

Interco case essay



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Interco Case Study Interco's financial performance was moderately successful for the 1988 fiscal year. Interco's current ratio (3.6 to 1) and debt-to-capitalization rate (19.

3%) indicate that the company is financially flexible. Furthermore, both overall sales and net income increased from the previous year (1987) due largely to the strong performance of Interco's furniture and footwear divisions. Sales in 1988 increased by 14.7% in the furniture division and 34.2% in the footwear division. Despite the promising nature of these two divisions, Interco still had to contend with the nagging issue of the underperforming apparel and general retail groups. Due to a number of factors including declining consumer spending and aggressive competition from other retailers, overall performance of both these groups was fairly unexceptional. Profits were down by 3.7% for the retail division. There were a number of characteristics that made Interco a coveted target for hostile takeover attempts.

It was widely recognized by the market that their stock was undervalued. Outside buyers could therefore somewhat easily accumulate a majority of the company's stock and thus gain the associated majority voting rights due to this undervaluation. City Capital, the potential takeover bidder had already accumulated 8.7% of Interco's stock. Furthermore, Interco had two lucrative industry-leading divisions that would potentially be high appeal spin-offs to outside buyers.

These divisions could potentially generate a high profit if broken up and sold off separately. As board members of Interco the premium paid analysis and

comparables transactions analysis have affirmed, our decision that City Capital's offer is inadequate. The premium paid analysis (Exhibit 10) confirms that the averages are indeed much higher than City Capital's proposal. Although the comparable transaction analyses for Rales' Proposal is similar to other benchmarks, a few major concerns about using comparable analyses still arise. Some of the benchmark merger transactions used are outdated by a few years.

Analysis is focused on current market conditions and thus should be compared with similar merger transactions during periods of similar market conditions. Historical data on the indexes of closing prices (see Exhibit 14) attest that the current market trend is very different to the market trends for some of the benchmarks used (i. e. West Point Pepperall/Cluett, Peabody). In addition, it is difficult to determine the true nature and equatability between the proposed benchmarks and Interco for each company can differ in its cash flow and revenue growth, its riskiness, and its future expansion opportunities. In consequence finding comparable ratios becomes increasingly problematic and challenging.

Thus, the issues that are specific to Interco limit the strength and validity of the valuation analysis. One must also note that comparable transaction analyses do not account for premiums or synergies gained in a transaction. There are a variety of possible questions in regards to Wasserstein, Perella and Co. 's discounted cash flow analysis of Interco. The financial analysts made some assumptions that could be questioned as ill-founded.

An increase in Working Investment for the Apparel and Retail divisions was predicted but the Strategic Positioning Goals of Interco dictated that underperforming assets were to be divested. Based on the 1988 Income Statement of Interco Apparel and Retail divisions, could easily be judged as underperforming assets. Based on the date it would not seem unreasonable these divisions could be divested as opposed to experiencing an increase in working investment. Also, sales growth in the Apparel division was predicted to increase by 7.1% but it had experience negative net operating earnings in the previous year; the assumption of growth does not seem to be supported by the date in the income statement. The Interco board was offered \$70 per share from City Capital.

We would advise against accepting this offer because their shares were valued at anywhere from \$68 to \$80 per share. Interco knows that their stock is currently undervalued because the apparel portion of their company isn't doing very well. Once they are able to sell off the apparel portion of their company their stock value will rise and will offer more value to their shareholders. City Capital knows that the current stock is undervalued, which is why they want to buy Interco in the first place. City Capital plans on selling off the apparel portion of the company once they acquire Interco.

City Capital also stated that they would be willing to offer more money per share for the stock, which is evidence that they believe the stock is truly undervalued due to the apparel. According to Figure 1, the data is very similar to Exhibit 12: Discounted Cash Flow Analysis. The stock prices between the two were mostly the same, however there were two deviations

of plus \$1 and one deviation of -\$1. Because the data from the two were similar, this gives us further evidence that the stock price is undervalued.

Interco should either ask for a much higher price if they decide they want to sell or they should decline the offer completely. Interco's board up to August 8, 1988 had a good understanding of their company. They were able to point out the weaker aspects of their company. They realize that the apparel group is negatively affecting their stock price, which means their stock price is undervalued. Interco's board put into affect a poison pill that strongly discourages other companies from coming in and buying them out.

The board decides to make this shareholder plan to protect their shareholders from City Capital coming in and selling off portions of the company. Interco is currently the leader in two of its industries, which shows what a strong company they truly are. The board believes a takeover would hurt their company more than it would benefit from it. Wasserstein concluded that the \$70 price per share would be a bad offer for Interco. Based upon their data we agreed that the \$70 price per share was lower than it should be. However, we question some of their assumptions in Exhibit 12.

We didn't agree with them assuming that the apparel group would increase sales growth because it goes against previous history. Also, they suggested to give apparel a high percentage of working capital, which we don't agree with because it is the weakest link within their company. Wasserstein stood to gain \$3.7 million once Capital City rescinds their offer; therefore they are given an incentive to make it look like Capital City is giving Interco a bad

offer. If their data is correct, then the offer is bad; however if they are skewing the data then the offer might not be bad. The Rale brothers are corporate raiders who buy out companies and then sell them off by pieces.

They are trying to mainly gain money for themselves instead of creating value for the company. Once the takeover takes place the target company completely disappears in the process of selling of portions of the company. The Rale brothers are not adding any sort of value to the target firm and are destroying the firm they take over for their own personal gain. Drexel Burnham, City Capital's advisor, believes that Interco is undervalued because he is willing to offer an extra \$1.

375 billion of debt and/or equity for the \$70 per share proposal. His action of offering more money is smart because once the offer is accepted, City Capital can sell off the apparel group and make more money through the rise of the stock price. The company would be valued at a higher price and they could then turn around and sell the company for a profit.