a
26 second request, limited information is turned over. In
27 Europe, those of us who have worked on Form CO have found

1 that a rather daunting and exhausting task, and it clearly
2 needs to be done in connection with the other side.

3 I would just say that the issues we do in the U.S.
4 to limit certain information to counsel and other outsiders
5 is followed in Europe. We have not found the preparation of
6 Form CO to be an issue in information exchange any
7 differently than it is in the United States. It is just a
8 factor to consider in the timing and what you want to do in
9 the U.S. versus Europe.

10 Now, obviously, it's a document. The first
11 question from DOJ or FTC is, oh, you made a filing, let me
12 see Form CO. So, I would suggest -- and we have seen recent
13 discussions -- anything that can be done between the
14 Commission staff and the regulatory staff in the United
15 States to kind of harmonize things and help things along
16 will be positive.

17 As far as the other issue you mentioned, it is
18 awkward in not allowing in-house counsel in Europe at times
19 to see documents that in-house counsel in the United States
20 can see. It's probably inefficient for getting the deal
21 done. This is an old chestnut that's been argued forever in
22 Europe, so I'm sure you're aware of it, but it has a
23 negative impact in trying to get the transaction done
24 efficiently. Typically the business attorney in France or
25 Germany or wherever will know an awful lot more that's going
26 to be helpful in preparing Form CO than will outside counsel
27 or the outside economist.

1 MS. DETWILER: Other questions or reactions?

2 Yes?

3 MR. DUCORE: Hi, I'm Dan Ducore from the FTC. I
4 wanted to follow up a point that Mr. Morphy made that I'm
5 not sure we've heard made frequently. That is, that
6 especially the selling side gets advised that it should keep
7 in the back of its mind at least that the deal could not go
8 forward, and it should be concerned about things it might do
9 and information it might give over to the buying side with
10 that in mind. In other words, that if the deal didn't go
11 through, you could regret having revealed this information
12 or having made a joint decision.

13 My question is, do you give that advice differently
14 or does the advice change as the particular deal works its
15 way through the regulatory review process, or is that sort
16 of a blanket kind of caveat? And if so, anybody on the
17 panel, would that be the basis for some kind of guidelines
18 or guidance by which the agencies might review what has
19 taken place? In other words, as a deal gets closer to
20 potential consummation, are you proposing that maybe the
21 agency should take a different view of information exchange,
22 or should it be sort of one side of the line versus the
23 other, either a deal is going forward because Hart-Scott has
24 closed out or it's not?

25 MR. BONANTO: Well, I guess I'll take the first
26 shot at it.

27 As I explained, I actually use it as a tool to

1 elicit information that I probably don't have, and that is
2 the first question of putting it to the business person to
3 say, what is it that you would not want them to have? And
4 to the extent they say to me, well, what they're looking for
5 I can get on the internet, it's available in various
6 industry sources, et cetera, obviously, the degree of
7 concern about that goes down. To the extent they come back
8 and say, this is actually the keys to the kingdom, if they
9 had this, they would be able to look inside and figure out
10 how we price, et cetera, the answer is, the alarm goes off.
11 Obviously, that's not something that we're going to be
12 prepared to give them. The businessman knows we're not
13 going to be prepared to give it to them. The entire
14 exercise at that point is turned to, well, how do we find a
15 way to provide some reasonable degree of information,
16 achieve some objective, without giving them that?

17 I agree with others who say that there shouldn't be
18 an artificial distinction between the due diligence phase
19 and the post-signing phase. I try to look at that, and I
20 think most people do through the entire process, that you
21 never know what could happen to a deal. It's a sliding
22 scale of what information you just shouldn't put across the
23 table under any circumstance.

24 Then the question is, what intermediaries can you
25 use -- at some point there is sensitive information that
26 isn't the keys to the kingdom, that may be necessary. You
27 hold off until the very end, and then you decide whether

1 that's dealt with through a third party who will aggregate
2 the information and provide data or it's dealt with through
3 a small group or siphoned off. So, again, it's a series of
4 judgments, and I still think it's hard to put that in the
5 form of guidelines. When you said everything is crystal
6 clear, the evidence is not, it's as clear as mud. But in
7 many ways, we all know what the mud is, and if you try to
8 make it too clear, there is a very high probability that you
9 will interfere with a process that actually kind of works.

10 I don't know if I've answered your question.

11 MS. DETWILER: Yes, Rick.

12 MR. DAGEN: This is Rick Dagen from the FTC. I
13 guess a comment and a question on unrelated subjects. The
14 comment is, it was suggested that IT, information
15 technology, was one of the prime issues that would be up and
16 running after the HSR period ends. There was never a
17 discussion concerning the deals that are done that don't
18 have any HSR waiting period, so they get negotiated and you
19 don't have this 90-day or year period. Presumably the IT
20 problems are much greater in those circumstances where a
21 deal gets negotiated in a week, you have got this limited
22 number of people that are involved, and the next day, it's
23 announced, and you don't have any IT coordination that's
24 possible. So, I don't think that was really addressed. I
25 think the HSR period would suggest that there are planning
26 opportunities that aren't present when there is no reporting
27 requirement. So, I'd be curious about that.

1 The second question relates to a suggestion by Paul
2 that there would be some degree of certainty with more
3 concrete ordinary course provisions. If you could set 10
4 percent as an allowable discount, then people might do the
5 discount or they might do discounting of 8 percent if they
6 knew that there was a 10 percent cap. Without an express
7 provision governing the level of permissible discounting,
8 there might not be any discounting. I don't know if that
9 made any sense. I think Mark's position on the other hand,
10 and perhaps another panelist, was that the ordinary course
11 provision really has no teeth. So, there seems to be some
12 tension between those two positions. If an employee is
13 afraid of breaching the ordinary course provision, that
14 would suggest that there is some teeth, but I think Mark's
15 position suggests that just by having an ordinary course
16 provision, people would not know what they could and
17 couldn't do, and there would be no remedy for the acquirer.

18

19 MR. WHITENER: Let me go first and try to clarify,
20 and then Paul can comment. I wasn't saying it had no teeth.
21 When I listened to what he was saying, I was, again, in
22 violent agreement. The issue of a generalized ordinary
23 course provision is ambiguous. It has in terrorem effect,
24 that was one of Paul's points. It, in fact, can and
25 probably does condition the seller's behavior, but not in a
26 way that's predictable. It may condition their behavior --
27 again, I think Paul's point -- more so than if you had a

1 defined provision that said, okay, this is specific conduct
2 that is deemed beyond the ordinary course.

3 So, what I was trying to say was fully consistent
4 with what Paul was saying, in that from the perspective of
5 the agency trying to preserve the maximum competition pre-
6 closing, you may in some cases be better off with specific
7 ordinary course provisions, rather than a general catch-all
8 that says we're going to leave it to whatever the seller
9 thinks it means and whatever the buyer decides it means and
10 whatever the two of them might later discuss and agree that
11 it means.

12 MR. BONANTO: Yeah, that's right. I think my point
13 only was if the seller was under a lot of pressure to make
14 sure this transaction closes, which sometimes they are for
15 financial or other reasons, ambiguity can cause the seller
16 to be less aggressive in the marketplace than if it had
17 greater clarity. It depends on the circumstances, but if
18 they say, Paul, this thing absolutely has to close, if we do
19 thus and so, what's it mean under the agreement? Lack of
20 clarity can cause more timidity at this than it might not.
21 It won't be true in every case, but it's possibly true in
22 that case.

23 On the other hand, I think it's also true, just to
24 state the other side to make sure it's balanced, as the
25 seller, I'm also always aware that the deal may not close.
26 In fact, First Chem, which was announced and finally did
27 close after we got through the second stage of regulatory

1 review, we were the acquirer in that case. Recently, just
2 before closing was scheduled, their plant had an explosion.
3 So, it always happens, you go to sell the house and
4 something doesn't work.

5 So, from the seller's point of view, too, I'm also
6 saying in these covenants, we are concerned about closing,
7 but as the seller, I'm also recognizing it may never happen.
8 So, that does create a certain degree of rigor in doing
9 things that from an agency's point of view you'd want us to
10 do as well.

11 MR. KOLASKY: Rick, if I can just address your
12 first question very briefly, I think the problem is, you're
13 absolutely right. If you don't have to go through the HSR
14 period, if you schedule a closing two weeks or a month after
15 you sign the agreement, you may not have your IT integration
16 in place. But the point is that on any large transaction,
17 the greater the delay from the time you sign the purchase
18 agreement or the merger agreement and the time that you
19 actually have the businesses integrated and up and running
20 is -- the worse it is for your business, and frankly, I
21 think the worse it is for the customers.

22 So, if you are anticipating a lengthy regulatory
23 clearance process, it's very important that you proceed with
24 your integration planning and especially the IT planning in
25 parallel with that so that you're in a position to hit the
26 ground running once you do get clearance.

27 MR. MORSE: To throw in my two cents worth,

1 enforceability and interim effect I don't think are
2 necessarily inconsistent. In fact, I want to tie that back
3 into something that Dan Ducore said. We usually think of
4 the restrictions on giving of information as protecting the
5 seller in an acquirer/seller situation, and the seller not
6 wanting to give up its crown jewels. One of the things that
7 has surprised me is on the buying side, companies saying,
8 sometimes, I don't want my business guys to have that
9 information. We've got a confidentiality agreement in
10 place, and the confidentiality agreement says you can only
11 use it for purposes of doing the deal, and you can't use it
12 for business purposes.

13 Well, what happens if this deal doesn't go through,
14 and we're actually a competitor of that guy, and my business
15 guy has gotten the information? I know that what's in his
16 head, he can't segregate. So, once he's got that
17 information, I don't know what I'm going
18 to be able to do. So, even on the buying side, you get the
19 concern, I don't want the information, or I don't want the
20 wrong guy to have the information.

21 MS. DETWILER: Are there any more questions or is
22 everyone getting a little bit hungry?

23 Well, thank you very much to our panel.

24 **(Whereupon, at 1:00 p.m., the hearing was adjourned.)**

