Gulf oil case study essay sample

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The Standard Oil Company of California(Socal) is trying to determine how much to bid on the Gulf Oil Corporation. George Keller, the CEO of Socal, would need to borrow 14 billion dollars in order to make a substantial bid. While banks are willing to lend the money because of Socal’s low to debt ratio, the loan would put the company in a highly leveraged position. In order to alleviate that debt, some of Gulf’s assets could be sold. Keller has to consider the value of Gulf’s exploration and development program when calculating future returns. Two billion dollars were being spent on the exploration and development program. This money could instead be used to reduce the debt if Socal acquired the company. However, the exploration program holds a lot of potential future value, because of its goal of new oil discovery. The discovery of future oil might not be necessary because of the substantial amount of oil Gulf already has on reserve.

Gulf’s Value

When putting the company up for the auction, Gulf established a minimum bid level of $70 per share. This $30 more than the the trading range Gulf was in a few months ago. Gulf can charge a high premium because it is worth a lot more than 40 dollars per share to potential buyers. A company verpayingfor an acquisition is not uncommon. The market value of 40 dollars does represent the actual value it has to the bidders. Part of the additional value comes from the ability to control the company. In addition, once a company gains control of Gulf there is a potential synergy that is created by the combination of assets. The acquisition of Gulf by Socal would produce a combination of two oil companies. The combination of assets could lead to a future return greater than the sum of their two parts.

Forced Liquidation

Boone Pickens , of Mesa Company, tried to push Gulf into a sale of its company. He did this by continually purchasing large amounts of shares of the company. James Lee the current chairman of Gulf, felt threatened by the possible takeover and made the decision to liquidate the company on his own terms. Mesa made a tender offer of 65$ per share, which would would only give them 21% ownership of the company. Mesa would need a majority hold of Gulf in order to elect alternative directors of the firm. The purpose of electing new directors would be to turn the Gulf corporation into a royalty trust. If Mesa were to put up more money for the company, it would only do so for the purpose of gaining a majority hold. Because this was not an attainable goal, Mesa sought the 21% ownership because it was enough attract the further banking needed.

Advised Decision

A prospective buyer has to consider the motives and financial positions of other bidders. Kohlberg wants to buyout the company in order to turn it into a private firm. ARCO has a pretty strict limit in what it can offer because of its highly leveraged position. Even if a company has the ability to take out a larger loan to make a greater offer, it has to consider the consequences of doing so. While a company like Socal has unrestricted credit, its decisions as to how to operate the company after the buyout are very limited. Creating a lot of debt in order to finance the purchase is a large risk. If the company does not perform well in the future it could face tremendous loss.

In this case, a bid of $80 per share would be appropriate for an un-leveraged company like Socal. This would be enough to win Gulf while still leaving

breathing room for shareholders. Taxes do not need to be considered, because the benefits cancel out the costs. The exploration program should be cut in order to decrease leverage. Other assets, including the oil reserves, would be enough to put the company into a favorable financial position and spur future gains. If the company ever got into a position where it needed to begin new exploration , it could do so by re-leveraging the company.