

The Evolution and Return of Hostile Activity

With hostile M&A activity on the increase, advance planning is essential

Hostile and unsolicited M&A activity for 2003 significantly exceeds 2002 levels, and we expect that trend to continue.

Several factors underlie this uptick. CEO confidence has surged, as we reported in our fourth quarter CEO Confidence Index earlier this month. Stock prices remain relatively volatile. Buyers are looking to complete acquisitions before valuations rise. Overcapacity in key sectors is pushing industry leaders to consider consolidation. And relatively cheap financing has enabled companies to strengthen their balance sheets, positioning them for acquisition growth.

Most surprising is that recent raid activity has come from unlikely places. Recent situations include:

- cross-border raids (Alcan's bid for Pechiney);
- a smaller company bidding for a larger company (ArvinMeritor's bid for Dana);
- hostile activity in the tech industry (Oracle's bid for PeopleSoft);
- an attempt to jump a deal in the financial institutions sector (SunTrust's bid for Wachovia);
- unsolicited bids in the medical technology sector (Zimmer Holdings' bid for Centerpulse);
- a hostile offer for a real estate company (Simon Property's bid for Taubman Centers); and
- an unsolicited bid for a subsidiary of a public company (Comcast's bid for AT&T Broadband).

No company is immune to hostile activity. Raids have occurred across industries and have involved both small and large companies. The market, regulatory and shareholder landscape is rapidly changing, and some important global trends are beginning to emerge.

The Changing Face of Raiders

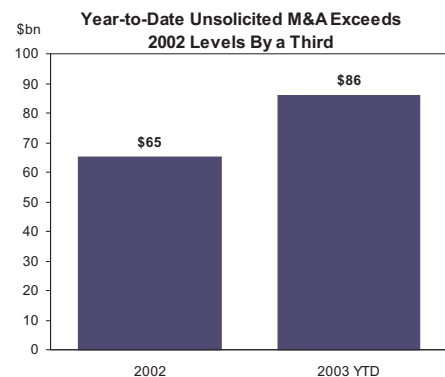
The face of hostile activity is very different from the 1980s. 'Blue chip' companies are increasingly willing to initiate hostile activity as a tactic to effect

strategic transactions. These strategic raiders have been opportunistic, launching bids at times of perceived vulnerability.

Strategic raiders frequently commence unsolicited activity against companies focused on internal change. When a company announces an internal reorganization, its management typically presents new financial information to rally support for its plan, which may unintentionally attract the interest of strategic buyers. This was the case when Comcast initiated its unsolicited approach for AT&T Broadband in 2001 (AT&T was undergoing a restructuring of its key business units) and when Alcan publicly announced its intention to acquire Pechiney (which was in the process of implementing an ambitious cost saving and restructuring plan). Management change is another time of potential vulnerability. After TRW's CEO announced that he would step down, Northrop Grumman promptly commenced an unsolicited offer to acquire TRW.

Another characteristic of strategic raiders is their willingness to break up existing transactions. Following the announcement of recent mergers, the level of interest in the merging companies has been acute, particularly in consolidating industries. The trend in US courts is to strike down coercive 'deal protections', and break-up fees and other lesser deal protections have not prevented determined buyers from offering 'superior proposals' for desired targets.

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As a result, 'deal jumping' has occurred in a number of transactions. Examples include SunTrust's unsolicited offer for Wachovia in 2001, after Wachovia announced its merger with First Union, and Zimmer Holdings' unsolicited bid for Centerpulse, following an announced transaction with Smith & Nephew.

Strategic raiders also have been willing to undertake hostile activity against companies with significant takeover defenses. Willamette Industries was the subject of an eventually successful bid by Weyerhaeuser, despite Willamette's classified board. Similarly, Barrett Resources' shareholder rights plan did not stop Shell from launching a hostile tender offer. Local or state laws also are not a complete deterrent, as seen when Northrop Grumman launched a tender offer for TRW, despite the significant protections afforded to TRW under Ohio's anti-takeover laws.

Takeover defenses have, however, helped management to extract value for their shareholders in excess of the initial hostile offer—in some cases by merging with a party other than the initial bidder.

Understanding the views of key players in the institutional investor and arbitrage communities also has become a critical component of effective raid defense. Companies that are targeted by strategic raids have had to undertake extensive efforts to advocate their response to their shareholders.

If a target company is unable to effectively articulate a credible strategy and a detailed financial plan for achieving it, institutional investors may be more willing to sell to a hostile bidder. Arbitrageurs will move in or out of a stock, depending on their views of the credibility of management.

In response to these trends, it has become common—and advisable—for companies to perform ongoing reviews of the M&A landscape with their financial advisors to identify potential strategic raiders as well as potential defenses. This review typically includes consideration of the company's financial, legal and other vulnerabilities and the development of plans regarding how to respond to hostile activity.

New Opportunities for Financial Buyers

'Financial' buyers are also playing a key part in recent M&A activity. The number of private equity firms working together to focus on buyouts and other investments is becoming a common phenomenon. In addition, there is what has been described as an overabundance of private capital. We estimate that approximately \$100 billion of equity funding is available. Inexpensive financing has further enhanced the ability of these buyers to aggressively pursue choice targets.

The recent economic downturn has given private equity firms a number of opportunities to utilize these funds. Companies looking to pay down heavy debt loads have been actively seeking to divest assets and have strongly preferred cash buyers. In some cases, financial buyers have helped companies explore 'go private' transactions.

These transactions, which involve the purchase of shares from public shareholders, remove from a company's cost structure the significant expense of being a public company (which, in the U.S., has surged as a result of the implementation of Sarbanes-Oxley reforms). Not surprisingly, private equity firms have been pursuing focused acquisition strategies in this favorable environment.

Some of this activity has been unsolicited. Cerberus, a leading hedge fund, recently attempted to wrest Clayton Homes from its announced merger partner. Other financial sponsors, often acting in concert, have been aggressive bidders in a number of auctions of US and UK companies. This trend is best illustrated by the number of private equity firms that recently pursued Debenhams in a well-publicized transaction in the retail sector.

Moreover, hedge funds may be an important factor in future unsolicited activity. While many private equity funds may have restrictions on their ability to pursue unsolicited or unfriendly activity, these types of restrictions generally do not apply to many hedge funds. Also, the arbitrage community and other hedge funds may be vocal and play influential roles during the pendency of a hostile transaction.

Private equity firms and corporations have not been the sole sources of unsolicited cash bids. For example, Dennis Gillings, founder and owner of a significant equity interest in Quintiles, put his company in play by launching a cash offer for the shares of Quintiles that he did not own. In the UK, financier Hugh Osmond and his private equity firm, Sun Capital, submitted a £5.6 billion unsolicited takeover bid for Six Continents, the hotels and pubs firm.

In other merger transactions, individuals have been active participants in bidding consortiums with private equity firms. This combination of wealthy individuals and private equity firms promises to remain a part of M&A for the near future.

Ten Largest Unsolicited Situations 2003YTD

Hostile Bidder	Target	Size (\$bn)
Gas Natural SDG	Iberdrola	\$28.7
Cap Mgmt & Inv	Six Continents PLC	10.7
Alcan	Pechiney	6.3
Oracle	PeopleSoft	6.2
ArvinMeritor	Dana	5.0
Zimmer Holdings	Centerpulse	3.5
Simon Property, Westfield	Taubman Centers	3.4
Investor Group	Metrovacesa	2.7
Consortium	Debenhams	2.7
Randgold Resources	Ashanti Goldfields	1.4

Goldman Sachs advisory roles are in bold
Source: Thomson Financial Securities Data

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Home Court Advantage?

Because many of the earliest hostile transactions involved Delaware companies, takeover tactics and behavior have been driven by developments in Delaware law. However, in the US many recent unsolicited transactions have involved targets not incorporated in Delaware, including companies based in Ohio (TRW), Michigan (Taubman) and North Carolina (Wachovia).

In addition, following the Vodafone/Mannesmann and Elf Aquitaine/Total Fina transactions, aggressive tactics have taken firm root in Europe and elsewhere. In 2003, unsolicited takeover bids have been made for companies in Switzerland (Centerpulse), France (Pechiney), Canada (Fording), Spain (Iberdrola), Australia (Principal Office Fund) and the UK (Six Continents).

Recent Challenged Deals			
Target	Original Bidder	Topping Bidder	Size (\$bn)
Wachovia	First Union	SunTrust	14.4
P&O Princess Cruises	Royal Caribbean Cruises	Carnival	6.9
PeopleSoft	J.D. Edwards*	Oracle	6.2
Sophia	Societe Fonciere Lyonnaise	GE Finance	4.1
Centerpulse	Smith & Nephew	Zimmer Holdings	3.5
Newport News	General Dynamics	Northrop Grumman	3.1
Normandy Mining	Newmont Mining	AngloGold	2.7
Tab	UniTAB	TABCORP	1.6
Ashanti Goldfields	AngloGold	Randgold Resources	1.4
National Steel (assets)	U.S. Steel	AK Steel	1.1

*PeopleSoft had recently announced it would acquire JD Edwards

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Source: Thomson Financial Securities Data

What can be learned from this global proliferation of hostile activity?

First, takeover tactics developed in the US can be used effectively in other countries. When Elf Aquitaine received an unsolicited bid from Total Fina, it turned the tables by employing a classic ‘Pac-Man’ defense and launching a hostile bid for Total Fina. Both US and non-US companies may pursue alternative buyers or investors (‘white knights’ and ‘white squires’) as a defensive tactic against a

hostile bid. Using litigation and press attacks as raid tactics also has migrated to non-US jurisdictions.

Second, companies need to know the legal and regulatory playing field—the law of the jurisdiction where the target is incorporated—before starting a raid. Some jurisdictions do not allow companies to take ‘frustrating action’ or employ certain takeover defenses in response to a hostile bid.

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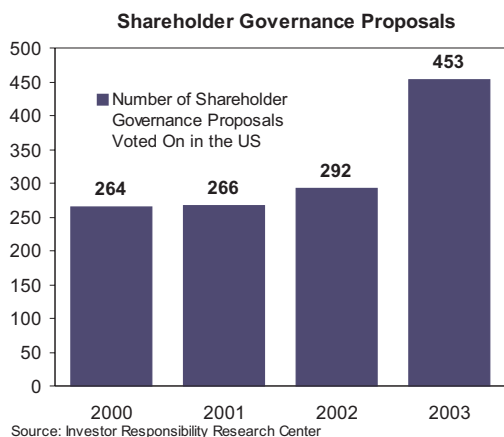
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Other jurisdictions require companies to hold special shareholder meetings regarding hostile offers promptly after the offer is commenced. Still other jurisdictions permit the implementation of a shareholder rights plan, but only for a limited period of time. Advanced takeover preparedness is at a premium for companies incorporated in these jurisdictions; they may have only weeks after a hostile offer is launched to develop, execute and publicize a plan that maximizes shareholder value.

In addition, there are inherent uncertainties regarding hostile transactions that involve a target incorporated in a jurisdiction where there has not been much takeover activity or which recently has changed its takeover laws. In these jurisdictions, it is often not clear how courts will evaluate raid and takeover defense tactics, making the outcome hard to predict.

The Growing Importance of Proxy Fights

Over the years, raiders frequently commenced proxy fights along with other aggressive tactics to acquire a target company. Raiders would use the proxy fight mechanic to replace the target's board of directors with the raider's nominees. If the proxy fight was successful and the raider's nominees gained control of the board, they would promptly remove the target's shareholder rights plan and other impediments to the raider's offer.



Proxy fights now are being used to replace boards solely to force changes to the strategic direction of the company. Dissident shareholders have launched proxy fights to gain control of a target's board without putting on the table an offer to acquire the target company. Hercules, El Paso, Computer Associates and other companies facing shareholder discontent have faced proxy battles by shareholder dissidents. In these proxy fights, Institutional Shareholder Services (ISS), a leading provider of proxy voting and corporate governance services, has played a key role in advising institutional investors how to vote.

In addition, activists have used the threat of a proxy fight to pressure management to take a particular course of action or put the company in play. When activists acquire a company's stock, there is often significant turnover and turbulence in the stock. Short-term investors buy shares with the expectation that the activists will force some short-term, value-enhancing strategy. In these circumstances, the company may quickly face a hostile and unfamiliar shareholder populace.

There also have been significant proxy fights in connection with friendly merger transactions. The Hewlett-Packard/Compaq transaction was nearly derailed when Walter Hewlett, a significant shareholder and board member of HP and the son of one of its founders, commenced a proxy fight to try to block the deal. The outcome of the proxy fight turned in large part on the ability of HP management to articulate the strategic and financial rationale for the transaction to its investors.

Shareholder Activism and Corporate Governance Organizations

A further development in the US is the prevalence of shareholder proxy proposals regarding takeover defenses. These



proposals have focused on the removal of classified boards and poison pills.

These proposals typically have been submitted by activists and other interest groups. In a shift from the recent past, however, institutional shareholders and fund managers have increasingly been willing to support these proxy proposals and make public their views regarding takeover defenses. As a result, the level of support for these proposals has reached a significant high at a number of companies.

This trend is due in large part to the decision by many institutional investors to defer their proxy voting decisions to ISS, which has supported shareholder proposals to remove takeover defenses. In addition, the press and corporate governance organizations have actively criticized takeover defenses as management entrenchment devices and therefore a worthy subject for derision in the post-Enron environment. Shareholder nomination rules recently proposed by the SEC may heighten the impact of these proposals.

Be Prepared

The world of mergers and acquisitions and hostile activity has become vastly more complicated and continues to evolve. Companies should assess the impact of these changes and determine whether they face any new vulnerabilities—before any raid activity occurs. Proactively addressing these issues will enable you to focus on your most important goal—delivering value to your shareholders. ■