Group case analysis: cooper industries, inc. essay sample

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I. Summary of the Problem

Cooper Industries was founded in 1919 as an equipment and heavy machinery manufacturer. Over time, Cooper Industries experienced significant growth through acquisitions. Nicholson File Company had been on Cooper's shopping list for years as a company to acquire. What made Nicholson so attractive was its basic competitive strength. Cooper believe that acquiring Nicholson could reduce overcome its violent fluctuation of earnings. Nicholson had a 50% share for files and wraps with high quality line and strong name. Its hand saws and saw blades also had a very strong quality with 9% of the market. Cooper is also interested in Nicholson's distribution system. Cooper believes that Nicholson will enjoy 6%-7% annual sales growth, cost of good sols reduced from 69% of sales to 65% and selling, general and administrative expenses form 22% of sales to 19%, which showed a great profitability.

Nicholson, a family-owned a managed hand-tool business, had not been interested in Cooper's offers until May 1972 when Nicholson was in the middle of a takeover fight. H. K. Porter Company, a large firm with operations in electrical equipment, tools metals, and rubber products, also sought to acquire Nicholson. By 1967, H. K. Porter Company had purchased 44, 000 of Nicholson's 584, 000 shares of stock outstanding. In March 1972, Porter informed Nicholson's management of their plan to purchase a majority of Nicholson's stock, or 437, 000 shares, at $42 per share. Cooper, upon hearing the news, offered to help Nicholson. Shortly after, Cooper withdrew their offer to help since the risks were too high that Porter would learn of their offer to help and would retaliate with an attack on Cooper. By late

March, Nicholson’s management felt the increasing pressure to find a different buyer, since they did not wish to be taken over by Porter. On April 3, Nicholson reached an agreement on a merger with VLN Corporation, a company primarily focused on automotive equipment.

Under the terms of the merger, each share of Nicholson common stock would be exchanged for one share of new VLN cumulative convertible preferred stock that would pay an annual dividend of $1. 60. The VLN preferred stock would be convertible into five shares of VLN common stock during the first year following the merger and four shares after the fourth year. Additionally, the preferred stock would have liquidating rights of $50 per share and would be callable at $50 per share after the fifth year. Nicholson’s management supported the merger with VLN Corporation and encouraged the shareholders to vote in favor of the merger. According to Nicholson, a preferred share was worth a minimum of $53. 10 (VLN common stock closed at $10. 62 prior to the offer), the $1. 60 preferred dividend equaled the current rate on the Nicholson common stock, and the exchange would be tax-free.

However, according to Porter, the VLN common stock recently sold for $45/8, making the first year value $23. 12. Porter also argued that since VLN had not paid common dividends since 1970, those who converted to VLN common stock would suffer an income loss. Therefore, shareholders were given differing information on the value of the stock compared to the $42 cash offer from Porter. Cooper Industries continued to be interested in the opportunities that Nicholson would afford them in terms of stable earnings and sophisticated distribution systems. Cooper was given a second

opportunity at Nicholson during the conflict between Porter and VLN. Porter was only able to acquire 133, 000 shares of Nicholson, which did not constitute a majority, and its slate of directors was defeated by Nicholson management.

Porter feared that they would be stuck with VLN preferred stock that paid low dividends and did not show potential for growth. Porter knew that a Cooper-Nicholson merger would allow him to convert his Nicholson shares to common stock or preferred stock. He speculated that the Cooper stock would appreciate and it would be a more liquid investment since it was traded on the New York Stock exchange. In late April, Mr. Evans of Porter Company agreed to support a Cooper-Nicholson merger if he received Cooper common or convertible stock in a tax-free exchange worth at least $50 for each Nicholson share he possessed.

Mr. Cizik of Cooper Industries was then faced with the difficult decision to move forward for control of Nicholson. Mr. Cizik only needed the support of at least 86, 000 of the unaccounted for shares. If he did go through with the merger, he wanted to be sure it was a fair merger that maintained the support of Nicholson management and shareholders. On May 3, Cooper common stock closed at $24 and Nicholson at $44.

II. Analysis of Options and Outcomes

1. If you were Mr. Cizik of Cooper Industries, would you try to gain control of Nicholson File Company in May 1972? The analysis is as follows. The Exhibit 1 shows the income statement of Nicholson company if it operating alone. We assume that Nicholson will continue to have sales growth of 2%, cost of

good sold of 69% and selling, general and administrative expenses of 22%. In 1972, the book value of shares is $50. 07 per share and the market value of the share price expected is $19. 88 minimum and $27. 83 maximum. The book value of share is higher than the market value. The reason why Nicholson is trading at a premium over its net present valuation of discounted cash flows is because of the looming acquisition, and the synergies it will create. The Exhibit 2 shows the valuation of Nicholson if it operates as a part of Cooper Industries.

Because two companies will get access to both industrial and consumer markets, the sales growth will rise from 2% to 6%. Furthermore, due to Nicholson's broaden market, the cost of goods sold could be reduced from 69% to 65%. Elimination of sales and advertising duplications would lower selling, general and administrative expenses from 20% to 19%. The book value of share would be $54. 92 in 1972. The market price expected would be $73. 75 at minimum and $89. 55 maximum. The Exhibit 4 shows the income statement of Cooper to operating along. According to the Five-year Forecast of Cooper Industries' earnings (excluding Nicholson File company), the EPS in 1972 is $2. 61. We calculated the historical price-earning ratio, which is the average from 1967 to 1970. We excluded the data in 1971 since the year's sale is regarded as the cyclical sales year.

The PE ratio is from $9-$18 which is very volatile. The expected market share price in 1972 is from $23 to $47 that fluctuates a lot. We added up the net sales, cost of goods sold and selling, general and administrative expenses of the before the merging of Cooper and Nicholson. As is shown in Exhibit 5, valuation of Cooper after merger shows that the EPS will rise from

$2. 61 in 1972 to $3. 52 in 1976. The PE ranges from $14 to $17 that is more stabilize. Also, the market share price increase from $37-$44 to $59-$60. As is analysis above, merging with Nicholson is a good decision for both Cooper and Nicholson. The stock price and value of both companies will rise. Furthermore, the Cooper will be less fluctuate to the market change.

2. What is the maximum price that Cooper can afford to pay for Nicholson and still keep the acquisition attractive from the standpoint of Cooper? Summarize your analysis. The calculation is in Exhibit 7.

Calculation of WACC:

Estimation of Cost of Debt: According to the Balance sheet and income statement of Nicholson, the interest is $0. 8 million for interest expense and the long-term debt is $ 12 million. The cost of debt for Nicholson is 6. 66 % ((0. 8 / 12) * 100). According to previously assumption the tax rate is 40%. The cost of debt after tax is 4% (6. 66% * (1-0. 4)). Estimation of Cost of Equity: Company’s common stock had the market value of $44. The expected growth rate of Nicholson is 6% which is equal to the general industrial growth rate. The expected dividend for next period is $1. 60. $44= $1. 60 / (r – 0. 06) which r = 9. 63%. Calculation of WACC:

At present Nicholson has a Long term Debt of $12 million and equity of $ 31 million. This gives the values of: D / (D + E) = 12 / 43 = 29%

E / (E + D) = 31/43 = 71%

WACC= 9. 63%*71%+4%*29%= 8%

Assumptions of future Free Cash Flows (FCFs):

1) Because two companies will access to the both industrial markets and

consumer markets, the sales growth will rise from 2% to 6%. 2) since Nicholson's efforts to sell to every segment, the cost of goods sold could be reduced from 69% to 65%. Elimination of sales and advertising duplications would lower selling, general and administrative expenses from 20% to 19%. 3) Tax rate remains constant at 40%

4) Depreciation takes the percentage of sales of 3. 8%.

5) Other expenses stay the same.

The discounted FCFs are 2. 55, 2. 74, 2. 96, 3. 17, 3. 42 from 1972 to 1976 respectively. We calculated the price per share $50. 07 which is the maximum price that Cooper can afford to pay for Nicholson and still keep the acquisition attractive from the standpoint of Cooper.

3. H. K. Porter's $42 tender offer has resulted in Porter owning 177, 000 ·shares of Nicholson stock. Identify and evaluate Porter's alternatives at this time. Since Cooper's offer provide more value than Porter's offer, Porter can either dramatically increase its offer price or it can sell its stock to the highest bidder. Since $48 is 15% more than Porter's original offer, it is reasonable to anticipate that Porter will sell its 177000 stock and make some profit.

4. What are Cooper's chances of actually acquiring Nicholson (e. g. 20%, 50%, 90%)? Explain your assessment? If Cooper preferred stock would pay an annual dividend of $2. 50 and would be convertible into 2 shares of Cooper common stock during the first year of the merger. The value will be $48 per Nicholson's stock, which is higher than market value. See Exhibit 8. As explained above, Cooper will have a great chance to stop the acquisition

of Porter and Merger with VLN. Since speculators sell their stocks to the highest bidder, Cooper will control 43% to 52% of Nicholson's outstanding stock. So without endorsement of Nicholson's management, Cooper will have a 28% chance to complete the acquisition. If Cooper wins the heart of Nicholson's manager, Cooper will complete the deal for certain. In order to enhance the possibility, Cooper should keep buying the Nicholson's stock on the secondary market. Overall, the company currently have 62. 4% chance to complete the deal.

5. What is the best method for Cooper to Acquire Nicholson?

We have three proposed suggestions:

Scenario 1 – Propose an all cash acquisition of Nicholson. Scenario 2 – Propose equity acquisition of Nicholson

Scenario 3 – An option is for Cooper to back out, and let either Porter or VLN acquire the Nicholson Company for themselves. Analysis for scenario 1:

The first and most obvious option before Cooper Industries is to move forward with acquiring further shares, through the Porter Company, to acquire control of Nicholson. To do so would require Mr. Cizik to buy Porter's shares of Nicholson at $44 per share for a total book value of $30 million. As shown in Exhibit 8, Cizik and Cooper will then need to attract and control another 292, 584 shares (86, 000 shares from unaccounted shares, 177, 000 shares from H K Porter and 29, 584 from specular) doing so at an offer price stronger than the average share price Nicholson has been experiencing. The merge requires Cooper to pay shareholders for $12, 873, 696. According to Cooper's Balance Sheet, the cash, which is available for paying the

shareholders, is only $9 million. Cooper should issue debt to fill in the gap. Cooper is also offering to keep the management of Nicholson in place.

They would give cash to shareholders and helps to convincing the shareholders to accept the deal because the management can influence the shareholders. Furthermore, the offer from Cooper does not depend on Cooper's performance. Porter, understandably, is open to this idea since Cooper stocks will be given to him in a far more liquid form than his VLN stocks, allowing a greater return on his investment. From Nicholson's point of view, Cooper and Porter together own and control 206, 000 shares of Nicholson stock. Cooper Industries has a history of leaving bought-out subsidiary management in place as leaders of the firm, and also believes they can increase Nicholson's value overall by reducing operating costs and cost of goods sold. Specifically, Cooper indicates they can bring COGS down to 65% from 69%. All other things holding equal, Nicholson's profit margin could be boosted almost 7%. Total company valuation could rise from $32 million to $42 million by 1976. This would seem to be the most beneficial arrangement for all parties concerned with the exception of VLN.

Analysis for scenario 2:

Cooper will need at least 12. 8 million dollars to acquire Nicholson in cash, which is larger than Cooper's 9 million cash holdings. Although Cooper should try to buy Nicholson's stock on the secondary market because of lower price (the Nicholson stock closed at $44) at Cooper's best effort, Cooper should also consider to exchange Nicholson's common stock with Cooper's preferred stock. In order to purchase at least 51% of Nicholson stocks, one share of Cooper new cumulative convertible preferred stock

would be traded for each share of Nicholson common stock. Cooper preferred stock would pay an annual dividend of $2. 5 and would be convertible into 2 shares of Cooper common stock during the first year of the merger. The exchange would be a tax-free transaction, the $2. 5 preferred dividend larger than the current rate on the Nicholson common stock and larger than VLN new preferred stock dividend. Cooper preferred share was worth a minimum of $48(Cooper common stock had closed at $24), which is larger than Porter's $42 cash offer. It's a better choice for both Cooper and Nicholson's shareholders.

Analysis for scenario 3:

A third option is for Cooper to back out, and let either Porter or VLN acquire the Nicholson Company for themselves. Nicholson has an offer on the table for continued operations and leadership independence and a chance for preferred VLN stock in exchange for a Nicholson share. VLN also offers annual dividends of $1. 60 and is a broadly diversified company. The problems with this option are as follows: 1) the VLN dividend is a lower offering than Cooper, lower even than Treasury bond yields at the time. 2) VLN does not offer any cost-saving opportunities or even plans for Nicholson, suggesting long-term profitability under VLN is not as likely as under Cooper. These reasons are among the motivators for Porter's sudden move to ally themselves with Cooper's intent to buy out Nicholson instead of allowing the VLN deal to move forward. If Nicholson continue to resisting offers. This is an impossible choice, as stockholders will eventually succumb to one of the two offers. It is up to Nicholson management to analyze the data and make their decision in favor of long term sustained profitability.

III. Conclusion

In order to purchase at least 51% of Nicholson stocks, one share of Cooper new cumulative convertible preferred stock would be exchanged for each share of Nicholson common stock. Cooper preferred stock would pay an annual dividend of $2. 5 and would be convertible into 2 shares of Cooper common stock during the first year of merger. The exchange would be a tax-free transaction, the $2. 5 preferred dividend larger than the current rate on the Nicholson common stock and larger than VLN new preferred stock dividend. Cooper preferred share was worth a minimum of $48(Cooper common stock had closed at $24), which is larger than Porter's $42 cash offer. Although Cooper preferred share was just worth a minimum of $48, less than that of VLN's preferred stock. However, Cooper is a huge NY Stock Exchange listed company. A merger of Cooper and Nicholson would allow Nicholson's stockholder to convert their Nicholson shares into either common stock or convertible preferred stock of Cooper.

This was a much more attractive alternative, since people can anticipate that earnings would increase next year and the price of Cooper would show significant price appreciation. Furthermore, Cooper stock was traded on the New York Exchange, which provided substantial liquidity. Management of Nicholson Company sought to merger with VLN that would ensure continuity of Nicholson management and operating independence. It's an ideal option for the Nicholson family. However, under current term with VLN, one share of new VLN cumulative convertible preferred stock would be exchanged for each share of Nicholson common stock. One share of VLN cumulative convertible preferred stock would pay an annual dividend of $1. 6 and would

be convertible into five shares of VLN common stock during the first year after the merger, scaling down to four shares after the fourth year.

Callable at $50 a share after the fifth year. Depending on the valuation method used for the VLN offer, the offer could be as high as $51. 10 per share, or as low as $23. 12 per share. Unlike Cooper, VLN is not traded on the New York Exchange, which means shareholder of Nicholson is hard to sell substantial amount of new VLN’s common stocks or preferred stocks. The volatility of price and uncertainty of liquidity both makes the option impossible to obtain enough votes from speculators. If Cooper can provide a lucrative price, the combined holding of Porter, Cooper, speculators amounting to 48% of outstanding shares, made it impossible to obtain enough votes to complete the VLN merger. Exhibit 1 – Nicholson File – Condensed Operating and Shareholder Information (No Merger)