United States General Accounting Office

GAO

Report to Congressional Requesters

September 1991

LEVERAGED BUYOUTS

Case Studies of Selected Leveraged Buyouts

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

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September 16, 1991

The Honorable Timothy J. Penny
House of Representatives

Dear Mr. Penny:

This responds to the request from you and 51 other Members of the House of Representatives (see app. I) for information on the effects of leveraged buyouts (LBO) and hostile business takeovers. This report answers questions you asked concerning (1) what happened to companies that had been taken over through an LBO, (2) how these companies have performed since the takeover, (3) how communities have been affected, and (4) what happened to companies that amassed tremendous debt to avoid being taken over.[1]

As agreed with your office, we addressed these questions by doing case studies of companies that experienced an LBO or a takeover attempt during the mid- to late 1980s. Our assessment was based primarily on public documents and financial reports filed by the companies with the Securities and Exchange Commission (SEC). Each company commented on a draft of its case study. The companies' comments generally involved minor corrections, which we made. (See app. II for details on our scope and methodology.)

The case studies included LBOs of Revco D.S. Inc.; Safeway Stores Inc.; and Allied Stores Corporation and Federated Department Stores Inc., both of which were purchased separately by the same acquirer; and a recapitalization to avoid an LBO by Phillips Petroleum. The case studies are included as appendixes III, IV, V, and VI, respectively.

Background

An LBO is a financing technique in which the takeover purchase of a company is transacted mostly with borrowed funds rather than contributed equity. As a result, the acquired company comes out of the LBO with a much different capital structure[2] than before. Debt replaces equity as the company's primary source of capital. The proceeds from the debt are used to purchase shares from stockholders, usually at a

[1]Information on what happens to company pension plans after an LBO is provided in Pension Plans: Terminations, Asset Reversions, and Replacements Following Leveraged Buyouts (GAO/HRD-91-21, Mar. 4, 1991). Other parts of your request are being addressed in ongoing work.

[2]A company's capital structure, or capitalization, is the total value of a corporation's long-term debt and preferred and common stock accounts.

premium to encourage the sale, leaving control of the company's stock concentrated within a small group of investors. The assets of the acquired company are generally used as collateral for debt and are often divested to provide funds to repay the increased debt. Debt may be either collateralized by assets or unsecured, using high-yield bonds referred to as "junk bonds."

The much-publicized LBO binge of the 1980s has resulted in concern about the impacts and efficacy of LBOs. Many studies and congressional hearings have been conducted addressing various effects of LBOs. For example, a 1989 study for the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, identified a variety of issues related to LBOs.[3] These issues included fairness to parties involved, such as stockholders and bondholders; role of and impact on financial institutions; and economic effects regarding taxes, employment, capital spending, and increased aggregate levels of debt.

Results in Brief

In the LBOs we studied, the purchasers bought out the target companies' equity holders with money from loans and bond issues. In Phillips' recapitalization, the company exchanged debt securities for nearly half of its outstanding common stock in order to avoid an LBO. For all the cases we studied, the equity holders, through selling or exchanging their common stock, earned premiums[4] ranging from about 36 percent to about 119 percent. The surviving companies' capital structures shifted so that debt became the primary source of funding, and debt reduction became one of the companies' highest priorities. The companies employed such strategies as asset sales, cost savings programs, employee layoffs, and spending restrictions to help pay off debt. Phillips and Safeway are currently operating profitably, but the remaining three companies have declared bankruptcy and are now operating under bankruptcy court protection.

The actions taken to service the increased debt load resulted in many employees losing their jobs. However, the companies we studied had

[3]Dr. Carolyn Kay Brancato, Leveraged Buyouts and the Pot of Gold: 1989 Update, a report prepared for the use of the Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives, (Washington, D.C.: U.S. Government Printing Office, 1989).

[4]Premium is the amount, which we express as a percent, by which a particular price per share exceeds the market price per share on a specific date. The methodology we used for calculating the premiums is described in our objectives, scope, and methodology section in appendix II.

locations across the country and were generally a small part of the economic base of any one community. In Phillips' case, however, the company's headquarters formed a major part of the economic base for the local community, and Chamber of Commerce officials told us that the company's efforts to reduce costs through employee layoffs adversely affected the overall earning power of the community and resulted in declining real estate values, city sales tax revenues, and volume of retail and service trade.

The financial success of the companies after their LBOs depended largely on their ability to meet debt service requirements when due. This is dependent upon the initial price paid; future economic conditions; the value of the company's assets, especially those to be sold to reduce the LBO debt; and management's ability to cut costs, reduce debt, and improve profits afterwards. The purchasers and their advisers were primarily responsible for making these determinations. However, in these highly leveraged transactions the purchasers had little to lose if they paid too much and a lot to gain if they could make the surviving company a success, while their advisers earned large fees regardless of the price paid or ultimate fate of the surviving company. Thus, both had incentives to complete the deals. For example, the purchasers' equity investment in the deals was small relative to the total purchase price—in only one case greater than 3 percent—allowing them large potential returns with limited financial risk. In addition, fees earned by the advisers increased if the transaction was completed.

Why Did These Deals Happen?

Although the reasons varied for doing the buyouts and recapitalization, there were some similarities between the cases. As stated in the filings we reviewed for Revco, Safeway, and Phillips, where management was an active and willing participant in the transaction, the motivation for the deals was related to the existing owners' desire to retain control of the company. Revco's management participated in the LBO because they were concerned that the company's depressed stock price made it susceptible to a takeover. Safeway's management participated in an LBO with Kohlberg Kravis Roberts & Co. (KKR), a private investment firm, as a defensive maneuver against a hostile takeover attempt by the Dart Group.[5] And Phillips' recapitalization was a defensive tactic against the second hostile takeover attempt of the company in less than 3 months.

[5]Dart Group is owned and controlled by the Haft family, who, despite losing the takeover battle for control of Safeway, earned about $153 million from selling their stock in Safeway and terminating an agreement made with KKR and Safeway's management.

In contrast, the LBOs of Allied and Federated were not done as part of a defensive strategy but were instead hostile takeovers. The acquirer, Robert Campeau of Campeau Corporation, sought the acquisition of Allied and Federated to expand his commercial real estate operations in the U.S. market and to position his company in retail merchandising. He envisioned that the retail department store chains would provide the anchor stores in shopping centers he planned to develop in the United States, which would attract other stores to rent space.

What Happened to the Companies?

Since the LBOs, Revco, Allied, and Federated have filed for protection from creditors under Chapter 11 of the U.S. Bankruptcy Code and have been operating as debtors-in-possession[6] while developing reorganization plans to submit to the bankruptcy court. A court-appointed examiner has investigated whether the Revco LBO constituted a fraudulent conveyance[7] against the interests of Revco creditors who did not participate in the LBO. Findings by the examiner indicate that viable causes of action do exist against various parties involved in the LBO under both fraudulent conveyance and other legal theories. A successful fraudulent conveyance action could have the effect of changing the priority of creditors' claims against what remains of Revco's assets. Safeway survived its LBO and during recent years has, by some measures of performance such as operating profit margin and gross margin on sales, operated with greater success than before the LBO. In the years following Phillips' recapitalization, the company's performance fluctuated, but it was able to reduce debt to a level it considered manageable. Our analysis of company performance focused on measures of changes the companies underwent, including capitalization, asset divestitures, capital expenditures, research and development spending, employment levels, stock and bond prices, and bond investment ratings.

A company's capitalization consists of long-term debt and equity. The capitalization of all the companies we studied changed from primarily equity to primarily long-term debt after the LBOs or recapitalization. Revco's long-term debt nearly quadrupled while its stockholders' equity became negative within 5 months of the LBO. Safeway's long-term debt

[6]Operating as a debtor-in-possession means the companies cannot engage in transactions outside the ordinary course of business without first complying with the bankruptcy code and, when necessary, obtaining bankruptcy court approval.

[7]A fraudulent conveyance is essentially a transaction in which a debtor transfers an interest in its property (i.e., grants a lender a security interest in the property) either (1) with the intent to defraud its creditors or (2) regardless of the debtor's intent, if the debtor did not receive fair consideration for the transfer made, causing it to be either insolvent or have insufficient capital to conduct its business.

increased from 46.5 percent of its capitalization 1 year before the LBO to 99.1 percent immediately after. Allied's long-term debt as a percentage of its capitalization more than doubled, from 34 percent before the LBO to 78 percent after, while Federated's increased from 24 percent to 53 percent after its LBO. Phillips' long-term debt increased from about 30 percent of its capitalization to about 81 percent immediately after its recapitalization.

Asset divestitures were significant for all the companies. By the end of its 1990 fiscal year, Revco had divested all of its subsidiary operations that were not retail drugstores and almost 11 percent of the nearly 2,100 retail drugstores it owned at the time of the LBO. Allied divested 18 of its 24 divisions and Federated divested over half of its 15 divisions. Safeway divested over half of its nearly 2,400 food outlets, and Phillips sold off $2 billion worth of assets, including several oil and gas properties, a crude oil tanker, a fertilizer business, and certain mineral operations. At the time of its recapitalization Phillips valued its total assets at about $15.8 billion.

Capital expenditures and research and development expenditures can be important to maintaining a competitive position. Capital spending at Revco, Allied, and Federated declined after the LBOs and was reduced after Phillips' recapitalization. Safeway's capital spending was reduced for 3 years after its LBO, then increased in 1990, and Safeway expects it to be restored to pre-LBO levels in 1991. After the recapitalization, Phillips' research and development expenditures initially declined, then rose, but they were refocused on the company's core businesses. The other companies did not report research and development expenditures in their consolidated financial statements.

Employment at the companies declined after the LBOs and the recapitalization as a result of asset divestitures and cost reduction efforts. Except for Phillips, the bulk of the reductions were probably due to asset divestitures. Employment at Revco fell by more than 2,000, or about 8 percent; Safeway laid off over 54,000 employees, or almost one-third of its workforce; combined employment at Allied and Federated fell by more than 108,000, or about 54 percent; and at Phillips, employment was reduced by 7,500, or about 26 percent. We did not determine how many of these companies' workers lost their jobs. However, the LBOs no doubt created significant hardships for many laid-off employees—some of whom had spent years with the companies before the reorganization. Not only were the income streams of these employees interrupted but, in all likelihood, the health and pension benefits associated with their lost jobs were either temporarily or permanently destroyed.

Stock and bond prices and bond investment ratings indicate financial gains for stockholders and financial losses for some bondholders. Stockholders earned premiums on the shares they sold. Revco stockholders received a premium of 36 percent. Allied stockholders received a premium of 79 percent, while Federated stockholders earned a 119-percent premium. Safeway stockholders received about a 49-percent premium. In Phillips' recapitalization, stockholders earned a premium of about 48 percent. According to data from W.T. Grimm & Co., a recognized publisher of financial data, premiums tended to range between about 31 to 49 percent on corporate takeovers from 1980 to 1986.[8]

On the basis of the record of bond prices and investment ratings, bondholders either lost or were unaffected by the LBOs and recapitalization. After the Revco LBO, prices and investment ratings of its outstanding bonds diminished. Investment ratings of Safeway's bonds diminished after its LBO but gradually improved as the company's debt was reduced while its bond prices remained relatively stable. The prices and investment ratings of Allied's and Federated's bonds fell after their respective LBOs. While the prices of Phillips' bonds were generally stable during the company's takeover fights and following its recapitalization, its investment ratings were downgraded. However, as Phillips reduced its debt and improved its financial strength and flexibility, its bond prices increased and its investment ratings were upgraded.

How Did the Companies Perform?

The companies' financial performance after the LBOs and recapitalization varied. The overall performance of Revco, Allied, and Federated diminished; Safeway's initially was mixed but then improved; and Phillips' fluctuated. In any event, the highly leveraged environment in which the companies operated after the transactions magnified the importance of management's operating decisions and increased the companies' vulnerability to economic downturns.

As indicated, the LBOs and Phillips' recapitalization resulted in the companies amassing tremendous amounts of debt. For example, the total debt-to-equity ratio for Allied increased from 1.2 before the LBO to nearly 21 for the first full year after the LBO. For the companies that were taken over, the acquiring company borrowed funds or sold bonds

[8] Leveraged Buyouts and the Pot of Gold: 1989 Update, p. 78.

to finance the buyout. Then, after the takeover, these bank loans and bond issues were transferred to the balance sheet of the company formed with the acquired company. To recapitalize, Phillips exchanged almost half of its outstanding common stock for the debt securities it issued.

Interest expenses after the LBOs tended to be so high at Revco, Allied, and Federated that the companies could not consistently generate sufficient cash flow to cover the interest expenses and remain solvent. This was the case even after they divested assets and used the proceeds to reduce debt. Before the LBOs, each of these companies had generated sufficient cash flow from operations to cover interest expenses by at least four times. For example, at Revco the year before the LBO, cash flow from operations before interest expense was over five times the interest expense. The year after the LBO, Revco could not cover its interest expense with cash flow from operations. In contrast, Safeway and Phillips generated sufficient cash flow from operations to cover interest expenses.

The profitability of Revco, Allied, and Federated diminished after the LBOs mainly because of their high debt servicing costs, while Safeway's profitability showed mixed results after the LBO but later improved. Revco has reported only net losses since its LBO and consequently has not generated a return on stockholders' equity since before the buyout. Allied and Federated, which had profit margins that were higher than average for department stores before their LBOs, fell below average or generated losses afterwards. Phillips' profitability initially fell after its recapitalization, then fluctuated as a result of internal management actions and uncontrollable external events.

How Have Communities Been Affected?

Many individual employees lost jobs or at least had their lives disrupted by having to change jobs or employers after the LBOs and recapitalization we reviewed. Although this obviously created hardships for these individuals, because the companies we reviewed had stores or facilities in widely dispersed geographic locations, it was not feasible to determine the overall effects of the LBOs or attempted takeovers on the communities. However, we did identify some community effects.

For example, according to officials of Bartlesville, Oklahoma, where Phillips is headquartered, the community was affected by the attempted takeovers and subsequent recapitalization of that company. The Bartlesville Area Chamber of Commerce said that the economy of the community depends significantly on Phillips because of the large number of people in the community the company employs. The Chamber stated that Phillips' reductions in employment adversely affected the overall earning power of the community and, in particular, reduced real estate values, city sales tax revenues, and the volume of retail and service trade.

After the Safeway LBO, employees who had been discharged filed suit and were awarded a settlement against Safeway. In addition, a Safeway Workers Assistance Program funded by two grants using Job Training Partnership Act money provided job training and placement assistance for 738 displaced Safeway employees in the Dallas/Fort Worth area. Of those served, 685 completed the program. The grantee determined that 83 percent of those obtained employment after about 24 weeks in the program. However, the grantee also determined that the average hourly wage at placement was below the wages previously earned at Safeway. Opportunities for employment with new owners of Safeway stores were limited, and where such employment was found, employee benefits and wages were also reduced.

Although Revco divested a number of its drugstores, we did not attempt to identify any community impact from the closings or sales because the small number of personnel typically employed at a single drugstore combined with the many different communities in which the stores were located, in our view, decreased the potential for any significant, adverse economic impact on a local community. Community effects of the Campeau LBOs could not be determined because of the department stores' numerous locations in highly diverse urban economies.

Other Observations

The small number of cases we reviewed does not allow us to comment about LBOs in general. However, in the cases we reviewed it is clear the financial success of the companies after the LBO depended largely on their ability to meet debt service requirements when due. This depended on judgments made by the purchasers and their advisers regarding the initial price paid; future economic conditions; the value of the companies' assets; and managements' ability to cut costs, reduce debt, and improve profits after the buyout. In these highly leveraged transactions, however, the purchasers had little to lose if they paid too much and a lot to gain if they could make the surviving company a success, while their advisers earned large fees regardless of the price paid or the ultimate success of the surviving company and thus had an incentive to complete the deals.

The purchasers in the transactions we reviewed had relatively little to lose because their equity investments were very small compared to the total purchase price. Specifically, in the Revco LBO the purchaser contributed only about 2.0 percent of the aggregate purchase price through equity contributions. In the acquisition of Federated, the portion of the acquirer's equity investment that was not borrowed was only 2.9 percent of the total purchase price, and that money came from the sale of Allied's Brooks Brothers chain. Similarly, in the Allied and Safeway LBOs, the purchasers' equity investments were only 8.5 percent and 2.7 percent of the total purchase price, respectively. This provided the purchasers the opportunity to earn tremendous returns if the surviving company were to prosper while at the same time limiting the financial risk they were taking.

The investment bankers acting as advisers and financial managers for the LBOs earned fees ranging from about $49 million to about $127 million for these and other services, including providing temporary "bridge" loans in the Allied, Federated, and Safeway deals and underwriting issues of securities to finance the Allied, Federated, and Revco deals. Similarly, other participants—primarily banks, but also attorneys, accountants, and others—received fees from these transactions that ranged from about $38 million to about $166 million. Total fees for the deals as a percentage of the purchase price ranged from nearly 4.5 to 7.5 percent. Many of these fees, such as those for bridge loans or underwriting services, would not have been earned unless the deals were completed. As a result, while the dealmakers and their advisers were tasked with assessing the price to be paid and the ability of the company to survive, they had financial incentives to simply see that the deals were completed.

We are sending copies of this report to the other congressional requesters, the Securities and Exchange Commission, other interested Members of Congress, and appropriate committees. We will also make copies available to the public.

The major contributors to this report are listed in appendix VII. If there are any questions concerning the contents of this report, please call me at (202) 275-8678.

Sincerely yours,

Suzanne J. McCrory
for Craig A. Simmons
Director, Financial Institutions
and Markets Issues

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Appendix VI Case Study: Recapitalization of Phillips Petroleum

Appendix VII Major Contributors to This Report

Tables

Abbreviations

CEO	chief executive officer
BBL	barrels
KKR	Kohlberg Kravis Roberts & Co.
LBO	leveraged buyout
NYSE	New York Stock Exchange
OTA	Office of Technology Assessment
R&D	research and development
SEC	Securities and Exchange Commission
SIC	Standard Industrial Classification

Congressional Requesters

The Honorable Timothy J. Penny
The Honorable Byron L. Dorgan
The Honorable Lawrence J. Smith
The Honorable Cass Ballenger
The Honorable Gerald D. Kleczka
The Honorable Thomas M. Foglietta
The Honorable Gerry E. Studds
The Honorable Robert J. Mrazek
The Honorable Barbara Boxer
The Honorable Harris W. Fawell
The Honorable Lane Evans
The Honorable Bruce A. Morrison*
The Honorable James H. Bilbray
The Honorable Gerry Sikorski
The Honorable Terry L. Bruce
The Honorable Richard Ray
The Honorable Robin Tallon
The Honorable John Lewis
The Honorable Chester G. Atkins
The Honorable Tim Johnson
The Honorable William O. Lipinski
The Honorable Jim Jontz
The Honorable Lynn Martin*
The Honorable Albert G. Bustamante
The Honorable Amo Houghton
The Honorable Christopher Shays
The Honorable Richard H. Stallings
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The Honorable Robert A. Roe
The Honorable Cardiss Collins
The Honorable Silvio O. Conte**
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The Honorable Clarence E. Miller
The Honorable Donald J. Pease
The Honorable Dennis M. Hertel

The Honorable Joseph M. Gaydos
The Honorable Ben Nighthorse Campbell
The Honorable H. Martin Lancaster
The Honorable Bob Traxler
The Honorable Jim Olin
The Honorable James A. Traficant, Jr.
The Honorable Marcy Kaptur
The Honorable Robert W. Kastenmeier*
The Honorable Julian C. Dixon

*No longer a Member of Congress.

**Deceased.

Objectives, Scope, and Methodology

Our objective was to prepare case studies that provide information about companies that had experienced a leveraged buyout (LBO) or had survived an attempted takeover. As requested, the case studies address the following questions:

- What has happened to companies as a result of an LBO or attempted LBO?
- How have those companies performed since the LBO or attempted LBO?
- How were communities affected?
- What has happened to companies that have amassed tremendous debt in order to avoid being taken over?

We did four case studies of companies that experienced an LBO or a takeover attempt during the mid- to late 1980s. We selected three LBOs and a recapitalization that occurred in 1985 or 1986[1] so that there would be a sufficient period of time after the LBO or recapitalization to assess subsequent performance of the company. Within this time frame, we attempted to select cases that would illustrate various features. We selected Revco because it appeared from press reports to be experiencing difficulties after its LBO and Safeway because it appeared to be successfully emerging from its buyout. We selected the Campeau buyout of Allied Stores Corporation and the subsequent buyout of Federated Department Stores, Inc., because of the bidding wars that took place between Campeau and the Edward J. DeBartolo Corporation for Allied and between Campeau and Macy's for Federated and the declining performance of both Allied and Federated after the Federated LBO. Finally, we selected Phillips Petroleum because it had received considerable publicity about its efforts to avoid being taken over by amassing tremendous debt.

In developing our approach for the case studies we interviewed officials of SEC and reviewed literature on case studies done by SEC and other organizations and individual researchers. The case studies address the above questions to the extent that they apply to the case or were answerable. For example, the Campeau case study did not address the community effect question because of the large number and diversity of communities where Allied and Federated had stores. The last question on amassing debt to avoid being taken over applied only in the Phillips case, in which we also addressed the other three questions and followed a methodology similar to the other case studies.

[1]Campeau's acquisition of Allied occurred in 1986; it acquired Federated in 1988, and we included this buyout as well in the case study.

Our information on how the LBOs were done, what happened to the companies, and the companies' post-LBO performance is largely based on public documents and financial reports filed by the companies with SEC. We obtained information on particular industries from various industry and trade reports. We also obtained selected information through telephone interviews with individuals knowledgeable about the LBOs, such as an attorney involved with one of the bankruptcies, ratings agency officials, and company officials. Officials of Revco, Allied, and Federated declined to meet with us or to provide information that was not already available through public sources because of their bankruptcy status and their concern about possible litigation. Phillips provided us with employment data by year for its Bartlesville headquarters. Safeway provided answers to questions we submitted regarding the buyout. All of the companies commented on a draft of their respective case studies, and we made changes as appropriate.

Our analysis of the effects of the LBOs and the recapitalization focused on several items. These include (1) capitalization, which reflects changes in the long-term debt and equity in a company's financial structure to indicate the increased demands placed on a company to service the LBO-induced debt and its subsequent increased vulnerability to economic downturns; (2) asset divestitures to illustrate how the companies downsized to reduce debt using the proceeds of asset sales; (3) changes in capital expenditures and, where applicable, research and development expenditures to show how the companies diverted funds from these activities, which are vital to maintaining a competitive position,[2] to service and reduce debt; (4) employment levels to indicate how the work force at the companies was affected by efforts to service and reduce debt; and (5) stock and bond prices and bond investment ratings to indicate financial gains or losses experienced by stockholders and bondholders.

Our calculations of the premiums received by stockholders as a result of the LBOs and Phillips' recapitalization were calculated as the percentage difference between the buyout price and closing common stock market prices 1 month before the initial buyout or tender offers.[3] Stock prices

[2]Some analysts have argued that forced reductions in capital spending after an LBO promote a company's efficiency because only the investments with the highest return will be made.

[3]In Campeau's LBO of Allied, we calculated premiums from April 1986, when Campeau began purchasing Allied shares. The actual tender offer did not begin until September. In Safeway's LBO we calculated premiums from 1 day before the June 11, 1986, disclosure by the Hafts that they owned about 6 percent of Safeway's common stock and might acquire the company. The Kohlberg Kravis Roberts & Co. tender offer did not begin until August 1, 1986.

are from The Wall Street Journal and The Daily Stock Price Record, New York Stock Exchange.

Our assessment of the effect of the LBOs on bondholders was based on changes in bond prices and investment ratings after the LBOs. Although changes in bond prices also reflect other factors, such as interest rates, issue terms, and rumors of potential takeovers, we generally associated trends in bond prices after the LBOs with the effects of the LBOs. Changes in bond investment ratings generally reflect changing investment risks associated with the bonds pursuant to changing conditions at the companies. The bond prices and investment ratings are from Moody's Bond Record, which publishes "current" bond prices and investment ratings as of the last trading day 1 month before the publication month.

To evaluate the companies' performance after the LBOs, we applied commonly known principles of financial analysis. Our primary tools for judging performance were ratios that compared the relationships among key financial statistics for a particular performance period, usually the companies' fiscal year. We calculated ratios for the last full year before the LBOs and for subsequent years through 1989. The statistics were drawn from the companies' consolidated financial statements—balance sheet, statement of operations, and statement of cash flows—and accompanying notes. The ratios used in our analysis are the following:

- The debt-to-equity ratio shows the relationship between financing sources—primarily loans and various debt instruments that require interest payments as opposed to stocks, which convey ownership and a share of profits. We used two ratios of debt to equity—long-term debt to total common stockholders' equity and total debt (defined as total liabilities) to total common stockholders' equity.
- Interest coverage ratios indicate a company's ability to service debt by comparing measures of cash flow to interest expenses. We used cash flow from operations before interest expense divided by total interest expense. Another interest coverage ratio that we used for the Campeau study to compare with department store industry data is earnings before interest and taxes divided by interest expense.
- Liquidity ratios measure a company's ability to meet short-term obligations by comparing current assets to current liabilities. We used the current ratio—current assets divided by current liabilities—and the quick ratio—cash plus marketable securities plus receivables divided by current liabilities. The quick ratio, by excluding inventories and pre-paid expenses, provides a more immediate measure of a company's short-term debt paying ability.

- Profitability ratios indicate how well an enterprise has operated. We used profit margin—net income as a percentage of net sales—to indicate how effectively the company's operations and finances were managed. For Safeway, we also used operating profit margin—operating profits as a percentage of gross sales—to indicate how effectively operating profits were managed. And, for both Campeau and Safeway, we also calculated gross margin—net sales less the cost of goods sold as a percentage of sales—to obtain an indication of these companies' operating efficiency, pricing policies, and ability to compete. For cases in which the company had a positive net worth position, we calculated return on average common stockholders' equity—net income divided by the average of beginning- and end-of-year common stockholders' equity—to indicate the returns available to the companies' owners.

We did our work between January 1990 and March 1991 in accordance with generally accepted government auditing standards.

Case Study: LBO of Revco D.S., Inc.

On December 29, 1986, Revco D.S., Inc., was acquired in an LBO by an investor group that included both private investors and management for a total cost of about $1.45 billion. As a result of the buyout, the company's long-term debt nearly quadrupled from $309 million at the end of the fiscal year before the buyout to about $1.3 billion after. Revco had difficulty meeting its increased debt requirements and, after unsuccessful attempts to restructure its debt, defaulted on a $46.5 million interest payment due bondholders June 15, 1988. Revco subsequently filed for Chapter 11 bankruptcy protection on July 28, 1988, 19 months after the buyout.

The company has since been trying to develop a reorganization plan that is acceptable to all of its constituencies. However, after waiting more than 2 years for Revco to devise a plan, some of the company's creditors formulated their own and filed it with the bankruptcy court on November 15, 1990. In addition, a court-appointed examiner has investigated whether the LBO constituted a fraudulent conveyance against the interest of Revco creditors who did not participate in the LBO.[1] Findings by the examiner indicate that viable causes of action do exist against various parties involved in the LBO under both fraudulent conveyance and other legal theories. A successful fraudulent conveyance action could have the effect of changing the priority of creditors' claims against what remains of Revco's assets.

This case study is based on public documents filed by Revco with SEC; interviews with representatives of Revco's vendors and bondholders; the Revco examiner's final report;[2] Moody's Bond Record, Moody's Industrial Manual, and Moody's Industrial News Reports; Standard & Poor's Industry Surveys; and stock price listings in The Wall Street Journal. Officials at Revco reviewed and provided technical comments on a draft of our study.

The LBO Transaction

Revco is a retail drugstore chain that sells prescriptions and proprietary drugs, health and beauty aids, vitamins, tobacco products, sundries, and

[1] A fraudulent conveyance is essentially a transaction in which a debtor transfers an interest in its property (i.e., grants a lender a security interest in the property) either (1) with the intent to defraud its creditors or (2) regardless of the debtor's intent, if the debtor did not receive fair consideration for the transfer made, causing it to be either insolvent or have insufficient capital to conduct its business.

[2] The United States Bankruptcy Court for the Northern District of Ohio approved the appointment of an examiner to investigate potential causes of action and other remedies arising from the Revco LBO and to analyze the benefits and detriments of pursuing any available claims. The examiner filed a preliminary report dated July 16, 1990, with his initial findings, and a final report dated December 17, 1990, with his final conclusions.

close-out merchandise. Its corporate fiscal year, which we refer to throughout this report, ends on the Saturday closest to May 31. Thus, the December 29, 1986, LBO occurred during the third quarter of Revco's fiscal year 1987.

Before the buyout, Revco was one of the nation's largest discount drugstore chains with 2,031 drugstores in 30 states at the end of fiscal year 1986. Although Revco had diversified into nondrug businesses, the majority of its sales originated from its core drugstore business. About 90 percent of fiscal year 1986 net sales was attributable to the drugstore division. Of the remaining 10 percent, 5 percent was from Odd Lot Trading Co., a wholesaler and retailer of close-out merchandise that Revco had acquired in 1984, and the other 5 percent from Revco's manufacturing and other nonretail divisions.

Investor Group

Revco was purchased by an investor group through a holding company. The investor group consisted of three parties:

(1) Management investors—composed of 33 officers and key employees of the company, including Revco's top two executives, Sidney Dworkin, Chief Executive Officer and Chairman of the Board, and William B. Edwards, Chief Operating Officer and President.

(2) Transcontinental Services Group N.V.—a Netherlands Antilles corporation formed in 1982 and an investment holding company that is generally engaged in making special situation investments, principally in the United States.

(3) Golenberg & Co.—an Ohio corporation, formed in 1978, engaged in the investment banking business.

Anac Holding Corporation is the holding company formed in 1986 by certain members of the management investors, through which the acquisition of Revco was effected. Because the investor group included members of Revco's existing management, the LBO is also referred to as a management buyout.

Summary Statistics of Revco's LBO

According to the examiner's final report, management was motivated to participate in an LBO of Revco because of fears that the company's depressed stock price made it susceptible to a takeover. Summary information about the Revco LBO is included in table III.1.

Table III.1: Summary Statistics of Revco LBO

Purchase price: (aggregate)	$1.45 billion
Outcome:	Initial offer, submitted March 11, 1986, equivalent to $36 a share of cash and equity, rejected. Subsequent merger agreement accepted August 15, 1986, equal to $38.50 a share, all cash; LBO effective December 29, 1986.
Investment advisers:	Revco—Goldman, Sachs & Co. Anac—Salomon Brothers, Inc.; Golenberg & Co.; TSG Holdings Inc.[a]

[a]TSG Holdings Inc. is a wholly owned subsidiary of Transcontinental, a member of the investor group. TSG provides management services to Transcontinental and those businesses in which Transcontinental or its affiliates have a direct or indirect interest.

Source: GAO analysis based on company data filed with SEC.

Stockholder Premium

During fiscal years 1984 and 1985, Revco's common stock traded between $24.00 and $37.50, and $22.50 and $32.88, respectively. During the first three quarters of fiscal year 1986, before delivery of the initial proposal in the fourth quarter, the market price of Revco's common stock ranged between $23.13 and $29.50. The final purchase price of $38.50 per share provided Revco's stockholders a premium[3] of 36 percent—almost 9 percent higher than what stockholders would have received if the initial offer had been accepted. To reflect the stock value before the LBO may have influenced it, the premium was based on the difference from the closing stock price of $28.25 per share on February 11, 1986, 1 month before the delivery date of the initial offer.

Financing

The financing of Revco's LBO was composed of senior debt,[4] subordinated debt,[5] and equity[6] investment. The senior debt, provided by a syndicate of 11 banks, was secured by the company's assets. The subordinated debt consisted of 13.125-percent senior subordinated notes due in 1994, 13.30-percent subordinated notes due in 1996, and 13.30-percent junior

[3]Premium is the amount, which we express as a percent, by which the offered price per share exceeds the market price per share on a specific date.

[4]Senior debt is generally provided by commercial banks. The amount available is influenced by projected cash flow and, if secured, by the collateral value of the acquired business's assets. It is considered senior because it has higher priority with respect to repayment than other types of outstanding debt.

[5]Subordinated debt instruments require that, in the event of liquidation, repayment of principal may not be made until another debt instrument senior to it has been repaid in full.

[6]Equity represents the ownership interest in a company of holders of its common and preferred stock.

subordinated notes[7] due in 2001 that were issued in a public offering underwritten by Salomon Brothers. The notes were unsecured obligations, and interest on all three was due semiannually—June 15 and December 15, with the first payment due on June 15, 1987, about 6 months after the effective date of the buyout.

The third part of the financing, the equity investment,[8] was made up of three types of redeemable preferred stock— convertible,[9] exchangeable,[10] and junior,[11] of which the exchangeable was issued publicly—and common stock, which the investor group and Salomon Brothers purchased.[12] The cash generated from these sources and applied to the aggregate purchase price of $1.45 billion is shown in table III.2.

[7]The junior subordinated notes were issued as part of 93,750 units—each consisting of one 13.3-percent junior subordinated note in the principal amount of $1,000, 4 shares of Anac common stock, and 4 common stock puts. Each put entitles the owner to tender to Anac one share of common stock for mandatory purchase by Anac at the fair market value of the common stock on December 15, 1993.

[8]After the LBO, Revco's common stock was owned entirely by Anac. The equity portion of the financing refers to preferred and common stock issued by Anac. Ownership of Anac's equity provides the holder an indirect equity interest in Revco.

[9]The convertible preferred stock entitles holders to convert their preferred stock into common stock in connection with any merger of Anac with or sale of its property and assets to any entity. The convertible preferred stock is convertible into an aggregate of 29 percent, on a fully diluted basis, of Anac common stock and contains antidilution provisions.

[10]The exchangeable preferred stock entitles holders to exchange their shares of preferred stock, at Anac's option, into subordinated notes of Anac at any time on or after December 15, 1988.

[11]The junior preferred stock has no conversion or exchange features. In the event of liquidation, holders have a claim on the assets available for distribution after payments to creditors and holders of convertible and exchangeable preferred stock.

[12]Common stock was also sold publicly as part of the units in which the junior subordinated notes were issued—see footnote 7.

Table III.2: Financing Sources for Revco LBO (Dollars in Millions)

	Amount	Percent
Proceeds from public offering of subordinated debt ($703,750) and exchangeable preferred stock ($130,020)	$833,770	58
Term loan from bank syndicate[a]	455,000	31
Issuance of Anac common stock ($29,538 invested by investor group)	34,381	2
Issuance of convertible preferred stock	85,000	6
Issuance of junior preferred stock	30,098	2
Revco cash	10,655	1
Total	**$1,448,904**	**100**

[a]An aggregate amount of $567 million was borrowed from the bank syndicate, of which $455 million was applied toward the purchase price. The remaining $112 million was placed into a revolving credit facility intended to finance any direct loans or letters of credit Revco needed in its ongoing operations after the LBO.

Source: GAO analysis based on company data filed with SEC.

The amount invested by the investor group, through purchasing Anac common stock, was very small in relation to the purchase price—only about 2 percent. Similarly, the management investors' investment was only about 1 percent of the total purchase price. The majority of the purchase price, about 80 percent, was composed of the senior debt term loan (about 31 percent) and subordinated debt (49 percent), with equity investment providing about 19 percent and Revco's cash about 1 percent.

Fees and Costs Paid in Connection With the LBO

According to Revco's proxy, dated November 14, 1986, an estimated $78 million in fees and costs were anticipated in connection with Revco's LBO and were to be paid by either Anac or Revco. However, based on the examiner's final report, approximately $86.9 million of fees and expenses related to the LBO were actually paid by Anac or Revco—$8.9 million more than that estimated before the LBO. These fees were about 6.0 percent of the aggregate purchase price.

Fees for financial advisory services provided by the four advisers involved in the LBO were payable upon consummation of the merger. The investment bank representing pre-LBO Revco received a $1 million fee up front. Anac's three advisers provided additional services, including underwriting,[13] private placement of debt,[14] and management and financial consulting. Based on the examiner's report, fees paid for various services are

- $3.0 million to Goldman, Sachs & Co. for financial advisory services provided to Revco's Board of Directors and Special Independent Committee and for preparing fairness opinion (includes $1 million fee paid up front).
- $38.8 million to Salomon Brothers, Inc., for financial advisory services provided to Anac, for underwriting publicly issued subordinated debt and exchangeable preferred stock, and for private placement of convertible preferred stock.
- $6.0 million to Golenberg & Co. for financial advisory services provided to Anac.
- $0.6 million to TSG Holdings Inc. for assisting Anac in structuring the merger and related transactions. TSG was also contracted to provide post-LBO Revco management, consulting, and financial services for an annual fee of $300,000.
- $7.8 million for legal and accounting services.
- $28.0 million for bank commitment and other fees. ($20.4 million, or about 73 percent, was paid to the agent banks, Wells Fargo Bank and Marine Midland Bank.)
- $0.8 million for other professional services.
- $1.7 million for miscellaneous expenses.

In addition to the services listed here, Salomon Brothers, Inc., and Golenberg & Co. also participated in the LBO as merchant bankers[15] by attaining an indirect equity stake in post-LBO Revco through purchasing equity of Anac. Salomon Brothers purchased about $11 million worth of Anac common stock and junior preferred stock giving the investment bank 9.3 percent of Anac common stock, assuming conversion of convertible preferred stock. Golenberg & Co. purchased about $520,950 of Anac common stock giving it a 1-percent equity stake in Anac's common stock, assuming conversion of convertible preferred stock.

[13]An underwriter acts as a middleman between a corporation issuing new securities and the public by purchasing the securities from the issuer and reselling them in a public offering.

[14]Private placement is the distribution of securities that have not been registered with SEC. Regulations restrict the distribution of such unregistered securities to a limited number of purchasers who all have a demonstrated ability to evaluate the merits and risks of the security.

[15]In merchant banking, investment bankers assume an equity stake in the surviving corporation of an acquisition through directly or indirectly purchasing preferred or common stock.

Impact of LBO on Revco

Various factors contributed to Revco declaring bankruptcy after the buyout, the most important being Revco's failure to (1) successfully reduce its increased debt through internally generated cash flow, asset divestitures, and inventory reduction and (2) achieve projected operating results. Management turnover and eroding trade credit placed further strain on the company, and capital expenditures were restricted. As Revco's performance deteriorated, bondholders also suffered as the value of their holdings decreased. On July 28, 1988, 19 months after the LBO, Revco filed for protection from its creditors under Chapter 11 of the bankruptcy code.

Revco's Capitalization Became Primarily Debt After LBO

The LBO had a significant impact on Revco's capitalization.[16] Specifically, Revco's long-term debt, including the portion currently due, nearly quadrupled from $309 million at the end of fiscal year 1986 to about $1.3 billion at the end of fiscal year 1987, and its total common stockholders' equity went from $393 million at the end of fiscal year 1986 to a deficit of about $20 million at the end of fiscal year 1987. The deficit, which represents the period of time since the LBO—December 30, 1986, through May 30, 1987—was due to the net loss and dividend obligations Revco had at the end of fiscal year 1987.

According to the prospectus, although management did not project the deficit in common stockholders' equity, they had expected the most significant effect of the buyout to be on Revco's capitalization. Specifically, on August 23, 1986, before the LBO, Revco had a ratio of long-term debt (including the current portion) to total capitalization of 44 percent, which means that more than half of Revco's capitalization came from invested capital. Assuming that the buyout and the financing had occurred on August 23, 1986,[17] management projected the ratio of long-term debt (including the current portion) to total capitalization to increase to 83 percent, making borrowed funds the largest source of capital.

[16]Capitalization is the total value of a corporation's long-term debt and preferred and common stock accounts.

[17]Based on pro forma financial statements which are projected financial statements embodying a set of assumptions about a company's future performance and funding requirements. The statements, included in the December 18, 1986, prospectus, were prepared as if the buyout had occurred on August 23, 1986.

Cash Flow From Operations Deteriorated After LBO

Cash flow from operations represents the net inflow or outflow of cash during a period resulting from the operating activities of a company. It focuses on the liquidity aspect of operations and when related to debt service can provide an indication of a company's ability to service its debt through internally generated cash. Despite finding, on a pro forma[18] basis for fiscal year 1986, that Anac's earnings before income taxes and fixed charges[19] were inadequate to cover fixed charges resulting from the debt incurred in financing the LBO, management expected Revco's cash flow from operations to be sufficient on an annual basis to meet post-LBO debt obligations. According to the prospectus, management based its expectation on the revenues and operating profits it projected Revco would generate after taking into account the divestiture program and the expected continued growth in the drugstore division's sales.

However, after the LBO, Revco's cash flow situation deteriorated. According to the Revco examiner's final report, concerns about cash flow existed immediately after the LBO as evidenced in a January 2, 1987, memorandum from Revco's treasurer, which stated:

> "I am very concerned about cash flow since the sales for the past six weeks have been poor resulting in approximately $30 million less cash flow. It will be very difficult to make up this loss of funds. In fact, we have no excess cash going forward."

Furthermore, because of higher interest costs and reduced profitability of operations, Revco's cash flow from operations declined significantly during fiscal year 1988, the first full year after the buyout, to a net outflow of $57.3 million. As a result of its bankruptcy filing, Revco's liquidity position during fiscal year 1989 improved dramatically because of the deferral of about $309.9 million in operating cash requirements. Excluding these cash requirements, Revco's cash flow from operations provided a net inflow of about $15.2 million at the end of fiscal year 1989. If Revco had not filed for Chapter 11 protection, it would have had a net outflow of cash used in operations of about $294.7 million at the end of fiscal year 1989. The decline in operating cash flow contributed to Revco's inability to service its debt.

[18]The pro forma results of operations are based on the assumption that the acquisition and merger and related financing occurred at the beginning of the fiscal year presented.

[19]Fixed charges consist of interest expense, amortization of deferred financing costs, amortization of discount on junior subordinated notes, and a portion of operating lease rental expense representative of the interest factor.

Proceeds From Asset Divestiture Program Below Expectations

Management established an asset divestiture program that initially included about 100 drugstores and substantially all of Revco's nonretail drugstore subsidiaries, except its close-out subsidiary, Odd Lot Trading Co. The proceeds from the asset sales were to reduce the senior debt term loan. The provisions of the term loan required the program to generate $255 million in proceeds by the second quarter of fiscal year 1989 (November 1988), all of which would be applied to reducing the loan.

According to the examiner's final report, sales under the asset divestiture program did not proceed as originally projected. For example, two subsidiaries were to be sold before the LBO with part of the proceeds being used to pay the merger consideration due stockholders. Neither sale was closed before the LBO was effected. Furthermore, as early as March 31, 1987, 3 months after the LBO, the examiner reported that management was having doubts as to whether asset sales would be able to generate enough proceeds to make a prepayment on the term loan due in May.

During fiscal year 1988, management revised its expectations of the program's total proceeds and projected they would fall short of the targeted $255 million. By the end of fiscal year 1988, before Revco filed for Chapter 11 protection, the program was substantially complete and the total amount of funds generated and applied toward reducing the term loan was $197 million—$58 million short of the amount required. At that point, the assets remaining to be divested consisted primarily of certain drugstores and Odd Lot. Management had initially excluded Odd Lot from the program on the condition that it continue to pass various financial tests and earnings levels. The divestiture of Revco's subsidiary operations was completed in the second quarter of fiscal year 1990, more than a year after Revco declared bankruptcy. According to the examiner's final report, total proceeds generated from Revco's asset divestitures were $231 million—$23.8 million short of what was required by the term loan agreement.

Inventory Reduction Created Unanticipated Problems

Management ran an inventory reduction program from March 1987 through July 1987 called "Operation Clean Sweep." It was intended to permanently reduce drugstore inventory levels and eliminate unwanted, outdated, slower selling merchandise that was not part of Revco's core drugstore business. According to the examiner's final report, the inventory targeted for elimination included television sets, video cassette recorders, microwave ovens, gas grills, and knockdown furniture. Revco had begun stocking these items in 1985 and 1986, before the LBO, hoping they would generate high margins. However, the examiner reported that over a 2-year period the items had not been selling.

According to Revco's fiscal year 1988 annual report, the inventory reduction program accomplished its goal of reducing inventory but created two major unanticipated problems during fiscal year 1988. First, although it reduced inventory levels, Revco failed to restock with appropriate amounts of normal selling merchandise. As a result, the company had to undertake a significant replenishment of inventories during the first quarter of fiscal year 1988. According to the company's annual report, the inventory purchased caused significant imbalances between product categories.

Second, the inventory reduction program triggered a covenant in Revco's term loan agreement regarding the application of excess cash flow. As a result, Revco had to pay $39.2 million toward the bank loan shortly after the end of fiscal year 1987. According to the Revco examiner's final report, the payment left Revco with depleted inventory and insufficient cash to replenish its inventory.

Revco's inventory problems continued to snowball during fiscal year 1988. Revco needed to generate enough funds not only to deal with its inventory imbalances but also to meet both inventory requirements for the 1987 Christmas season and an interest payment on its subordinated debt due December 15, 1987. The company's cash and short-term borrowing ability were insufficient to satisfy all its obligations, and in spite of securing a $30 million overline on its revolving bank credit, its 1987 Christmas inventory suffered. Inadequate inventory levels of some product lines existed, while others had to be marked down to be sold.

Because we did not talk with Revco officials, we could not determine why the adverse effects of Operation Clean Sweep were unanticipated. However, according to the examiner's final report, several parties in interest cited improper implementation by senior management, including inadequate monitoring or supervising of store managers, and insufficient training of store managers with respect to inventory control as two factors contributing to Revco's post-LBO inventory reduction efforts.

Projections Were Not Achieved

Before the LBO, certain members of Revco's management—included among the management investors—prepared projections of Revco's future operations and provided them to the investor group and prospective lenders interested in participating in the acquisition of Revco. Management's projections assumed an annual increase in net sales of 12 percent and operating profit before depreciation as a percentage of sales of 7.7 percent for fiscal years 1988 through 1991. Underlying the projected sales increases was an assumption that existing stores would increase their sales and new stores would be added at a rate that would add about 10 percent additional retail space each year.

According to the examiner's final report, the projections were based on management's expectations that substantial improvements in Revco's sales and margins would be achieved. Specifically, despite poor operating results for fiscal years 1985 and 1986, according to the prospectus, management expected Revco to perform at the same levels it did during the 10 fiscal years before fiscal year 1985, when net sales grew at a compound annual rate of 19 percent and net earnings grew 23 percent a year. Management did not think Revco's poor performance in fiscal years 1985 and 1986 was indicative of the results it would achieve in 1987 and beyond but instead attributed the results to various extraordinary events that were considered to be nonrecurring.

Even before the LBO was closed, Revco was unable to meet its own financial projections. For example, after receiving disappointing first quarter results for fiscal year 1987, management revised its initial projections downward. However, the examiner's final report pointed out that management adjusted projections downward for only the first half of 1987—projections for the latter half of 1987 and the growth assumptions underlying those projections remained unchanged. Furthermore, although Revco's second quarter results for fiscal year 1987 also fell short of management's original projections, no further revisions in the projections or growth assumptions were made, even though the results were announced more than 2 weeks before the buyout was closed.

After the LBO, Revco did not achieve its projections for fiscal year 1987 or the growth assumptions management made for fiscal years 1988 through 1991. Specifically, the examiner reported that Revco's fiscal year 1987 operating income was almost 30 percent below its revised projections, and, on the basis of the company's annual reports for fiscal years 1988 through 1990, we calculated that annual increases in Revco's net sales were 4 percent or less, operating profit before depreciation as a percentage of sales was below 7.7 percent each year, and gross retail footage declined each year.[20] According to Revco's fiscal year 1989 annual report, the company's inability to achieve projected operating results was a major factor in its Chapter 11 filing.

Corporate Control Changed After LBO

After the LBO, corporate control at Revco underwent many changes, including an increased equity stake by the management investors and heavy turnover among executive officers. As of October 31, 1986, before the LBO, the management investors owned about 3.1 percent of Revco's outstanding common stock. After purchasing about $10.2 million in Anac common stock in the buyout,[21] the management investors owned about 19.5 percent of the total voting capital stock of Anac, on a fully diluted basis.[22]

According to the examiner's final report, significant concerns about the ability of Revco's pre-LBO management to successfully run the company in a highly leveraged environment were developing before the closing of the deal. For example, the banks that organized the senior debt expressed doubt as to whether Revco's pre-LBO chief executive officer (CEO) was capable of operating the company on a daily basis when it had such a heavy debt burden. The examiner reported that Anac's financial adviser indicated to the banks that the daily management responsibilities of the pre-LBO CEO would be significantly diminished after the LBO. In fact, 3 months after the deal was closed, a new CEO was named.

During fiscal year 1988, the first full year after the buyout, Revco's management team changed significantly due, in part, to the board's election of another CEO in October 1987, 7 months after the initial change in

[20]Changes in the accounting method used and the exclusion of operating results of units to be divested make Revco's post-LBO data incomparable to its historical results of operations. To enhance comparability of pre- and post-LBO data, Revco prepared unaudited pro forma statements, which assumed the merger and divestiture program were completed at the beginning of fiscal year 1987. Subsequent to fiscal year 1988—after the Chapter 11 filing—management changed the drugstores to be divested. In order for pre- and post-filing data to be comparable, Revco made unaudited pro forma adjustments to fiscal years 1987 and 1988. During fiscal year 1990, management announced it would be selling over 700 drugstores. Operating results of these stores were excluded from the company's fourth quarter operating results for fiscal year 1990. Thus, to enhance comparability between fiscal year 1990 and previous years, Revco prepared pro forma financial statements for fiscal years 1988 through 1990. We used pro forma data when comparing changes between years.

[21]The management investors purchased Anac common stock for $6.946 a share, the same price paid by other investors. According to the Revco examiner's final report, the management investors paid an aggregate in cash of about $756,000, issued promissory notes of about $200,000, and transferred 238,867 shares of old Revco common stock.

[22]Fully diluted basis assumes conversion of convertible preferred stock into Anac common stock but does not assume the grant or exercise of any employee stock options to purchase Anac common stock.

this position. Attempting to improve Revco's performance, the new CEO essentially installed a new management team: only 7 of the 22 fiscal year 1987 officers remained at the end of fiscal year 1988 and 12 new officers were hired. As a result of the high turnover, the number of executive officers that had been employed with the company for over 5 years was significantly less than before the buyout—about one-third of fiscal year 1988 officers had been with Revco for over 5 years compared with 90 percent of the officers during fiscal year 1986, before the LBO. Because we did not talk with Revco officials, we could not determine the effect that the high turnover in management had on Revco's operations and the business decisions being made.

Vendor Confidence Declined, Leading to Erosion of Trade Credit

During fiscal year 1988, as Revco's financial situation and ability to service its debt worsened, vendors' confidence in Revco's ability to meet its obligations began to decline. It became increasingly difficult for the company to buy on credit from some of its vendors, who began demanding cash-on-delivery. The erosion of trade credit placed additional strain on Revco's ability to deal with its inventory problems because it further exacerbated Revco's lack of funds for restocking shelves with needed, saleable merchandise. Revco subsequently filed for Chapter 11 protection.

According to the Chairman of the Trade Creditors Committee—the committee that represents Revco's vendors in the Chapter 11 proceedings—almost all of Revco's vendors interrupted shipments of merchandise from the date of the filing, July 28, 1988, until August 24, 1988, when Revco's debtor-in-possession (D-I-P) financing[23] was approved. The Chairman explained that this time frame had been critical because Revco had no financing in place, and consequently vendors had no confidence that they would be paid. The combination of eroding credit and vendors' refusal to ship merchandise created significant out-of-stock conditions that led to a deterioration in customer confidence.

According to the Chairman, the D-I-P financing was instrumental in restoring vendor confidence because of its unique terms. The terms granted more security to vendors than is usual under the bankruptcy code, in which vendors are generally unsecured lenders. Specifically, vendors who extended customary payment terms to Revco after the filing date were given a "super-priority lien," which gave them the same

[23]The D-I-P financing was a $145 million line of credit provided by a syndicate of banks for Revco's use in continuing its operations while in bankruptcy.

level of security as the banks providing the funds. Thus, if Revco could not make post-filing payments, those vendors had the same claim on Revco's assets as the banks. Revco's fiscal year 1990 annual report credits the D-I-P financing with enabling the company to begin restoring vendor support, improving its out-of-stock condition, and restoring customer confidence.

Capital Spending Restricted After LBO

After the LBO, Revco's capital expenditures were reduced because of restrictions in the senior debt credit agreement. Specifically, capital expenditures were limited to $37.5 million in fiscal year 1987 and to a maximum of $30 million annually thereafter. This was much less than before the buyout when, from fiscal year 1981 to fiscal year 1986, Revco's capital expenditures had been about $48 million, $45 million, $32 million, $58 million, $90 million, and $96 million, respectively. Management did not anticipate that the restrictions would adversely affect Revco's efforts to maintain and modernize its drugstore division, because significant levels of expenditures and improvements had been made since 1981. For example, at the end of fiscal year 1986, management estimated that approximately 75 percent of all Revco's pre-LBO drugstores were either new or had been remodeled within the past 5 years.

Because we did not talk with Revco officials, it is difficult to determine whether the restrictions impeded the company's modernization efforts. However, it appears that Revco was unable to complete its modernization program during 1988 as it had indicated it would in its 1987 annual report. The program, which included remodeling existing stores to adopt major aspects of a new store prototype, was still ongoing at the end of 1988 but had become subject to the company's overall reorganization process. Furthermore, contrary to Revco's pre-LBO goal of expanding drugstore operations through opening or acquiring 100 drugstores a year for the next 5 years,[24] there was a net decline of 91 drugstores at the end of fiscal year 1988, 2 months before Revco filed for Chapter 11 protection.

[24]Proxy (Nov. 14, 1986), p. 44.

Bond Values Declined as Revco's Performance Deteriorated

Revco has five bond issues outstanding, two of which were issued before the LBO. Under the provisions of the two pre-LBO bonds, Revco could not secure the senior debt financing without equally and ratably securing[25] these bonds. To satisfy the provisions, Revco modified the terms of one of the bond series—after obtaining consent from at least two-thirds of the bondholders—so that in lieu of receiving equal and ratable security, holders of the bond received a flat payment and a 1-percent increase in the bond's interest rate. Holders of the other pre-LBO bond were granted equal and ratable security in the collateral with the banks: a lien and security interest in substantially all of Revco's assets. The other three bonds were issued as part of the LBO financing and were unsecured obligations of Revco. As Revco's performance deteriorated after the LBO, the value of its bonds similarly declined as evidenced by Moody's Investors Service downgrading[26] in their investment ratings and their diminished prices.

Before the LBO, Moody's downgraded the investment ratings on Revco's pre-LBO bonds from A3 to B1, indicating that the bonds' investment risk had increased and that they now provided less assurance that interest and principal payments would be paid in the future. The downgrading of these ratings before the LBO illustrates the adverse effects pre-LBO bondholders may have when a buyout is pending that will add riskier levels of high-interest, low-rated debt.

After the buyout, investment ratings on all five bonds were downgraded toward the end of fiscal year 1988, as indicated in table III.3.

[25]Equally and ratably secured means that after securing the new debt, already existing debt must continue to have the same proportion of collateral it had before the new debt was secured.

[26]The purpose of Moody's ratings is to provide the investors with a simple system of gradation by which the relative investment qualities of bonds may be noted. Gradations of investment quality are indicated by rating symbols, each symbol representing a group in which the quality characteristics are broadly the same. There are nine symbols as shown below, from that used to designate least investment risk (highest investment quality) to that denoting greatest investment risk (lowest investment quality): (1) Aaa, Aa, A; (2) Baa, Ba, B; and (3) Caa, Ca, C.

Moody's applies numerical modifiers, 1, 2, and 3, in each generic rating classification from Aa through B in its corporate bond rating system. The modifier 1 indicates that the security ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates that the issue ranks in the lower end of its generic rating category.

Table III.3: Investment Ratings for Revco Bonds

	Date				
	10/86	11/86	04/88	06/88	07/88
Pre-LBO					
11.75-percent sinking fund debentures due in 2015	A3	B1	B3	Caa	Ca
11.125-percent notes due in 1995[a]	A3	B1	B3	Ca	Ca
Post-LBO					
13.125-percent senior subordinated notes due in 1994	[b]	B2[c]	Caa	Ca	Ca
13.30-percent subordinated notes due in 1996	[b]	B2[c]	Caa	Ca	Ca
13.30-percent junior subordinated notes due in 2001	[b]	B3[c]	Caa	Ca	Ca

Note: Dates selected reflect all rating changes by Moody's from January 1986 to December 1990.

[a]Interest rate increased to 12.125 percent after the LBO as part of modifications made to the bond's terms to allow the senior debt financing to be secured.

[b]Ratings were not yet assigned for post-LBO bonds.

[c]Per examiner's final report, rating assigned by Moody's Speculative Grade Service on November 20, 1986.

Source: Moody's Bond Record.

Moody's revised Revco's bond ratings at times that generally corresponded to periods of stress within the company and where Revco's credit became more questionable. For example, ratings were downgraded for all five bonds in both April and June 1988, when Revco was having difficulty servicing its debt. Revco announced in April that it might not make its June 15th interest payment, then was unsuccessful in attempts to restructure its debt, and finally failed to make the June 15th interest payment. As of July 1988, the month Revco filed for Chapter 11 protection, all of its bonds had been downgraded to Ca. Moody's generally assigns this rating to bonds that are in default or have marked shortcomings indicating they are speculative to a high degree. As of June 1991, the Ca rating had not been revised and still represented Moody's assessment of the investment quality of Revco's bonds.

All five bonds were originally sold at par[27] except for one pre-LBO bond, which was sold slightly below. As Revco's performance deteriorated after the LBO, the prices of its bonds—especially those issued to finance the LBO—also declined. Table III.4 illustrates the price changes.

[27]Par is the redemption value of a bond that appears on the face of the bond certificate, unless that value is otherwise specified. The 93,750 units through which the junior subordinated notes were issued were sold for $1,000 each.

Table III.4: Revco's Bond Prices (Prices Are Rounded)

	Date					
	12/87	04/88	06/88	12/88	12/89	12/90
Pre-LBO bonds						
11.75-percent sinking fund debentures due in 2015	$850	[a]	[a]	[a]	$850	$600
11.125-percent notes due in 1995[b]	870	$790	$790	$650	700	710
Post-LBO bonds						
13.125-percent senior subordinated notes due in 1994	[c]	590	530	500	420	110
13.30-percent subordinated notes due in 1996	[c]	[a]	[a]	[a]	[a]	—[d]
13.30-percent junior subordinated notes due in 2001	[c]	440	320	160	80	30

Note: Except for the period of time right before filing for Chapter 11 protection, when Revco was having difficulty servicing its debt, dates selected reflect year-end bond prices. All bonds have a $1,000 face value.

[a]No price was listed in Moody's Bond Record.

[b]Interest rate increased to 12.125 percent after the LBO as part of modifications made to the bond's terms to allow the senior debt financing to be secured.

[c]Subordinated bonds were not listed in Moody's Bond Record at this point.

[d]According to Moody's officials, — indicates that either no data were available or the bond was not trading.

Source: Moody's Bond Record.

Unable to Service Its Debt, Revco Filed for Chapter 11 Protection

Inadequate proceeds from the asset divestiture program, continuing inventory problems, eroding trade credit, and inability to borrow funds from the revolving credit facility or to achieve projected operating results led Revco to announce in April 1988 that it might not be able to meet pending debt obligations. The company hired Drexel Burnham Lambert Inc. to help restructure its debt through a debt-for-equity swap. Their efforts were not successful, and as discussed, Revco was unable to make its June 15th interest payment of $46.5 million on its subordinated debt. Afterwards, holders of more than 25 percent of the senior subordinated notes informed the company of their intention to accelerate the maturity date on the principal amount of $400 million. The percentage of notes involved was high enough that the entire issue would have been accelerated. This, combined with the existing problems listed above, caused Revco to file for Chapter 11 protection under the bankruptcy code on July 28, 1988.

As of the date Revco filed for Chapter 11 protection, substantially all of its pre-filing secured and unsecured debt was deferred while the company continued to operate its business as a D-I-P. Operating as a D-I-P means the company cannot engage in transactions outside the ordinary course of business without first complying with the bankruptcy code and, when necessary, obtaining bankruptcy court approval. Until the bankruptcy court approves a plan of reorganization, Revco does not have to meet scheduled principal payments on senior debt or pay interest expense on unsecured debt after the filing date.

By May 19, 1989, Revco had received about 7,800 proofs of claims from creditors. Although numerous claims did not specify the amount claimed, those that did totalled approximately $9.3 billion. According to its 1989 annual report, the company thought this overstated its liabilities and was an unreliable estimate because creditors had filed duplicate and unrealistic claims. Revco is now reconciling claims that differ from its records and is evaluating them to determine which are likely to be allowed by the bankruptcy court. At the end of June 1990, Revco had paid about $11.6 million of allowed claims, pursuant to an order of the bankruptcy court dated August 13, 1989.[28]

Financial Indicators of Revco's Performance After the LBO

After the LBO, Revco's performance deteriorated rapidly until the company was forced to file for Chapter 11 protection from its creditors. Revco's changing financial position is reflected by changes in the company's debt-to-equity ratios, ability to service debt, and profitability.

Revco's Debt Burden Increased Significantly After LBO

Changes in a company's debt burden are reflected by ratios of its debt to total common stockholders' equity (hereafter we refer to total common stockholders' equity as equity). After the LBO, Revco's debt increased significantly with respect to its equity, which actually was negative only 5 months after the buyout due to a net loss and dividend obligations on redeemable preferred stock. As Revco continued to report losses and its dividend obligations accumulated, the deficit in equity increased each fiscal year after the buyout.

Because Revco's equity was negative after the buyout, calculating ratios of debt to equity is meaningless. However, Revco had prepared debt-to-equity ratios before the buyout reflecting how it expected the debt burden to change. Specifically, on August 23, 1986, Revco's total debt-

[28]The order authorized Revco to enter into stipulations providing for the payment of up to 50 percent of allowed reclamation claims. As part of the stipulations, reclaiming vendors had to give Revco "most favored nation" credit terms.

to-equity ratio was 1.6 to 1 and its long-term (including the current portion) debt-to-equity ratio was 0.8 to 1. Assuming that the buyout and financing had occurred on this date, these ratios[29] increase to 5.7 to 1 and 4.8 to 1, respectively.

Revco's Ability to Service Debt Declined

To illustrate Revco's increasing difficulty in servicing its debt after the LBO we calculated an interest coverage ratio and two measures of liquidity: current ratio and quick ratio.

Cash Flow From Operations Unable to Cover Interest Expense

An indication of Revco's ability to service its debt is reflected by its ability to cover interest costs with cash generated internally from operations—its interest coverage ratio. A ratio of less than one indicates cash flow coverage is inadequate.

As indicated in table III.5, Revco's interest expense increased tremendously after the buyout, reaching $146.7 million in fiscal year 1988, before the company filed for bankruptcy. On the basis of its interest coverage ratio, Revco was able to cover interest costs incurred immediately after the buyout, from December 30, 1986, to May 30, 1987. However, during fiscal year 1988, the first full year after the LBO, Revco's interest coverage fell below 1, indicating that it could not cover its interest obligations with internally generated cash.

As a result of Revco's filing for Chapter 11 protection, its interest coverage ratio improved during fiscal year 1989. Specifically, until approval of a reorganization plan, some of its operating cash requirements were deferred, and it no longer had to pay or accrue interest on its unsecured debt. Consequently, this ratio excludes about $309.9 million in operating cash requirements and about $84.1 million of interest on unsecured debt.

[29] After accounting for the buyout and related financing, equity consisted of redeemable preferred stock and common stockholders' equity.

Table III.5: Interest Coverage (Dollars in Millions)

	Fiscal year 1986[a]	06/01/86 to 12/29/86[a]	12/30/86 to 05/30/87	Fiscal year 1988	Fiscal year 1989
Interest expense	$29.0	$19.4	$64.7	$146.7	$70.1[b]
Cash flow from operations (before interest)/interest expense (ratio)	5.5	1.5	1.9	0.6	1.0

[a]Data are not comparable to post-LBO data because of changes in accounting method and exclusion of operating results of those assets to be divested after the LBO. They are presented as an indication of Revco's operating results before the LBO.

[b]Excludes about $84.1 million of interest on unsecured debt due to Chapter 11 filing.

Source: GAO analysis based on company data filed with SEC.

Short-Term Liquidity Declined

An indication of a company's liquidity, or its ability to meet short-term obligations, is shown by the current and quick ratios. The current ratio compares the level of current assets to current liabilities, while the quick ratio includes only cash, marketable securities, and receivables as current assets to provide a more immediate measure of a company's short-term debt-paying ability.

Revco's current ratio declined after the LBO. However, in comparison to the industry[30] it was not noticeably low until the end of fiscal year 1988, when it fell below 1 indicating that the company could not meet currently maturing obligations with current assets. In contrast, Revco's quick ratio actually increased from fiscal year 1986 to fiscal year 1987 before falling below that of the industry in fiscal year 1988. The increase in the quick ratio was due, in part, to the classification of assets of operations to be divested as current. The dramatic decline in both ratios from fiscal year 1987 to fiscal year 1988 was due in part to the classification of all long-term debt as a current liability. After Revco filed for bankruptcy early in fiscal year 1989, its liquidity position improved dramatically because it deferred much of its pre-filing obligations and reclassified long-term debt as a noncurrent liability. Table III.6 illustrates changes in Revco's liquidity ratios.

[30]Industry ratios were obtained from an on-line database produced by Media General Financial Services, Inc. The industry data were compiled as of June 22, 1990, based on 13 companies whose primary line of business was classified under the same Standard Industrial Classification (SIC) code as Revco. The SIC code indicates a company's primary line of business.

Table III.6: Liquidity Ratios

	1986[a]	1987	1988	1989
Current ratio				
Revco (fiscal year)	2.5	1.9	0.4	2.7
Industry (calendar year)	1.7	1.6	1.4	1.4
Quick ratio				
Revco (fiscal year)	0.5	0.9	0.1	0.3
Industry (calendar year)	0.4	0.4	0.3	0.4

[a]Revco data are not comparable to post-LBO data because of changes in accounting method and the exclusion of operating results of those assets to be divested after the buyout. They are presented as an indication of Revco's operating results before the buyout.

Sources: GAO analysis based on company data filed with SEC and industry data produced by Media General Financial Services, Inc. Industry data were compiled as of June 22, 1990, based on 13 companies whose primary line of business was classified under the same SIC code as Revco. The SIC code indicates a company's primary line of business.

Revco's Profitability Fell After the LBO

After the LBO, Revco's profitability declined as indicated in table III.7 by the negative trend in net income, stockholders' equity, and earnings before interest expense and income taxes. Revco reported a net loss and a deficit in stockholders' equity every fiscal year since the LBO. Earnings before interest expense and income taxes, which had been declining since the buyout, were negative in fiscal year 1989, indicating the company was operating at a loss before interest expense was taken into account. Previously, when earnings before interest expense and income taxes had been positive and Revco had reported a net loss, interest expense had triggered the loss. As a result of the net losses and deficit in stockholders' equity, Revco had no profit margin and no return on equity[31] after the buyout.

[31]Return on equity represents the interests of Anac's equity holders because all of Revco's common stock is owned by Anac.

Table III.7: Indicators of Revco's Declining Profitability (Dollars in Millions)

	Fiscal year			
	1986[a] (52 weeks)	1987 (52 weeks)	1988 (52 weeks)	1989 (53 weeks)
Earnings before interest and taxes	125.3	72.6[b]	21.5	(69.4)
Net profit (loss)	56.9	(45.6)[b]	(88.6)	(133.4)
Stockholders' equity[c]	392.5	(20.1)	(161.7)	(314.3)

[a]Data are not comparable to post-LBO data because of changes in accounting method and the exclusion of operating results of those assets to be divested after the buyout. They are presented as an indication of Revco's operating results before the buyout.

[b]Based on pro forma fiscal year 1987 data.

[c]For fiscal years 1987 through 1989, data are based on consolidated financial statements presented on the "Push Down Accounting" basis whereby the equity section of Revco's balance sheet reflects Anac's equity.

Source: GAO analysis based on company data filed with SEC.

Impact of LBO on Communities

We did not attempt to determine the impact of Revco's post-LBO actions on the communities where its drugstores are located because there did not appear to be much potential for Revco's drugstore closings or sales to have had a substantial impact. Specifically, because a drugstore is in the retailing business, which, unlike manufacturing or other industries, generally does not provide the economic foundation of a community, we would not expect a drugstore to be a large part of the economic base of most communities. Furthermore, a drugstore is generally not the predominant employer in most communities but typically employs a small number of people. Consequently, while the closing or sale of a particular store may adversely affect the individuals working there, it is unlikely to have a significant impact on the economy of the community. In addition, Revco is a nationwide drugstore chain with drugstores located in several communities enabling the company to spread out its store closings and sales, thus diluting the impact on any one particular community or area. Further, Revco sold a large number of its drugstores from July 1990 through October 1990, but those stores were purchased by other drugstore companies. After agreeing to either offer employment or consider for employment existing Revco employees, these companies may have absorbed those employees, diminishing any impact that the change in control may have had on the community.

Drugstore Closings and Sales Were Dispersed

From the effective date of the LBO to the end of fiscal year 1990, the number of Revco drugstores fell from 2,086 to 1,853, a net decline of about 11 percent. The closings from the end of fiscal year 1986, before the LBO, to the end of fiscal year 1990 were spread over several states: Revco closed 10 or more drugstores in only 8 states, and in all other states that experienced a net decline in the number of Revco drugstores, Revco closed 6 or fewer stores. In addition, the number of states with Revco drugstores declined by 3—from 30 to 27—and these 3 had a total of only 4 drugstores. Since the end of Revco's fiscal year 1990, the company has sold over 700 stores in 19 states. The sales, which began in July 1990, were completed by October 10, 1990, and left the company with about 1,140 stores in 10 eastern states.

Number of Employees Declined After LBO

After the LBO, the number of Revco employees declined about 8 percent by the end of fiscal year 1990. Specifically, as of July 31, 1986, before the buyout, Revco and its subsidiaries employed about 28,800 persons. By the end of fiscal year 1990, the number had fallen to approximately 26,400 employees. On the basis of the filings, most of the decline—about 2,000 employees—occurred during fiscal year 1988, the year in which Revco essentially completed the bulk of its divestiture program and sold almost all of its nonretail subsidiaries and closed or sold a net 56 drugstores. Because we did not talk with Revco officials, we could not determine how much of the decline was attributed to the sale of subsidiaries versus drugstore closings or sales. As discussed earlier, since the end of fiscal year 1990, Revco has sold over 700 drugstores, further decreasing the number of Revco employees. We do not know how many employees were affected by the sales because this information has not yet been disclosed in Revco's filings with SEC.

Current Status of Revco

Since filing for Chapter 11 protection, Revco has been trying to develop a reorganization plan, which must be approved by the bankruptcy court and voted on by all classes of impaired creditors and equity security holders. Revco's creditors are represented by three committees: Official Committee of Unsecured Noteholders, Official Committee of Unsecured Trade Creditors, and Unofficial Committee of Secured Bank Lenders.[32] On October 31, 1990, more than 2 years after Revco filed Chapter 11, the bankruptcy court terminated Revco's exclusivity period—the time in which only Revco could file a reorganization plan and solicit acceptance of that plan. Consequently, on November 15, 1990, a Joint Plan of Reorganization was filed by Revco's three creditor committees and on December 21, 1990, a disclosure statement for the Joint Plan was filed. According to the examiner's final report, Revco's management supports the Joint Plan, but neither Revco nor Anac's Board of Directors has

[32]According to a Revco official, two additional creditor groups have been formed representing the pre-LBO bondholders: Unofficial Committee of Holders of 11.75-Percent Sinking Fund Debentures and Unofficial Committee of Holders of 12.125-Percent Notes (previously 11.125 percent).

approved it. The examiner also noted that various classes impaired under the Joint Plan have contacted him with respect to their objections to the Plan. In light of these objections, the examiner reported that he was not optimistic that the Joint Plan would be confirmed and implemented promptly. In fact, according to a Revco official, the plan is still on file but would have to be revised before being considered acceptable by all parties. The official stated that Revco's management had recently generated a 5-year business plan, which it has shared with all creditors and equity security holders. As a result, the plan is serving as a basis for renewed discussions concerning reorganization of the company.

The examiner filed a final report, dated December 17, 1990, concluding that viable causes of action exist against various parties involved in the LBO under both fraudulent conveyance and other legal theories. A fraudulent conveyance is essentially a transaction in which a debtor transfers an interest in its property (i.e., grants a lender a security interest in the property) either (1) with the intent to defraud its creditors or (2) regardless of the debtor's intent, if the debtor does not receive fair consideration for the transfer made leaving the debtor either insolvent or with insufficient capital to conduct its business. The latter condition is considered constructive fraud. Although some courts have held that actual intent is necessary to establish a fraudulent conveyance in the context of an LBO, a majority of the courts that have considered the issue have allowed creditors to present evidence of constructive fraud. Therefore, while no convincing evidence of actual fraud has been uncovered, the examiner concluded that Revco's estate[33] could establish a fraudulent conveyance on the grounds that it did not receive fair consideration for the obligations it incurred in the LBO. Specifically, the examiner found that a substantial basis exists for showing that Revco was left with insufficient capital to conduct its business after the LBO. In addition, the examiner's analysis indicates that a basis may exist for a finding that the LBO rendered Revco insolvent. These and other findings provide Revco's estate with a basis for litigation to recover funds from various parties involved in the LBO including management, banks, advisers, holders of the subordinated debt, and former stockholders, particularly those having inside information about the transaction, who benefited from the deal.

[33]Revco's estate came into being when Revco filed for bankruptcy. The estate consists of all Revco's legal and equitable property interests at the time it filed for bankruptcy, any property interest acquired as a result of avoiding a transaction in which Revco had engaged (i.e., a fraudulent conveyance), and any other property interest acquired by the estate. Revco, as D-I-P, is managing the estate under the supervision of the bankruptcy court for the benefit of its creditors.

Although the Official Committee of Unsecured Trade Creditors commenced fraudulent conveyance litigation on November 5, 1990,[34] the examiner recommended that Revco and its creditors agree on a reorganization plan as a way of resolving the potential claims. The examiner stressed that the plan be fully consensual, otherwise opposing parties could delay implementation of the plan resulting in an economic and managerial drain on Revco. In the absence of a fully consensual plan, the examiner recommended that Revco's estate consider aggressively pursuing fraudulent conveyance litigation. To that end, on December 11, 1990, the bankruptcy court approved the retention of special litigation counsel for Revco's estate to pursue the Revco LBO claims.

[34]On direction of the bankruptcy court, the trade creditors filed suit to preserve the fraudulent conveyance claim. The examiner expects that any benefits accruing to Revco's estate from successful fraudulent conveyance litigation would benefit this group of creditors.

Case Study: LBO of Safeway Stores, Inc.

Safeway Stores, Inc.'s[1] estimated $4.9 billion LBO was a two-tiered transaction[2] by which Kohlberg Kravis Roberts & Co. (KKR),[3] an investment company, purchased for cash a controlling amount of Safeway's common stocks and obtained the remaining stock by exchanging junior subordinated debentures (junk bonds) and warrants for new Safeway stock. The transaction began on July 25, 1986, when Safeway agreed to merge with KKR as a defense against a hostile takeover attempt by Dart Acquisition Corporation, a Maryland corporation and subsidiary of Dart Group Corporation, owned by members of the Haft family. The final merger became effective on November 24, 1986.

Safeway increased its long-term debt (which included the current portion due) from $1.4 billion 1 year before the buyout to $5.7 billion after. To reduce its increased debt requirements, from 1986 through 1988 Safeway sold supermarket operations in the United States and abroad for net cash proceeds of about $2.4 billion. Safeway has since initiated a $3.2 billion capital expenditure program for 1990 through 1994 to be financed primarily through cash from operations, lease obligations, a portion of $460 million in undistributed earnings repatriated[4] from its Canadian subsidiaries, and proceeds from public offerings. During 1990, the company sold 11.5 million shares of common stock at $11.25 per share in an initial public offering in which Safeway became a publicly held company again. In April 1991, Safeway offered an additional 17.5 million shares of common stock at $20.50 per share.

[1]In February 1990, the company changed its name to Safeway Inc.

[2]A two-step acquisition technique in which the first step is a cash tender offer and the second step is a merger in which remaining stockholders of the company typically receive securities of the bidder valued below the cash consideration offered in the tender offer. Despite the reduced consideration being offered in the merger, the merger is certain to be approved by the company's stockholders as the bidder, due to its acquisition of a controlling interest in the company through the tender offer, will vote in favor of the merger.

[3]KKR is a private investment firm organized as a general partnership under New York law, the general partners of which were Jerome Kohlberg, Jr.; Henry R. Kravis; George R. Roberts; Robert I. MacDonnell; and Paul E. Raether. Limited partnerships and corporations organized at the direction of KKR in connection with the LBO transactions include KKR Associates, SSI Holdings Corporation, SSI Acquisition Corporation, and SSI Merger Corporation. All such corporations will be referred to as KKR throughout this report except SSI Holdings Corporation, which will be referred to as Holdings. The merger became effective after KKR, through SSI Holdings and its wholly owned subsidiary SSI Acquisition Corporation, purchased about 73 percent of Safeway's stock. In the merger, SSI Merger Corporation was merged with and into Safeway Stores, Inc., with any outstanding Safeway stock being converted to bonds and warrants of SSI Holdings. After the merger was completed the bonds of SSI Holdings became Safeway bonds.

[4]To bring or send back to ones's own country. Safeway repatriated $460 million in undistributed earnings from its Canadian subsidiaries in the form of an intercompany dividend.

This case study is based on public documents filed with SEC; Moody's Bond Record, Moody's Industrial Manual, and Moody's Industrial News Reports; Standard & Poor's Industry Surveys; Media General Financial Services, Inc.; and information provided by Safeway officials, the North Central Texas Council of Governments, and the United Food and Commercial Workers International Union.

The LBO Transaction

Safeway is a multiregional food retailer with operations located principally in Northern California, Oregon, and Washington; the Rocky Mountain, Southwest, and Mid-Atlantic regions; and Western Canada. The company has an extensive network of distribution, manufacturing, and processing facilities. Safeway's specialty departments include full-service bakeries, delicatessens, pharmacies, fresh seafood counters, floral and plant shops, and self-service soup and salad bars. Its corporate fiscal year, which is referred to throughout this report, ends on the Saturday nearest December 31. Before the November 24, 1986, buyout, Safeway was the world's largest food retailer, operating 2,365 stores in the United States, Canada, and the United Kingdom. At year-end 1985, Safeway employed 164,385 full- and part-time employees. In 1989, 3 years after the buyout, Safeway remained a leading competitor in 18 of the 21 major metropolitan areas it served. Its number of stores decreased by about 53 percent to 1,117 stores located in the United States and Canada, and the number of its full- and part-time employees decreased by about 33 percent to 110,000.

KKR's Two-Tiered Transaction to Acquire Safeway

KKR acquired Safeway through a two-tiered LBO in which it paid cash for a controlling number of shares through a tender offer[5] (first tier) and obtained the remaining outstanding common shares in exchange for high-yield subordinated debentures (junk bonds) and warrants to purchase up to a 5-percent equity stake in Holdings following a merger[6] (second tier). After the merger, the equity in Holdings became equity in Safeway. The first tier began on August 1, 1986, when KKR offered cash to purchase up to 45 million shares (about 73 percent) of Safeway common stock for $69 a share—a total purchase price of $3.105 billion.

[5]A formal proposition to stockholders to sell their shares in response to a large purchase bid. The buyer customarily agrees to assume all costs and reserves the right to accept all, none, or a specific number of shares presented for acceptance.

[6]A merger is a combination of two or more companies in which one survives as a legal entity.

Among other conditions of the offer, stockholders were to tender a minimum of 41.6 million shares, which would have provided KKR a controlling amount of shares sufficient to obtain approval of the required two-thirds stockholders for the merger. On August 29, 1986, KKR completed its offer by purchasing 45 million shares. Safeway stockholders offered to sell about 97 percent of the outstanding shares to KKR. Because more than 45 million shares were validly offered, KKR, according to the terms of its offer, accepted all the shares for payment on a pro rata basis. In essence, stockholders received $69 per share for a portion of the shares offered based on a pro rata factor determined by the number of shares tendered. The pro rata factor was 76 percent. Therefore, stockholders who tendered shares received $69 cash per share for 76 percent of their shares tendered. The remaining 24 percent of their shares were returned to them to be converted into junk bonds and warrants under the merger.

The second tier began when Safeway's stockholders approved the LBO merger on November 24, 1986. Merger approval was guaranteed by KKR's ownership of the required two-thirds of Safeway's outstanding common stock. The merger became effective on November 24, 1986, and the remaining outstanding shares of Safeway common stock (other than those held by KKR, Safeway, or any affiliates) were converted into (1) $1.025 billion in junior subordinated debentures (junk bonds) and (2) stock warrants for 5 percent of the common equity of Holdings valued at $17.5 million. Each of the remaining shares was converted into one junk bond with a value of $61.60 and an initial interest rate of 15 percent and one merger warrant. A warrant holder had to exercise 3.584 warrants and pay a total exercise price of $3.77 to purchase one share of the new company's common stock. Warrant holders' first opportunity to exercise their warrants came when Safeway made its public offering of 11.5 million shares of common stock in 1990.

The LBO Was a Successful Hostile Takeover Defense

Safeway's LBO with KKR successfully defeated the Hafts' hostile takeover attempt to acquire the company. The Hafts began acquiring Safeway common stock in mid-May 1986. Following news reports of the Hafts' stock accumulation, KKR contacted the chairman of the board and CEO of Safeway to determine if the company might be interested in exploring an LBO. The chairman informed KKR that the company was not at that time interested in such a transaction.

On June 12, 1986, the Hafts disclosed that they owned nearly 6 percent of Safeway's outstanding common stock and were considering acquiring all of or at least a majority interest in Safeway stock. Five days later

Safeway filed a lawsuit against the Hafts alleging that their Safeway stock accumulation was part of a scheme to manipulate the markets and that the Hafts' true intention was not to acquire the company but to coerce Safeway to repurchase the shares acquired by them in a "greenmail"[7] transaction, among other allegations. On July 9 the Hafts filed an answer in court that denied Safeway's claims and asserted a counterclaim against Safeway's "poison pill."[8] They also made an offer of $58 cash for each outstanding share of Safeway common stock.

On July 9 KKR again contacted the chairman and executive vice president of Safeway and indicated interest in discussing an LBO. KKR asked to review confidential information of the company for this purpose. The next day KKR and Safeway agreed that KKR would keep confidential any company information it received and would not acquire Safeway shares for 3 years without the company's consent.

On July 17, 1986, Safeway's board of directors met to consider its response to the Hafts' offer. Merrill Lynch, Safeway's financial adviser for the Haft offer and for exploring alternatives to that offer, advised the board of its preliminary view that the Haft offer was inadequate from a financial point of view and that alternative responses were under study. Because these responses included a possible LBO, in which members of management might participate, the board appointed a special committee consisting of nonmanagement directors to work with Merrill Lynch in reviewing and developing alternatives.

During negotiations regarding the KKR buyout, representatives of KKR offered senior Safeway management the opportunity to purchase up to 10 percent of Holdings' equity at $2 per share, which was considerably less than the warrant holders' $3.77 a share exercise price under the

[7]In response to a corporate takeover attempt, the "target" corporation buys back its shares from the potential acquirer at a premium. The would-be acquirer then abandons the takeover bid.

[8]Any kind of action by a takeover target company to make its stock less palatable to an acquirer. Tactics include issuing new preferred stocks that give stockholders the right to redeem at a premium price if a takeover does occur. This makes acquisition much more expensive for the would-be acquirer. Safeway's poison pill, which was a dividend of one common share purchase right on each outstanding share of common stock, had certain antitakeover effects that could have caused substantial dilution to a person or group that attempted to acquire Safeway on terms not approved by its board of directors. If Safeway was acquired in a merger or other business combination transaction, each right had entitled its holder to purchase, at an exercise price of the right ($100), that number of shares of common stock of the surviving company that at the time of such transaction would have had a market value of two times the exercise price of the right. The rights were established so as not to interfere with any merger or other business combination approved by the board of directors, because the rights were redeemable by Safeway at $.05 per right before the time that a person or group acquired 20 percent or more of the common shares.

buyout terms. Such management participation was not a condition of the KKR transaction to acquire Safeway. No agreement was entered into between KKR and Safeway's management regarding equity participation for the duration of the offer.

After the offer was completed, KKR entered into subscription agreements for the sale of 2.5 million shares of common stock at $2 per share with management investors. Management investors, who primarily comprised Safeway executive officers and vice presidents, acquired a total of 9.3 percent of Safeway's outstanding fully diluted[9] common stock by the end of February 1990.

On July 21 the Hafts announced a $6 increase in their offer price to $64 cash per share for all outstanding Safeway common shares. At a meeting on July 22 the board announced its finding that the Hafts' original $58 cash per share offer was inadequate and not in the best interest of the company or its stockholders. It also directed the special committee to explore alternative transactions by (1) contacting the Hafts; (2) pursuing discussions with respect to an LBO led by KKR; and (3) investigating a recapitalization of the company, which would leave it an independent, publicly owned entity. The board made no recommendation on the Hafts' new offer until July 25, when it determined that the offer was inferior to the KKR proposal.

From July 22 through July 24, 1986, Safeway's advisers and KKR discussed a possible LBO transaction. KKR's representatives stated that if Safeway were to furnish any confidential information to the Hafts or were to advise the Hafts of terms of any proposal that KKR might make, KKR would not submit any proposal for consideration by the board. KKR's representatives also stated that KKR would not pursue a transaction with Safeway unless Safeway agreed to pay it a $15 million fee on signing and an additional $45 million fee plus expenses if such proposed transaction were not consummated for certain reasons, such as if Safeway failed to redeem its poison pill before the KKR offer. On July 24, KKR advised Safeway it was prepared to submit an LBO proposal and that its proposal would expire the next day if Safeway's board failed to accept the proposal. In essence, KKR's buyout proposal had to be accepted within 1 day and, if accepted, Safeway would have to agree to pay a total of $60 million to KKR if Safeway later wanted to accept another offer, such as the Hafts' offer.

[9] Assumes the exercise of warrants and stock options to purchase common stock.

Merrill Lynch, on behalf of Safeway, met with the Hafts' financial adviser, Drexel Burnham Lambert Inc. on July 24 to obtain the Hafts' best price to acquire Safeway. Drexel responded that the Hafts could not provide their best price unless they first obtained access to Safeway's confidential business information, which had been provided to KKR. That evening the special committee met to consider Safeway's alternatives. Merrill Lynch advised the special committee that in its opinion, the KKR proposal was economically superior to the Hafts' $64 per share all-cash proposal and that the Hafts had made no further proposal. During the special committee meeting, the Hafts delivered a letter requesting to meet with Safeway to receive its confidential information and to negotiate all aspects of the offer, including the price.

The next day the special committee reconvened and determined that the KKR proposal should be recommended to the board. During this meeting, Safeway representatives tried to persuade KKR to reduce its $45 million termination fee and to extend the deadline for acceptance so that information could be given to the Hafts. KKR declined to reduce the fee or extend the proposal's deadline. However, KKR modified certain provisions of the proposal to enable Safeway to meet with the Hafts and provide them with the requested information. Also during the meeting, the special committee received a letter from the Hafts reiterating that all aspects of their offer were negotiable, including the price to be paid pursuant to KKR's proposed merger and the amendment of their tender offer to provide the identical merger price of KKR's proposal. Because the Hafts did not increase their $64 per share price as requested by Safeway and because KKR's proposal deadline was not extended, Safeway signed a merger agreement with KKR based on the opinions of Merrill Lynch and its special committee that the KKR proposal was economically superior to the Hafts'. Safeway announced its merger agreement with KKR through a press release dated July 27, 1986.

Although the Hafts lost their takeover attempt, they still made about $153 million. After receiving a letter from Safeway informing them of the merger agreement signed with KKR, the Hafts contacted KKR on July 27 to explore the possibility of purchasing certain Safeway assets. Negotiations among the Hafts, KKR, and Safeway resulted in an agreement reached on July 31 in which the Hafts terminated their offer and supported the Safeway/KKR merger. In return, KKR agreed to form a limited partnership with the Hafts in which the Hafts received the right to acquire 20 percent of the shares of Holdings common stock at $2 per share. The Hafts purchased their limited partnership interest by issuing a $1 million note to the partnership. KKR, Safeway, and the Hafts further agreed to use their best efforts to negotiate and identify assets that Safeway might sell to the Hafts. After the agreement with the Hafts was effective, a number of disagreements arose between the parties and, as a result, the Hafts and Safeway did not negotiate the sale of Safeway's assets. Accordingly, on October 18, the agreement with the Hafts was cancelled, the Hafts' promissory note was cancelled, and Safeway purchased the Hafts' limited partnership interest for $59 million. When KKR completed its tender offer of Safeway common shares, the Hafts also earned a profit of about $94 million on the 6 percent of Safeway's shares they had acquired.

Stockholders' Premium

Safeway's common stockholders of record on June 11, 1986—the last day of trading before the Hafts disclosed they owned about 6 percent of Safeway shares and might acquire the company—realized about a $22 per share (49 percent) premium of cash and consideration received in the form of junk bonds and warrants. That is the difference between the value of KKR's final purchase price of about $67 and the approximately $45 per share closing price of shares traded June 11.

However, Safeway's stockholders filed a class action suit on July 29 against Safeway, Safeway's board of directors, and KKR to prevent the merger from occurring. The stockholders' suit called for a public auction to take place for control of Safeway or, alternatively, sought compensatory damages if the LBO merger was consummated. The suit alleged that the LBO would freeze out stockholders at an unfair price per share. It said the LBO was undertaken primarily to enable KKR to acquire Safeway's highly valuable assets and business at an inadequate price and to permit certain Safeway executives to keep their positions with the company.

On September 28, 1987, a California court approved a settlement between Safeway's stockholders, Safeway, and KKR in which Safeway paid about $26.2 million in dividend payments to stockholders—including KKR, which owned 45 million shares upon completion of the tender offer. Safeway paid stockholders of record on August 28, 1986 (the last day before KKR purchased shares through its tender offer), about $15.7 million in dividend payments and paid about $10.5 million to stockholders of record on September 2, 1986. KKR was the beneficial owner of 45 million shares of Safeway common stock by September 2 and therefore received about $7.7 million of the dividend payments. The court also awarded $1.8 million to the stockholders' attorneys for fees and costs related to the suit.

Financing the LBO

Holdings financed the estimated $4.9 billion LBO primarily through senior and subordinated debt, a bridge loan, and equity investment. A syndicate of 10 banks headed by Bankers Trust Company provided the senior debt under a bank credit agreement. The bank financing was guaranteed by Safeway's stock following the buyout merger. The subordinated debt constituted unsecured junior subordinated debentures, secured senior subordinated notes, and secured subordinated debentures. The bridge loan was provided by a KKR partnership, which also provided an equity investment through the purchase of common stock. Holdings also sold redeemable preferred stock to repay a portion of the KKR partnership loan (the bridge loan). Safeway immediately refinanced $1.045 billion of this debt.

Initial Financing

The estimated $4.907 billion buyout financing included "initial" financing of $4.195 billion to acquire all of Safeway's common stock and attendant fees and expenses. The remaining $712 million was financed by $570 million in additional bank borrowing to repay certain existing Safeway debt; a $59 million note to settle the agreement with the Hafts; and $43 million in Safeway cash for fees and expenses, including costs incurred by Safeway for its takeover defense and cancellation of stock options and stock appreciation rights.

The initial financing of $4.195 billion included $2.72 billion provided by a syndicate of 10 banks under a bank credit agreement, which provided up to $3.5 billion in borrowing for the buyout transaction and attendant costs. About $1.025 billion was provided by Holdings, which issued merger debentures (junk bonds) and warrants. Two limited partnerships formed by KKR provided a bridge loan of $320 million. These partnerships also bought 65 million shares of Holdings common stock at $2 per share for an equity investment of $130 million. This equity investment was only about 3 percent of the initial $4.195 billion buyout financing (2.7 percent of the estimated $4.9 billion total purchase price), while senior debt was about 65 percent of the financing, junior subordinated debentures were about 24 percent, and the KKR bridge loan was about 8 percent.

Refinancing $1.045 Billion of LBO Debt

Three months after the initial financing was in place, Holdings issued $750 million in senior subordinated notes and $250 million in subordinated debentures, and sold 450,000 shares of redeemable preferred stock for $45 million to refinance certain borrowings under the bank credit agreement and to repay the KKR bridge loan. (It is important to note again that after the merger, Holdings, in effect, was Safeway.) The estimated sources and applications of funds required in connection with the offer, merger, and refinancing are shown in table IV.1.

Table IV.1: Estimated Financing Sources and Application of Funds for Safeway's LBO (Dollars in Millions)

	Offer and merger[a]	Refinancing	Total	Percent of total purchase price
Sources of funds				
Bank financing	$3,290[b]	$(685)	**$2,605**	53
Senior subordinated notes		750	**750**	15
Subordinated debentures		250	**250**	5
KKR bridge loan	320	(320)	**0**	0
Junior subordinated debentures (merger debentures/ junk bonds)	1,025		**1,025**	21
Holdings note	59[c]		**59**	1
Holdings redeemable preferred stock		45	**45**	1
Holdings common stock (KKR equity investment)	130		**130**	3
Safeway cash	43		**43**	1
Total	**$4,867**	**$40**	**$4,907**	**100**
Application of funds				
Payment of cash for shares of Safeway common stock	$3,105[d]		**$3,105**	63
Issuance of junior subordinated debentures (merger debentures/junk bonds)	1,025		**1,025**	21
Repayment of certain existing Safeway indebtedness	500		**500**	10
Payment of fees and expenses incurred in connection with the offer, merger, and refinancing	237	$40	**277**	6
Total	**$4,867**	**$40**	**$4,907**	**100**

[a]No specific value had been assigned to the merger warrants.

[b]Increases bank borrowing from acquisition financing by approximately $570 million, which represents the amount borrowed under the bank credit agreement to repay existing indebtedness of Safeway and to pay certain additional fees related to the LBO. Excludes $210 million of additional borrowings that were available under the bank credit agreement, which provided buyout financing of up to $3.5 billion.

[c]Represents settlement of the agreement with the Hafts (note issued by Holdings that was due Feb. 2, 1987).

[d]Represents the purchase of 45 million shares of Safeway common stock pursuant to the offer.

Source: GAO analysis based on company data filed with SEC.

Advisers' Fees

Safeway's November 3, 1986, prospectus estimated that advisers' fees and expenses related to Safeway's LBO would cost about $277 million, or about 5.6 percent of the buyout's purchase price. Where actual costs could be determined, the fees increased by $15.3 million, making the total cost at least about $292 million. Investment bankers' fees and expenses accounted for a large share of the costs, about $126.7 million (2.6 percent of the total purchase price).

One investment banking firm, Drexel Burnham Lambert Inc., earned fees for services provided in both the Safeway/KKR LBO and the Hafts' unsuccessful takeover attempt for a combined total of about $42.3 million. Table IV.2 describes the investment bankers' fees and expenses associated with the LBO.

Table IV.2: LBO Investment Bankers—Services and Fees (Dollars in Millions)

Adviser	Service	Fee	Cost to LBO
KKR	Financial adviser to Safeway on the merger agreement, offer, and buyout. KKR negotiated the bank credit agreement and prepared the merger agreement and buyout.	$62.7 million was paid by Safeway for fees and related expenses.	$62.7
Drexel Burnham Lambert Inc.	Underwriter of $1 billion in senior subordinated notes and subordinated debentures issued to refinance a portion of KKR's LBO bank refinancing.	Received a $40 million fee for underwriting services. The $40 million was deducted from the $1 billion in notes and debentures resulting in net proceeds of $960 million for refinancing.	$40
Merrill Lynch	Financial adviser to Safeway with respect to the Hafts' hostile tender offer and other matters which included assisting Safeway in exploring alternatives in light of the Hafts' tender offer.	$14 million for providing financial advisory services.	$14
Morgan Stanley & Co., Inc.	Financial adviser to KKR during the merger agreement with Safeway and as dealer manager in connection with KKR's offer to acquire Safeway.	$10 million in fees and expenses.	$10
Total fees and expenses related exclusively to the LBO			$126.7

Source: GAO analysis based on company data filed with SEC.

KKR and Safeway also entered into a management agreement under which Safeway agreed to pay KKR an annual fee of $500,000 for management, consulting, and financial services during the first year and 10 percent more for each subsequent year. Safeway paid KKR a fee of $500,000 in 1987 for management consulting services. The fee increased by 10 percent each year in 1988 and 1989. When payments for special services and expenses were added to the annual management consulting fees, KKR received from Safeway a total of $726,000 in 1987; $592,000 in 1988; $655,000 in 1989; and $807,000 in 1990.

Drexel was also financial adviser to the Hafts during their hostile takeover attempt of Safeway. The Hafts paid Drexel $2.25 million—$2 million for acting as dealer/manager and financial adviser and $250,000 for providing a letter regarding takeover financing. Additional fees of $12.25 million could have been earned for completing the Hafts' acquisition.

Table IV.3 shows the remaining estimated fees, expenses, and costs relating to the LBO as presented in a November 3, 1986, prospectus. These fees totalled $165.6 million. When these fees are added to the estimated investment bankers' fees of $126.7 million, total estimated fees, expenses, and costs of the LBO were $292.3 million, or about 6 percent of the total purchase price.

Table IV.3: Remaining Estimated Fees, Expenses, and Costs Related to Safeway's LBO (Dollars in Millions)

Bank fees	$51
Settlement of the agreement with the Hafts (note due Feb. 2, 1987)	59
Legal and accounting fees and expenses	25
Printing fees and expenses and solicitation and distribution fees	3
Filing and other fees	1
Cancellation of Safeway stock options and stock appreciation rights[a]	26.6
Total	**$165.6**

[a]Immediately before the merger buyout, Safeway cancelled all outstanding stock options and stock appreciation rights and offered each holder of outstanding options under Safeway's employee stock option plans a cash payment. The payment was the difference between the price paid per share pursuant to the offer ($69) and the per-share exercise price of such options multiplied by the number of shares covered by such options in cancellation of the options. Safeway paid $17.5 million in cash and $9.1 million in deferred compensation contracts with certain employees to cancel all of its outstanding stock options and related stock appreciation rights.

Source: GAO analysis based on company data filed with SEC.

Safeway After the LBO: Increased Debt Required Massive Asset Divestitures

Safeway's LBO increased its long-term debt by $4.3 billion to $5.7 billion, requiring asset divestitures of $2.4 billion to help reduce the debt. By October 1987, despite this massive increase in debt, Safeway had redeemed $539 million of its LBO junk bonds and its preferred stock, continued a capital expenditure program, and maintained its top executives. KKR gained control of Safeway's board of directors after the LBO, and by 1989 Safeway's bond ratings had increased.

Safeway's Capitalization Changed Dramatically After the LBO

Safeway's capitalization was greatly affected by the LBO.[10] Long-term debt constituted 99.1 percent of Safeway's capitalization in 1986 after the LBO, compared with 46.5 percent in 1985 (1 fiscal year before the LBO), when over half of Safeway's capitalization came from invested capital. Long-term debt, including the portion currently due, increased from $1.4 billion the year before the LBO to $5.7 billion after, an increase of $4.3 billion. Total common stockholders' equity decreased from $1.6 billion in fiscal year 1985 to only $2.9 million in fiscal year 1986, a decrease of 99.8 percent. Using pro forma data,[11] management projected a significant increase in long-term debt but did not anticipate such a large decline in total common stockholders' equity.

Specifically, management projected long-term debt to increase to $5.8 billion; such debt actually increased to $5.7 billion, $100 million less than expected. Total common stockholders' equity, however, was projected to decrease to $130 million, when in fact it decreased to $2.9 million, $127.1 million less than expected. The decrease in stockholders' equity was caused predominantly by a deficit of $125.1 million in retained earnings for fiscal year 1986. The subscription agreements to purchase 2.455 million shares of common stock resulted in an initial cash payment of $0.6 million by the management investors in December 1986 with the remaining $4.3 million to be paid over the next 9 years.

Major Asset Divestitures Were Used to Reduce the LBO Debt

Safeway reduced its LBO debt predominantly by using $2.4 billion in proceeds from a massive asset divestiture program. The sale of such assets was required under the bank credit agreement to reduce a portion of the bank borrowing used to finance the LBO. The program's objective was to reduce the principal of the LBO financing to a level at which the remaining operations would be able to generate adequate cash flow to make all principal and interest payments when due. As the company evaluated which operations to sell to reduce the LBO debt, primary emphasis was placed on those operations in which Safeway lacked labor cost parity. The asset divestiture program was completed in 1988, 2 years after the LBO. At that time, 1,221 supermarket operations had been sold to reduce the LBO debt.

[10] Capitalization is the aggregate value of a corporation's long-term debt and preferred and common stock accounts.

[11] Pro forma capitalization data were prepared to illustrate the estimated effects of the LBO merger as if the merger had occurred as of June 14, 1986.

From the date of the LBO through August 1988, Safeway (1) sold supermarket operations headquartered in the United Kingdom, Kansas, Utah, Oklahoma, Arkansas, Texas, and Southern California; (2) closed about half of its Richmond, Virginia, operation and merged the remaining portion into its Washington, D.C., operation; (3) sold its Liquor Barn operation, which was located in California and Arizona; (4) sold its equity investment in Woolworths Limited of Australia; and (5) sold other facilities no longer used in the retail grocery business. Because of the asset divestitures, Safeway at year-end 1988 operated only 1,144 supermarkets compared with 2,365 in 1985, 1 year before the LBO. By year-end 1989, Safeway operated only 1,117 stores.

Mr. Peter Magowan, Safeway's chairman and CEO, disclosed in a November 12, 1990, Forbes article that Safeway sold stores included in its asset divestiture program for more cash than expected.[12] Mr. Magowan was quoted in the article as saying: "I told Kohlberg Kravis we could get $2.2 billion, we told the banks we'd get $1.8 billion, and we ended up getting $2.4 billion." However, as of 1989, Safeway continued to rely on borrowed funds in addition to cash from operations to service its debt and meet its other needs. Safeway anticipated in 1989 that it would be able to service its long-term debt primarily with cash from operations in 1995.

Safeway Reduced Its Borrowing Costs

About 1 year after the LBO, in October 1987, Safeway obtained bank financing to redeem $539 million (49 percent) of its junk bond debt. This reduced Safeway's interest costs. The terms of the bank loan also gave Safeway the money to pay cash interest payments on the remaining bonds instead of issuing new bonds. Safeway made its first junk bond interest payment by issuing additional bonds, but since December 1987, these payments have been made in cash, thus eliminating interest costs on the additional bond issues.

In April 1988, Safeway also redeemed all outstanding redeemable preferred stock for $57.1 million. The stock included 450,000 shares sold for $45 million and another 96,000 shares issued to satisfy dividend requirements. The redemption price included a $1.1 million redemption premium and a $1.4 million accrued dividend.

[12]Gretchen Morgenson, "The Buyout That Saved Safeway," Forbes (Nov. 12, 1990), pp. 88-92.

Safeway Continued Capital Expenditures Despite Its Massive LBO Debt

Safeway's capital investment strategy after the LBO was to continue capital expenditures despite its $4.3 billion increase in debt. Safeway spent $304.4 million in 1987, $312.6 million in 1988, and $375.5 million in 1989 to build new stores and renovate existing supermarkets. Because of restrictions in the bank credit agreement, average capital expenditures for 1987 through 1989 were about half the average expenditures for 1984 and 1985 ($702 million and $622 million, respectively). The agreement did, however, allow some of the capital expenditures to be financed by incurring additional secured indebtedness. For instance, in 1989, Safeway issued $57 million of 11-percent term notes and about $90 million of 10-percent long-term debt to finance a portion of the $375.5 million in capital expenditures.

In 1989, Safeway also announced a 5-year, $3.2 billion capital expenditure program for 1990 through 1994. The program, which is intended to restore capital spending to its pre-LBO levels, included plans to open 70 new stores and complete major remodeling projects in about 240 stores during the first 2 years. Safeway expected to finance the program primarily with cash provided by operations, borrowing, lease obligations, a portion of the repatriated funds, and the net proceeds from the proposed common stock sale.

KKR Officials Took Control of the Board of Directors, but Management Remained

Safeway's board of directors had seven members as of 1989—five from KKR and two from Safeway. Before the LBO, Safeway's board of directors had 18 members. Although the number of directors decreased and only two former board members remained after the LBO, most of Safeway's top executive officers maintained their positions with Safeway. Safeway's 21 executive officers as of 1989 included only 4 elected after the LBO. The executive officers no longer with the company were eligible to receive substantial severance compensation benefits pursuant to 1985 severance agreements. The agreements obligated Safeway to pay these employees an amount in which its present value at the date of termination was equal to not more than nearly 3 times the employee's average annual taxable compensation from the company for the 5 tax years immediately preceding the change in control. The payments could be made in a lump sum or over a period of years. Such agreements also required Safeway, as security for payment of severance compensation in a lump sum, to purchase a letter of credit or provide other satisfactory security for the payment of an amount equal to 125 percent of the amount of such severance payment. On August 25, 1986, Safeway purchased letters of credit totalling $10 million—about 125 percent of its maximum obligation—as security, at an annual cost of $100,000.

Bondholders' Investments Improved With Time

Safeway's bond ratings began to improve 3 years after the LBO, while its bond prices remained relatively stable throughout the post-LBO period. Bonds covering the years 1985 through 1990 included two pre-LBO bonds and three post-LBO bonds. One of the pre-LBO bonds was prepaid in 1987 because it became due as a result of the LBO. The other remaining pre-LBO bond was a 13.50-percent lease certificate bond due in the year 2009. The certificates evidence ownership interests in certain mortgage loans on commercial properties secured by, among other things, rights to receive rental payments from Safeway under long-term net leases relating to such properties. The three post-LBO bonds were issued as part of the LBO's consideration for the tender offer or to refinance the LBO debt as previously described.

Bond Ratings Eventually Improved

Moody's downgraded Safeway's pre-LBO bond ratings after the LBO indicating a decline in the bonds' investment quality. Although Moody's subsequently upgraded the post-LBO bond ratings over the next 3 years, the ratings remained below those assigned before the LBO. Table IV.4 illustrates Safeway's year-end bond ratings for 1985 through 1990. (Moody's bond ratings are explained in appendix III, footnote 26.)

Table IV.4: Safeway's Year-End Bond Ratings

	1985	1986	1987	1988	1989	1990
Pre-LBO debt						
7.40-percent debentures due in 1997	A3	B1	[a]	[a]	[a]	[a]
13.50-percent lease certificates due in 2009	Baa1	B2	B2	B2	B1	[b]
Post-LBO debt						
11.75-percent senior subordinated notes due in 1996	[b]	B2	B2	B2	B1	B1
12-percent subordinated debentures due in 1998	[b]	B2	B2	B2	B1	B1
15-percent junior subordinated debentures due in 2006[c]	[b]	[b]	B3	B3	B2	B2

[a]Prepaid in 1987 because it became due as a result of the LBO.

[b]The bond was not listed in Moody's Bond Record.

[c]Interest rate lowered to 14.5 percent in 1988.

Source: Moody's Bond Record.

As illustrated in table IV.4, Moody's upgraded the ratings for all of Safeway's bonds in 1989. The higher ratings followed the completion of the company's asset divestiture program, which greatly reduced its LBO debt; the redemption of 49 percent of its junk bonds; and the announcement of a 5-year, $3.2 billion capital expenditure program.

Bond Prices Generally Showed Minimal Fluctuation

Current prices for all of Safeway's bonds generally remained relatively stable during year-end 1985 through 1990. Table IV.5 presents Moody's year-end current prices for Safeway's bonds for 1985 through 1990.

Table IV.5: Safeway's Year-End Bond Prices

	1985	1986	1987	1988	1989	1990
Pre-LBO debt						
7.40-percent debentures due in 1997	$840	[a]	[b]	[b]	[b]	[b]
13.50-percent lease certificates due in 2009	[a]	[a]	$1,030	$1,030	$990	[c]
Post-LBO debt						
11.75-percent senior subordinated notes in due 1996	[c]	[a]	970	980	1,020	$1,000
12-percent subordinated debentures due in 1998	[c]	[a]	[a]	[a]	1,020	990
15-percent junior subordinated debentures due in 2006[d]	[c]	[a]	1,040	1,030	1,030	1,020

Note: All bonds have a face value of $1,000.

[a]According to Moody's officials, either no data were available or the bond was not trading.

[b]Prepaid in 1987 because it became due as a result of the LBO.

[c]The bond was not listed in Moody's Bond Record at this point.

[d]Interest rate lowered to 14.5 percent in 1988.

Source: Moody's Bond Record.

Impact of LBO on Employees and Communities

Safeway's stores are geographically dispersed domestically and internationally, and its retailing business, unlike manufacturing or other industries, generally does not establish the economic foundation of a community. The Safeway LBO resulted in store closings and layoffs in communities in some states, such as Arkansas, Kansas, Oklahoma, and Texas, but had little effect in other areas, such as Washington, D.C. We tracked the effects that closing 141 Safeway stores had on one community—Dallas/Ft. Worth—but we could not conclude that the results identified apply elsewhere. Safeway's buyout resulted in decreased personnel costs for the company at the expense of experienced, union-organized employees and caused two class action lawsuits to be filed on behalf of the employees.

Many employees' lives were obviously disrupted after the LBO, at least in the short term. In the 3 years after the LBO, Safeway laid off over 54,000 employees and sold or closed over 1,200 stores. Many of the displaced employees could have been rehired by the acquiring firms. However, it is unclear whether the LBO caused the disruptions or whether they might have occurred anyway. Safeway's CEO stated in a June 15, 1990, letter to the editor of The Wall Street Journal that the

> "primary reason for most of the changes that took place at Safeway [was] labor costs that were out of line, the consequences, long and short-term, of those costs, and the absolute business necessity in a low-margin, highly competitive industry for parity of labor costs. Safeway had to confront its major business problem - labor costs that were so out of line with its nonunion competition that they caused a situation where 66 percent of the company was either making no money or losing money. It was this that caused the pressures for and the need for change at Safeway. And it was this business problem, LBO or not, that had to be solved. The bleeding had to stop. The most important effect of the LBO was to highlight this need and provide the urgency and incentive to act quickly."

Although Safeway's asset divestiture program primarily targeted stores or divisions that lacked labor cost parity, such as those in the Dallas area, profit-producing divisions, such as the United Kingdom division, were also sold. Proceeds from the sales were used to reduce the LBO debt.

Two Class Action Lawsuits Filed Against the LBO

Two separate class action lawsuits were filed in California against Safeway, KKR, and other business associates in response to the LBO. One, filed on August 27, 1986, involved a United Food and Commercial Workers International Union suit representing about 107,000 of Safeway's employees who allegedly were to be laid off because of the LBO. The suit sought to prevent the LBO from occurring and sought damages of about $1 billion. The suit was settled on June 19, 1987, when the company agreed to certain provisions the union wanted concerning severance pay and transfer rights. In return, the union agreed to drop its $1 billion lawsuit.

The other suit, filed on September 26, 1986, involved a class action on behalf of 210 terminated administrative employees who allegedly lost their jobs because of the LBO. This suit sought damages in the amount of $400 million and attorneys' fees. On February 14, 1990, Safeway, KKR, and the other plaintiffs settled the suit by agreeing, without any admission or finding of liability on the part of the company, that Safeway would pay $8.2 million to class members over a period of 5 years and that the action would be dismissed. In April 1990, the action was dismissed.

Safeway Achieved an Improved Labor Cost Structure Following the LBO

Safeway achieved an improved labor cost structure in its continuing operations after the LBO. By year-end 1989, the company had about 110,000 full- and part-time employees. About 90 percent of Safeway's employees in the United States and Canada are covered by collective bargaining agreements negotiated with local unions affiliated with one of 13 different international unions. Safeway negotiated long-term contracts in several key areas. The contracts stabilized labor costs over a longer period of time and instituted a voluntary cash buyout program that resulted in the replacement of highly compensated employees with new employees hired at lower compensation levels.

Impact on Employees in Dallas/Ft. Worth

About 8,800 Safeway employees were laid off in 1987 after 141 Dallas/Ft. Worth stores were sold. About 6,100 of those laid off were residents of the Dallas/Ft. Worth area. Information was not readily available on what then happened to all 6,100 people. However, a Safeway Workers Assistance Program funded through grants by the U.S. Department of Labor and the state provided job training and placement services for 738 displaced Safeway employees and collected information on their subsequent employment.

The grants provided $1 million through federal Job Training and Partnership Act funds and $750,000 through the Texas State Rapid Response Fund. The North Central Texas Council of Governments operated the assistance program in conjunction with the United Food and Commercial Workers International Union, which had a subcontract agreement with the council. The council's manager of employment and training programs reported that of the combined $1.75 million in grants provided, only $1.3 million had been expended. The grants operated from September 1987 through June 30, 1989. The remaining funding was transferred into newly funded dislocated worker grant programs for about 40 displaced employees still in training. According to a council official, results from the program showed that of the 738 displaced workers served, 685 (93 percent) completed the program. Of those who completed the program, 570 (83 percent) obtained employment. The average participant spent about 24 weeks in the program before finding new employment. The average hourly wage at placement, however, was $7.09, below rates previously earned by Safeway workers, according to council and union officials.

According to a study on displaced Safeway employees, of the 141 Safeway stores that closed, 130 (92 percent) were purchased by other food retailers; however, "in-house training programs implemented by the purchasing stores meant that employees would not be sought from the ranks of the former Safeway workers."[13] Council officials also believed that the "non-union stores were reluctant to hire former Safeway employees." The union reported that new Dallas store employers offered an employee benefit package with drastically reduced wages, limited health insurance coverage, and no pension benefits. Some dislocated workers opted for education and training programs to change careers. Only as a last resort did some participants return on a part-time basis to the retail food industry.

Safeway's Performance Since the LBO

Safeway carried a heavy debt burden after the LBO, yet it was able to cover its interest expense and short-term obligations. Safeway's profits as measured against net income, sales, and average common stockholders' equity were mixed.

Safeway's Debt Burden Remained High

Safeway's debt burden as reflected by debt-to-total-common-stockholders'-equity ratios (we refer to total common stockholders' equity as equity), which measure the amount of debt per dollar of equity, remained high 3 years after the LBO. As noted previously, Safeway's long-term debt increased by $4.3 billion after the LBO, from $1.4 billion 1 year before the LBO to $5.7 billion after. Safeway reduced its long-term debt (including the current portion) by $2.6 billion to $3.1 billion in 1989, yet its debt burden remained high. For each of the years from 1987 (1 year after the LBO) to 1989, Safeway actually had negative equity. Accordingly, debt-to-equity ratios for those years would not be meaningful because of such deficits.

Before the LBO, Safeway's 1985 debt burden as reflected in its debt-to-equity ratios was lower. Its long-term debt-to-equity ratio was 0.8, meaning that for every $.80 of long-term debt there was $1.00 of equity. Safeway's total liabilities-to-equity ratio was 2.0; i.e., for every $2 of total liabilities there was $1.00 of equity. Safeway's pre-LBO debt-to-equity ratios in 1985 were slightly higher than the industry's average ratios, which were 0.5 for long-term debt-to-equity and 1.5 for total liabilities-to-equity.[14]

[13]Kim Peden Garrett and Laverne D. Knezek, Psychological Effects and Mental Health Implications of Food Retail Business Shutdown in a Depressed Economy (Arlington, Texas: Women and Work Research Center, University of Texas at Arlington, 1988), p. 3.

[14]Industry average of 37 grocery store companies for calendar years 1985 to 1989 compiled by Media General Financial Services, Inc.

Financial Indicators of Safeway's Ability to Service Its Debt

To illustrate Safeway's ability to continue servicing its debt after the LBO, we calculated an interest coverage ratio and two measures of liquidity: current ratio and quick ratio. The ratios showed that Safeway could meet its expenses. The liquidity ratios also showed the importance of the company's inventory in providing a cushion for its short-term lenders.

Safeway Covered Its Interest Expense

Safeway's interest coverage ratio, which indicates whether a company has adequate cash from its operations to cover all interest expenses, shows that the company was able to meet its interest expense for 1987 through 1989. The interest coverage ratio is calculated by dividing pre-interest net cash flow from operations by total interest expense.

A ratio above 1 indicates the company could cover all its interest expense for the period, while a ratio below 1 indicates that interest expense could not be covered with existing cash flow from operations. Table IV.6 shows that Safeway's net cash flow from operations was adequate to cover its interest expense after the LBO. The table also indicates that Safeway's coverage ratio was not as high as its pre-LBO ratio, in which net cash flow from operations enabled the company to meet its interest expenses nearly five times.

Table IV.6: Interest Coverage

	Fiscal year			
	Pre-LBO	Post-LBO		
	1985[a]	1987[b]	1988	1989
Net cash flow from operations (before interest)/interest expense	4.8	1.6	1.4	2.1

[a]Safeway's pre-LBO data are not comparable with post-LBO data because of changes in the accounting method and exclusion of operating results of those assets to be divested after the buyout.

[b]Safeway's asset divestiture program ended in fiscal year 1988; therefore, data for fiscal years 1988 and 1989 do not include the operating results of the divested assets. Accordingly, the data are not directly comparable to those of fiscal year 1987.

Source: GAO analysis based on company data filed with SEC.

Safeway's Ability to Meet Short-Term Obligations

Safeway's liquidity, i.e., its ability to meet short-term obligations, remained relatively stable after the LBO, compared to the period before the LBO and to the industry as a whole for pre- and post-LBO years. To provide an indication of Safeway's liquidity we used the current ratio and the quick ratio. The current ratio is calculated by dividing current assets by current liabilities; the quick ratio is derived by dividing the sum of cash, marketable securities, and receivables by current liabilities. The quick ratio provides a more immediate measure of a company's short-term debt-paying ability because it recognizes that a portion of current assets could be tied up in inventories that might not be readily convertible into cash without major price reductions. A ratio greater than 1 indicates that a company could meet all current obligations and still have current assets as an extra safety margin for its short-term lenders, while a ratio less than 1 indicates that a company could not meet current liabilities with current assets and must use other assets to cover debt currently due. Because of the liquidity of inventories for grocery stores, the quick ratio is not as meaningful as it is for other industries.

Current Ratio

For post-LBO fiscal years 1987 and 1988 Safeway's current ratios were 1.2 and 1.0, respectively, indicating the company could meet currently maturing obligations with current assets. However, in fiscal year 1989, Safeway's current ratio declined to 0.9, indicating that current assets were inadequate to cover current liabilities. This decline in liquidity is primarily attributable to a one-time $46 million income tax expense recognized in the fourth quarter of fiscal year 1989; the decline depleted Safeway's current assets for that year. The income tax expense resulted from the company's decision to repatriate $460 million in undistributed earnings from its Canadian subsidiaries in the form of an intercompany dividend. The dividend was paid by its Canadian subsidiaries in June 1990. Safeway used the after-tax dividend to reduce debt and fund capital expenditures in the United States.

Safeway's post-LBO current ratios declined slightly from its pre-LBO level, which was consistent with the trend for the industry, as shown in table IV.7. Safeway's pre- and post-LBO ratios were consistently slightly lower than the industry average. The LBO had minimal impact on Safeway's ability to meet its short-term liabilities except for the slight decrease in fiscal year 1989 as previously discussed. Table IV.7 shows Safeway's and the industry's average current ratios for pre- and post-LBO time periods.

Table IV.7: Current Ratio

	Pre-LBO	Post-LBO		
	1985[a]	1987[b]	1988	1989
Safeway (fiscal year)	1.2	1.2	1.0	0.9
Industry (calendar year)	1.4	1.3	1.2	1.2

[a]Safeway's pre-LBO data are not comparable to post-LBO data because of changes in the accounting method and exclusion of operating results of those assets to be divested after the buyout.

[b]Safeway's asset divestiture program ended in fiscal year 1988; therefore, data for fiscal years 1988 and 1989 do not include the operating results of the divested assets. Accordingly, the data are not directly comparable to those of fiscal year 1987.

Sources: GAO analysis based on company data filed with SEC and industry data produced by Media General Financial Services, Inc. Industry data are based on the average of 37 grocery store companies for calendar years 1985 to 1989.

Quick Ratio

The exclusion of inventories and prepaid expenses from current assets for calculating the quick ratio for grocery food chains indicates Safeway and the industry had insufficient current assets to cover current liabilities, as shown in table IV.8.

Table IV.8: Quick Ratio

	Pre-LBO	Post-LBO		
	1985a	1987[b]	1988	1989
Safeway (fiscal year)	0.2	0.6	0.2	0.2
Industry (calendar year)	0.4	0.4	0.3	0.3

[a]Safeway's pre-LBO data are not comparable to post-LBO data because of changes in the accounting method and exclusion of operating results of those assets to be divested after the buyout.

[b]Safeway's asset divestiture program ended in fiscal year 1988; therefore, fiscal years 1988 and 1989 do not include the operating results of the divested assets. Accordingly, the data are not directly comparable to those of fiscal year 1987.

Sources: GAO analysis based on company data filed with SEC and industry data produced by Media General Financial Services, Inc. Industry data are based on the average of 37 grocery store companies for calendar years 1985 to 1989.

Inventories are crucial to the grocery store business and therefore generally comprise over 50 percent of Safeway's and the industry's current assets, as shown in table IV.9. Unlike other retail businesses, grocery store inventories are not slow moving and are therefore more readily convertible into cash than other types of inventory. Thus, using the quick ratio as an indicator of Safeway's and the industry's abilities to meet their short-term liabilities may be misleading.

Table IV.9: Inventory (Dollars in Billions)

	Pre-LBO	Post-LBO		
	1985[a]	1987[b]	1988	1989
Safeway (fiscal year)				
Inventory	$1.6	$1.0	$1.1	$1.2
Percent of current assets	77.3%	49.4%	76.7%	78.5%
Industry (calendar year)				
Inventory	$3.8	$4.9	$6.8	$7.7
Percent of current assets	63.2%	64.1%	65.3%	69.7%

[a]Safeway's pre-LBO data are not comparable to post-LBO data because of changes in the accounting method and exclusion of operating results of those assets to be divested after the buyout.

[b]Safeway's asset divestiture program ended in fiscal year 1988; therefore, data for fiscal years 1988 and 1989 do not include the operating results of the divested assets. Accordingly, the data are not directly comparable to those of fiscal year 1987.

Sources: GAO analysis based on company data filed with SEC and industry data provided by Media General Financial Services, Inc. Industry data are based on the average of 37 grocery store companies for calendar years 1985 to 1989.

Safeway Achieved Mixed Results After the LBO

As indicated in table IV.10, Safeway's profitability after the LBO showed an improvement from pre-LBO results in some areas, such as the operating profit margin and declines in other areas, such as the profit margin. When comparing Safeway's post-LBO profitability to the industry average, Safeway generally performed below average as compared to its pre-LBO performance, when Safeway's profitability was generally better than or about equal to the industry average.

Table IV.10: Safeway and Industry Profitability Measures (Dollars in Millions)

	Pre-LBO	Post-LBO		
	1985	1987	1988	1989
Safeway (fiscal year)[a]				
Net income (loss)	$231.3	($487.7)	$31.2	$2.5
Earnings before interest and taxes	$527.0	$105.8	$466.5	$476.8
Sales	$19,650.5	$18,301.3	$13,612.4	$14,324.6
Gross profit	$4,778.3	$4,542.1	$3,435.8	$3,689.5
Operating profit	$427.6	$479.3	$398.9	$462.4
Stockholders' equity	$1,622.6	($461.8)	($368.4)	($388.9)
Operating profit margin	2.2%	2.6%	2.9%	3.2%
Gross margin	24.3%	24.8%	25.2%	25.8%
Profit margin	1.2%	[b]	0.2%	0.0%
Industry (calendar year)				
Gross margin	23.5%	23.9%	21.6%	22.2%
Profit margin	1.5%	1.5%	1.1%	1.0%

[a]Pre-LBO data are not comparable with post-LBO data because of changes in the accounting method and exclusion of operating results of those assets to be divested after the buyout. Fiscal year 1987 data are not directly comparable with fiscal years 1988 and 1989 data because fiscal year 1987 data include the operating results of assets divested in fiscal year 1988. Safeway's asset divestiture program ended in fiscal year 1988.

[b]Not meaningful because of net loss.

Sources: GAO analysis based on company data filed with SEC and industry data produced by Media General Financial Services, Inc. Industry data are based on the average of 37 grocery store companies for calendar years 1985 to 1989.

Safeway's Post-LBO Improvements in Profitability

Safeway's profitability showed improvement in two areas—the operating profit margin and the gross margin. Safeway's performance in these areas exceeded its pre-LBO level and, where a comparison with the industry average was available (the gross margin), Safeway performed better than the industry as a whole for pre- and post-LBO years. The operating profit margin—operating profits as a percentage of gross sales—indicates how well a company manages its operating profits. During its post-LBO years, Safeway consistently improved its performance.

The gross margin—sales less cost of goods sold as a percentage of sales—reflects a company's operating efficiency, pricing policies, and ability to compete. Safeway's post-LBO performance for this ratio exceeded its pre-LBO level and consistently improved each year after the LBO. Safeway out-performed the industry's average during all of its pre- and post-LBO years.

Safeway's Post-LBO Declines in Profitability

Safeway's profitability declined after the LBO as indicated by the following ratios: (1) profit margin, which indicates how effectively the company's operations and finances are managed, and (2) return on equity, which indicates the potential returns owners receive on their equity investment in the company. The underlying causes for these declines were decreases in net income and stockholders' equity, and the LBO's conversion of equity to debt.

Profit Margin Decreased Significantly

One year before the LBO, Safeway's profit margin was 1.2 percent compared with the industry's average of 1.5 percent. After the LBO, Safeway's profit margin decreased to nearly zero and the industry's average also experienced a downward trend. Safeway's profit margin decreased as a result of a decline in net income after the LBO. In fiscal year 1985, 1 year before the LBO, Safeway's net income was $231.3 million compared to a loss of $487.7 million 1 year after the LBO. The company's net income increased in fiscal year 1988 to $31.2 million but then declined the next year to $2.5 million. Safeway attributed this decline primarily to a one-time $46 million income tax expense recognized in fiscal year 1989 on the company's intercompany dividend of $460 million. When interest expense and income taxes are added back to net income, as in calculating earnings before interest and taxes, Safeway's post-LBO performance improved annually. Thus, this measure substantiates Safeway's reason for the decline in its net income after the LBO. Earnings before interest and taxes for fiscal year 1989 of $476.8 million also shows that the loss in net income was probably due to the one-time tax expense.

Return on Equity Disintegrated

Before the LBO, Safeway's return on average common stockholders' equity was 15.5 percent, slightly higher than the industry's average of 15.3 percent. Safeway's return on equity disintegrated following the LBO because stockholders' equity became negative. Safeway attributed the deficit to the LBO's negative effect on capitalization and net income. Safeway also reported that the largest factor leading to the deficit in stockholders' equity was a $409 million expense in 1987 caused by a change in accounting when the company adopted Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes."

Current Status of Safeway

According to an annual report the company filed with SEC covering fiscal year 1990 and to recent news reports, Safeway seems to have improved its results. Specifically, in fiscal year 1990, the company's net income increased by $84.6 million to $87.1 million from only $2.5 million in fiscal year 1989. Safeway attributed the increase in part to operating profits, which rose to $535.3 million in fiscal year 1990 from $462.4 million in fiscal year 1989. Sales also increased from $14.3 billion in fiscal year 1989 to $14.9 billion in fiscal year 1990. As a result of the increases in operating profits, net income, and sales, Safeway's operating profit margin, gross margin, and profit margin also increased. Safeway, however, still had a deficit in stockholders' equity. The deficit in stockholders' equity did improve, however, from $388.9 million in fiscal year 1989 to $183.4 million in fiscal year 1990. Safeway's debt burden in fiscal year 1990 remained high, with its long-term debt (including the current portion due) remaining at $3.1 billion. Although Safeway continued to cover its interest expense in fiscal year 1990, its interest coverage ratio declined slightly from fiscal year 1989. Safeway attributed this slight decline to the effect of higher interest rates on Canadian borrowings during 1990. This resulted from Safeway's Canadian subsidiaries borrowing about $410 million to finance the dividend given to its U.S. parent.

Three major events occurred at Safeway in 1990: (1) an initial public offering of common stock, (2) the implementation of the company's 5-year capital expenditure program, and (3) the completion of the $460 million intercompany dividend from Safeway's Canadian subsidiaries.

Initial Public Offering

Safeway sold 11.5 million shares of common stock at $11.25 per share in an initial public offering during the second quarter of 1990. Net proceeds were about $120 million. Safeway used the net proceeds to fund a portion of capital expenditures in 1990. The price per share offering was less than Safeway had envisioned. A preliminary prospectus filed with SEC on February 12, 1990, offered to sell 10 million shares of common stock at a price of $13 to $16 per share. A May 16, 1990, article in The Wall Street Journal stated that in the summer of 1989, Safeway anticipated the offering would result in the price of $20 per share. The article quoted Safeway's CEO as saying: "I think if we had known right at the start that this [$11.25 price per share] was the price that we would've gotten, we probably wouldn't have come out with our offering." The article stated that Safeway's CEO blamed the much-publicized problems of other leveraged companies for unjustly tainting Safeway's offering and driving away stock purchasers. As of April 18, 1991, Safeway's stock price had increased to $20.50 per share at the end of the day's trading on the New York Stock Exchange.

In April 1991, Safeway offered an additional 17.5 million shares of common stock at $20.50 per share. Proceeds from this offering were

$341 million. Safeway also intends to use the proceeds from this offering to help finance the company's 5-year, $3.2 billion capital expenditures program.

Five-Year Capital Expenditure Program

A key component of Safeway's long-term strategy is the 5-year, $3.2 billion capital expenditure program for 1990 through 1994. As disclosed in Safeway's annual report, during fiscal year 1990, the company incurred capital expenditures of $490 million, compared to $375.5 million in 1989. During fiscal year 1990, Safeway opened 30 new stores, closed 26 stores, and completed 90 major remodelling projects. As of year-end 1990, Safeway had 1,121 stores in the United States and Canada compared to 1,117 stores at the end of 1989. Capital expenditures in 1991 are expected to exceed $600 million, restoring capital spending to pre-LBO levels, even though the number of stores and the volume of sales are lower.

$460 Million Repatriation

Safeway's Canadian subsidiaries borrowed about $410 million in June 1990 to complete the dividend of $460 million of accumulated Canadian earnings to its U.S. parent. According to a quarterly report Safeway filed with SEC covering the period ending September 8, 1990, Safeway finalized a restructuring of its LBO bank credit agreement to allow its Canadian subsidiaries to borrow up to $475 million (U.S. dollar equivalent). Safeway used the dividend to reduce its LBO debt and fund capital expenditures in the United States.

Case Study: Campeau's LBOs of Allied Stores Corporation and Federated Department Stores, Inc.

On January 15, 1990, Allied Stores Corporation and Federated Department Stores, Inc., and certain of their subsidiaries and affiliates filed voluntary petitions for relief under Chapter 11 of the U.S. Bankruptcy Code with the U.S. Bankruptcy Court of the Southern District of Ohio, Western Division. According to the Allied and Federated press release, they filed the voluntary petitions for reorganization under Chapter 11 to preserve the operating strength and assets of the two department store companies while they restructured their corporate debt. According to the Forms 10-K filed by the companies in May 1990, the bankruptcy filings were precipitated by cash flow and liquidity problems in the third and fourth quarters of 1989. The cash flow and liquidity problems were due in part to the companies' high debt structures that existed after they had undergone LBOs by Campeau Corporation.

Campeau Corporation (U.S.) Inc., now Federated Department Stores, Inc., is the U.S. subsidiary of the Toronto, Canada-based Campeau Corporation, a developer of commercial real estate properties. Campeau acquired Allied in October 1986 and acquired Federated in May 1988, after which the companies operated under the general management of a Campeau subsidiary. Both acquisitions were preceded by takeover fights in which the companies' managements were hostile toward Campeau's acquisition offers. Campeau, nevertheless, out-bid other bidders in both cases and financed the acquisitions with borrowed funds.

Campeau sought to acquire the companies as a basis for positioning itself in retail merchandising and expanding its commercial real estate operations into the U.S. market. The regional department store chains were expected to provide the anchor stores in shopping centers that Campeau would develop. Federated's Bloomingdale's, in particular, was envisioned as providing the showcase outlets in this plan.

This case study is based primarily on public documents filed by the companies with SEC. Because of concern about possible litigation involving the Campeau takeovers and later bankruptcy filings, officials of Allied and Federated declined to be interviewed or to provide information for this review, but did comment on a draft of this case study.

Allied: The Target Company

When Campeau targeted it for an LBO, Allied Stores Corporation was one of the nation's largest retailing organizations, operating department stores, specialty stores, and shopping centers nationwide and in Japan. The stores offered a wide range of merchandise, including soft goods such as clothing and accessories for men, women, and children and hard goods such as home furnishings and housewares.

At the time of the Campeau LBO, Allied was a profitable and property-rich retailing chain. For its 1985 fiscal year, Allied had net sales of over $4 billion and net income of $159 million. Allied's sales over the previous 5 years on the average had grown annually by 11 percent while net income had increased by about 17 percent annually. Allied's fiscal year 1985 cash flow from operations was $273 million with interest expenses of about $80 million. Allied's total assets were valued at $2.8 billion, and its property and equipment were valued at $975 million. Allied had working capital of $972 million. Selected Allied pre-LBO financial statistics are shown in table V.1.

Table V.1: Allied Stores Corporation Selected Pre-LBO Financial Statistics

	Fiscal year 1985[a]	Average 1981 to 1985 percent change
Earnings per share	$3.70	14.9
Dividends	1.07	5.2
Price per share - New York Stock Exchange		
High for year	36.63	
Low for year	25.13	
(Dollars in Millions)		
Net sales	$4,135	11.0
Net income	159	16.7
Cash flow from operations	273	[b]
Working capital	972	20.7
Total assets	2,772	6.2
Property and equipment	975	2.1
Long-term debt	664	3.6
Stockholders' equity	1,258	12.1

[a]Before the LBO, Allied's fiscal year ended on the Saturday closest to January 31. Fiscal years 1986 and 1987 ended on the Saturday closest to the end of the calendar year. Fiscal years 1988 and 1989 ended on the Saturday closest to January 31.

[b]Not calculable because of insufficient data.

Source: Company data filed with SEC and obtained from Compustat.

Campeau's LBO of Allied

Campeau's takeover of Allied began in April 1986 when Campeau began acquiring shares of Allied's common stock and began seeking commitments for credit to purchase Allied. By late August 1986, Campeau had acquired 2 million shares of Allied and had obtained commitments from banks for $1 billion of credit advances toward the acquisition of Allied. After several unsuccessful attempts to negotiate a friendly merger agreement with Allied's management, on September 12, 1986, Campeau made a tender offer, which is a formal purchase offer to stockholders, to purchase up to 30 million shares of Allied at $58 per share in cash. A few weeks later, a second bidder, the Edward J. DeBartolo Corporation, obtained a merger agreement with Allied's management and initiated a tender offer for shares of Allied at $67 per share. Campeau, however, obtained firm financing commitments from its financial adviser, First Boston, Inc., for a bridge loan and from a bank syndicate led by Citibank for other bank loans. Then, on October 24, 1986, Campeau terminated its tender offer and purchased 25.8 million shares of Allied common stock on the open market at $67 per share.[1] Campeau completed purchasing the shares on October 31, 1986, after briefly being restrained from doing so by a court order issued as a result of complaints filed by DeBartolo and Allied. The stock purchase gave Campeau ownership of 53 percent of Allied. Also on October 31, Allied and Campeau entered into an agreement to merge. Summary information on Campeau's takeover of Allied follows:

- Aggregate purchase price - $3.5 billion;
- Initial tender offer price per share - $58;
- Acquisition price per share - approximately $67;
- Price per share for remaining shares outstanding at merger -$69; and
- Financial advisers - for Campeau—First Boston, for Allied—Goldman Sachs.

Allied used several methods to avert the Campeau takeover, including a "poison pill,"[2] litigation alleging that Campeau's tactics were illegal, and favoring the "white knight"[3] bid from DeBartolo. With the poison pill, if anyone had acquired 50 percent of Allied, stockholders would have received the right to $67 in debt securities for each outstanding share of Allied. However, the poison pill was never exercised, because Allied's

[1]Such open market purchases of a company's stock are referred to as "market" or "street sweeps." As a result of the Campeau and other such street sweeps, SEC published in October 1987 proposed rules that would subject any purchase, sale, offer to purchase, or solicitation to sell involving a large block—10 percent or more—of a class of stock that is the subject of a tender offer to the same regulatory restrictions that apply to the tender offer. According to an SEC official, those rules have not been enacted.

[2]A poison pill is any kind of action by a takeover target company to make its stock more expensive for the would-be acquirer.

[3]A white knight is a third person or firm that blocks a hostile takeover attempt by trying to take over the target company.

board, in responding to events, extended the date that it would have been exercisable to allow for a merger with Campeau under favorable terms.

Before the LBO, shares of Allied's common stock were publicly traded and listed on the New York Stock Exchange (NYSE). As of April 1, 1986, Allied had 19,604 stockholders of record. After the acquisition and merger, Allied became a wholly owned subsidiary of Campeau, with Campeau as the sole stockholder.

Allied Takeover Was Financed Mostly With Bank Debt and Unsecured Bonds

Campeau's acquisition subsidiary and Allied merged on December 31, 1986, and the successor was renamed Allied Stores Corporation. In exchange for shares of old Allied, remaining stockholders (other than Campeau and its subsidiaries) were given rights to receive $69 per share in cash as determined by the merger agreement.

The financing for the merger included bank loans provided by a syndicate of banks led by Citibank, proceeds from the sale of shopping centers, offerings of securities, and $350 million of equity from Campeau. The Campeau equity contribution included pre-merger Campeau equity in Allied and a $150 million loan from DeBartolo. The sources and uses of funds for financing the merger are shown in table V.2.

Table V.2: Sources and Uses of Funds for Financing the Campeau-Allied Merger (Dollars in Millions)

	Amount	Percent of total
Sources of funds		
Bank debt	$2,256.2	54
Sale of shopping centers	382.0	9
Senior notes	200.0	5
Senior subordinated debentures	700.0	17
Preferred stock	250.0	6
Common stock issued to Campeau	350.0	9
Total	**$4,138.2**	**100**
Uses of funds		
Payment of acquisition and merger consideration	$3,546.3	86
Refinancing of old Allied debt	280.0	7
Financing-related fees and expenses	311.9	7
Total	**$4,138.2**	**100**

Source: GAO analysis based on company data filed with SEC.

In March 1987, Allied issued the three securities offerings of $200 million of 10-1/2-percent unsecured senior notes due in 1992; $700 million of 11-1/2-percent senior subordinated debentures due in 1997; and 10 million shares of redeemable preferred stock at $25 per share with an annual dividend of $3.3125. The senior notes and debentures were unsecured and subordinated to all other debt of the company, and the preferred stock was restricted for a limited period of time by the bank loan agreement to pay dividends in additional shares rather than in cash. First Boston was the underwriter for the securities, and the proceeds from selling the securities were used to repay the bridge loan that First Boston provided to Campeau to acquire control of Allied in October 1986.

During the years following the Campeau buyout and merger, Allied refinanced its bank debt. In December 1987, Allied refinanced the bank loans that financed the merger with another syndicate of banks led by Security Pacific National Bank. The new bank loans were secured by Allied's capital stock and receivables and were to expire on December 31, 1991. In December 1987, Allied also entered into a mortgage loan agreement with Prudential Insurance Company that provided it the ability to obtain mortgage loans of up to $463 million for real estate-related uses.

On April 7, 1989, Allied again refinanced the working capital and receivables loans that Security Pacific National Bank had provided with another syndicate of banks led by Citibank. These loans were scheduled to mature on March 15, 1990, and April 6, 1992, respectively. We do not know the reasons for the company's refinancing of the bank loans because Allied officials declined to be interviewed.

Allied Stockholders Benefited From the LBO

Holders of Allied's stock benefited from the premium realized during Campeau's efforts to take over Allied. On April 11, 1986, 5 months before the Campeau tender offer and about when Campeau first began to purchase Allied shares, Allied's shares closed on NYSE at $38.50. On September 11, 1986, the day before the tender offer, Allied's shares closed at $57.88. On October 30, 1986, the day before the Campeau acquisition of Allied, Allied's shares closed at $66.25. The following day, Campeau completed the purchase of 25,800,000 shares at $67 per share. On December 31, 1986, the date of the merger, Allied's remaining outstanding shares were purchased at $69 per share. Hence, stockholders of record in April could have realized a premium of from $19.38 to $30.50 per share, depending upon when during the takeover attempt they sold their shares. Allied's share prices and possible percent premiums at selected dates are shown in table V.3.

Table V.3: Allied Stores Corporation Prices per Share of Common Stock on Selected Dates

Date	Closing NYSE price	Premium per share	Percent premium
04/11/86	$38.50	[a]	[a]
09/11/86	57.88	$19.38	50.3
10/24/86	67.00[b]	28.50	74.0
10/30/86	66.25	27.75	72.1
12/30/86	68.75	30.25	78.6
12/31/86	69.00[c]	30.50	79.2

[a]Calculation not applicable for base year.

[b]Price paid per share during the Campeau street sweep.

[c]Price paid per share at the merger for shares not acquired in the tender offer and street sweep.
Source: The Wall Street Journal and GAO analysis.

Banks and Investment Bankers Earned Big Fees on the Allied LBO

The completion of Campeau's LBO of Allied involved several firms, each of which was paid a sizable fee for its services. First Boston provided Campeau with advisory services during the takeover and the bridge loan that helped make the LBO possible; it underwrote the securities that were later offered to finance the bridge loan. Goldman Sachs provided Allied with advisory services during the takeover fight. Citibank led a syndicate of banks that provided the short-term loan used to finance Campeau's acquisition of Allied and provided the bank credit facilities for the merger.

Following is a list of the fees earned by banks and investment bankers for services provided on the Allied LBO:

- $47.4 million payable to First Boston in connection with the bridge loan;
- $7 million payable to First Boston for financial advisory services rendered to Campeau;
- $43.8 million payable to First Boston for underwriting discounts and expenses in connection with the securities offerings;
- $26.9 million payable to Citibank and the bank syndicate in connection with the initial acquisition loan;
- $80 million payable to Citibank and the bank syndicate in connection with the merger credit facilities;
- $12 million payable to Goldman Sachs for financial advisory services rendered to Allied; and

- $36.6 million payable to various firms for legal, accounting, and other services and expenses.

In addition, Allied paid $116.3 million to DeBartolo for expenses incurred in the bidding contest for Allied.

The $7 million in advisory fees paid to First Boston was about 0.20 percent of the acquisition price paid for Allied. According to data compiled by Fortune magazine on the nine mergers, acquisitions, and recapitalizations of 1986 of over $3 billion in value, the fees paid to the advisers of the successors ranged from 0.12 to 1.05 percent of the total values of the deals. While First Boston's fee was relatively low in this range, it had other interests and earned other fees as part of the Allied deal, such as the fees in connection with the bridge loan and the securities offerings. The nearly $100 million in fees paid to First Boston was about 2.6 percent of the acquisition price. The total of all fees and expenses connected with the Allied LBO was about 7.5 percent of the total acquisition price.

Federated: Another Campeau Target

Before Campeau acquired it, Federated was an even larger department store chain than Allied. Although its growth in net income lagged during the mid-1980s, Federated still earned $313 million in fiscal year 1987. Federated's net sales for 1987 exceeded $11 billion, almost three times Allied's net sales for 1985, and its cash flow from operations was $656 million. For 1987, Federated had total assets of just over $6 billion and property and equipment valued at $2.7 billion, mostly in buildings on owned land, store fixtures, and equipment. Selected Federated pre-LBO financial statistics are shown in table V.4.

Table V.4: Federated Department Stores, Inc., Selected Pre-LBO Financial Statistics

	Fiscal year 1987[a]	Average fiscal year 1983 to 1987 percent change
Earnings per share	$3.40	(0.2)
Dividends	1.48	7.7
Price per share - New York Stock Exchange		
High for year	58.50	
Low for year	28.38	
(Dollars in Millions)		
Net sales	$11,118	6.4
Net income	313	(1.6)
Cash flow from operations	656	b
Working capital	1,447	11.3
Total assets	6,009	5.2
Property and equipment	2,649	5.5
Long-term debt	957	11.2
Stockholders' equity	2,629	3.1

[a]Federated's fiscal year ended on the Saturday closest to January 31.

[b]Not calculable because of insufficient data.

Source: Company data filed with SEC.

Campeau's LBO of Federated

Campeau's takeover of Federated occurred over 9 weeks beginning with its tender offer on January 25, 1988, and ending on April 1, 1988. During this period, Campeau had to boost its initial $47 per share offer price several times to win over Federated's board of directors and got caught in a bidding contest for Federated with the R.H. Macy Company. The bidding contest ended when Campeau, Federated, and Macy reached an agreement under which Campeau would acquire Federated at $73.50 per share and sell two of Federated's divisions to Macy. The acquisition cost Campeau $6.4 billion, which it financed almost completely from debt. Selected summary information on the Federated LBO follows:

- Aggregate purchase price - $6.4 billion;
- Initial tender offer price per share - $47;
- Final acquisition price per share - $73.50; and
- Financial advisers - for Campeau—First Boston and Wasserstein, Perella, for Federated—Goldman Sachs, Hellman and Friedman, and Shearson Lehman Hutton.

Federated also tried to avert the Campeau takeover using methods such as a poison pill, litigation, and Macy as a white knight in the bidding contest. The Campeau takeover of Federated was also subject to court review under antitakeover laws in several states, including Florida, South Carolina, Nebraska, Ohio, and Delaware, and was examined by the Antitrust Division of the Department of the Attorney General of the state of Massachusetts. Both Campeau and Federated used the various state courts to clarify or to question the legality of the takeover. To avoid any antitrust action from Massachusetts—with the Federated acquisition, Campeau would own two major area department stores, Federated's Filene's and Allied's Jordan Marsh—Campeau agreed to sell Filene's to the May Company.

Before the LBO, Federated's shares were publicly traded and were listed on NYSE. At the end of fiscal year 1987, Federated's common shares outstanding of 88.5 million were held by 19,200 stockholders. The Campeau cash tender offer of Federated shares was completed on May 3, 1988, when a Campeau subsidiary purchased 87.2 million shares of Federated for $73.50 per share in cash, which together with 400,200 shares it owned at the time represented 98.5 percent of Federated's outstanding capital stock. The total cash paid in the tender offer was $6,410.7 million. On July 29, 1988, Federated became a 92.5-percent-owned subsidiary of Campeau. The other 7.5 percent of Federated's capital stock is owned by the Edward J. DeBartolo Corporation through its 50-percent interest in a partnership with a Campeau subsidiary.

Bank Loans, First Boston's Bridge Loan, and Borrowed Equity Financed the Federated LBO

The Federated acquisition was financed through bank debt, a temporary bridge loan from Campeau's investment bankers led by First Boston, and Campeau's equity contribution, which consisted largely of borrowed funds. Financing for the tender offer is shown in table V.5.

Table V.5: Sources and Uses of Funds for Financing Campeau's Acquisition of Federated (Dollars in Millions)

		Amount	Percent of total
Sources of funds			
Tender offer facility (bank debt)		$3,219.9	48
Bridge facility (sale of notes to First Boston, Paine Webber, and Dillon Read)		2,086.8	31
Campeau equity			
Bank of Montreal and Bank Paribus loans	$500.0		
DeBartolo loan	480.0		
Campeau debentures sold to Olympia and York, Ltd.	226.7		
Sale of Brooks Bros.	193.3		
Total cash equity		1,400.0	21
Total		**$6,706.7**	**100**
Uses of funds			
Tender offer		$6,410.7	96
Fees, expenses, etc.		296.0	4
Total		**$6,706.7**	**100**

Source: GAO analysis based on company data filed with SEC.

On November 9, 1988, Federated refinanced the tender offer bridge loan by issuing $500 million of 16-percent senior subordinated debentures due in the year 2000 and $582.9 million of 17-3/4-percent subordinated discount debentures due in 2004. Federated used the proceeds to repay $722.5 million of the $1,109.7 million outstanding of the bridge loan. The securities were underwritten by First Boston, Paine Webber, and Dillon Read.

On January 27, 1989, Federated issued to First Boston, Paine Webber, and Dillon Read $401.3 million of 13-3/4-percent series II exchange notes due in 1994 in exchange for $387.2 million remaining on the bridge loan. To assist the lenders in selling the exchange notes, Campeau deposited into an escrow account 6.96 percent of the common stock of the Campeau subsidiary that owned Federated.

Federated Stockholders Earned a Substantial Premium on the LBO

One month before the tender offer was announced, on December 24, 1987, Federated's common shares closed on NYSE at $33.50 a share. On January 22, 1988, the last full day of trading before the tender offer, Federated shares closed at $35.875. On March 31, 1988, the last full day of trading before the settlement and merger agreement, Federated shares closed at $72.875. The share price at which the tender offer and merger were consummated was $73.50. Hence, as shown in table V.6, stockholders of record from about 1 month before the LBO stood to gain a premium in the range of $31 to $40 per share, a gain of about 92 to 119 percent.

Table V.6: Federated Department Stores, Inc., Prices per Share of Common Stock on Selected Dates

Date	Closing NYSE price	Premium per share	Percent premium
12/24/87	$33.50	[a]	[a]
02/26/88	64.50	$31.00	92.5
03/31/88	72.88	39.38	117.5
07/28/88	73.13	39.63	118.3
07/29/88	73.50[b]	40.00	119.4

[a]Calculation not applicable for base year.

[b]Price paid per share at the merger for shares not acquired in the tender offer.

Source: The Wall Street Journal and GAO analysis.

The Federated Deal Provided Big Fees for the Players

The fees associated with the Federated LBO included the following:

- $73.5 million payable to First Boston ($51 million), Paine Webber ($15 million), and Dillon Read ($7.5 million) in connection with the tender offer bridge loan;
- $18.9 million of advisory fees payable to First Boston;
- $81.5 million payable to Citibank, Sumitomo Bank, and a bank syndicate in connection with the tender offer credit facility;
- $10.0 million of advisory fees payable to Wasserstein, Perella;
- $12.5 million of legal fees;
- $15.5 million of miscellaneous fees payable in connection with the tender offer; and
- $44.8 million payable to the bank syndicate for credit facilities provided in connection with the merger.

Federated agreed to pay $60 million of expenses incurred by Macy in its bid to acquire Federated.

The $18.9 million of advisory fees payable to First Boston was about 0.28 percent, and the $10.0 million of advisory fees payable to Wasserstein, Perella was about 0.15 percent of the acquisition price paid for Federated. According to data compiled by Fortune magazine on the eight mergers, acquisitions, and recapitalizations of over $3 billion in value in 1988, the fees paid to the advisers of the successors ranged from 0.04 to

1.12 percent of the value of the deals. Both First Boston's and Wasserstein, Perella's fees were at the lower end of this range. First Boston, however, also had other interests and earned other fees as part of the Federated deal, such as the fees in connection with the bridge loan and the November 1988 securities offerings. The $70 million in fees paid to First Boston in connection with the LBO was about 1.0 percent of the acquisition price. The total of all fees and expenses connected with the Federated LBO was about 4.4 percent of the total acquisition price.

Impact of LBOs on Allied and Federated

After the LBOs, Allied and Federated changed vastly. The companies became debt-ridden; store divisions were sold to repay the debt; and capital spending was reduced. Many top management positions turned over, and the overall level of employment at the companies fell. As the companies' financial performances declined, the value of their bonds also declined.

After the LBOs, the Companies' Capitalization Became Primarily Debt

A company's capitalization is the combined aggregate value of the current portion of long-term debt, long-term debt, and stockholders' equity. After the Campeau LBOs of Allied and Federated, the makeup of both companies' capitalization changed. These changes, particularly the burden of debt imposed by the LBOs, would later have drastic consequences on the companies' performances.

For fiscal year 1985, the last full fiscal year before the Allied LBO, Allied's long-term debt accounted for about 34 percent of its total capitalization; after the LBO, for fiscal year 1987, long-term debt was about 78 percent of its total capitalization. Before the LBO, Allied had retained earnings of $960 million that constituted about 50 percent of its total capitalization. After the LBO, Allied's retained earnings dropped to zero.

The high levels of debt incurred in Federated's LBO also substantially changed the structure of its capitalization. Before the LBO, at the end of Federated's 1987 fiscal year, Federated's long-term debt was about 24 percent of total capitalization. A year later, after the LBO, long-term debt constituted about 53 percent of total capitalization. Before the LBO, Federated had retained earnings that were about 63 percent of total capitalization. After the LBO, retained earnings became a negative entry on Federated's balance sheet because of the company's net losses.

Campeau Divested Many Poor Performers and Some Shining Stars

The asset sales that occurred as part of and after Campeau's LBOs of Allied and Federated left those companies as abridged versions of the vast retailing empires they were before the LBOs. While the surviving companies gave up some famous retailing names, they retained many of the nation's most prestigious regional department stores.

Allied Divestitures

At the time of the LBO, Allied had 24 operating divisions, including 17 department store divisions and 7 specialty store divisions with 697 stores in 46 states, the District of Columbia, and Japan. Currently, Allied has 4 department store divisions operating 128 stores in 17 states. Allied's divisions retained or sold since the LBO, their geographic locations, and number of stores are shown in table V.7.

Table V.7: Allied Stores Corporation Divisions Retained and Sold After the LBO

	Principal geographic location	Number of stores as of 01/03/87
Divisions retained[a]		
The Bon	Pacific Northwest	39
Jordan Marsh-New England (including Read's)	New England	25
Maas Brothers (including Jordan Marsh-Florida)	Florida	38
Stern's	Mid-Atlantic	24
Total		**126**
Divisions sold for $2.2 billion		
Ann Taylor	National	91
Block's	Indianapolis	10
Bonwit Teller	National	13
Brooks Brothers	National and Japan	57
Cain-Sloan	Nashville	4
Catherine's	National	210
Dey's	Syracuse	4
Donaldson's	Minnesota	15
Garfinckel's	Washington, D.C.	10
Heer's	Missouri	2
Herpolsheimer's	Western Michigan	6
Jerry Leonard	Midwest and Southwest	26
Joske's	Texas	27
Miller and Rhoads	Virginia	17
Miller's	Eastern Tennessee	12
Plymouth Shops	Washington, D.C., and New York City	51
Pomeroy's (2 divisions)	Pennsylvania	16
Total		**571**

[a]Before the LBO, The Bon, Stern's, Read's, Jordan Marsh-Florida, Jordan Marsh-New England, and Maas Brothers were separate divisions. After the LBO, the six were combined into four divisions, as shown.

Source: GAO analysis based on company data filed with SEC.

Pursuant to its bank loan agreements, Allied was required to use its best efforts to sell 16 of its 24 divisions as soon as possible and to make such sales so that by December 31, 1988, total net proceeds of $1.1 billion were realized. The proceeds from the asset sales were to be used to reduce the bank debt. Allied completed the initial divestitures during fiscal year 1987, the first fiscal year after the LBO, and applied the proceeds of approximately $1,019.2 million to reduce the bank debt. In addition, pursuant to the agreement with DeBartolo, on March 31, 1987, Allied sold five shopping centers to DeBartolo and a subsidiary of Campeau for $400 million.

Following the initial dispositions and the consolidation of certain retained divisions, Allied reorganized into six operating divisions composed of The Bon, Jordan Marsh-New England (which included Read's), Maas Brothers (which included Jordan Marsh-Florida), Stern's, Brooks Brothers, and Ann Taylor. These six divisions were Allied's higher sales volume operations and accounted for about 63 percent of net sales for fiscal year 1986. The 16 divisions sold accounted for about 37 percent of Allied's fiscal year 1986 net sales.

After the merger and completion of the initial dispositions required by the bank loan agreement, Allied divested other assets, which it had earlier planned to keep. On April 29, 1988, Allied sold the Brooks Brothers division to Marks and Spencer p.l.c. for an aggregate price of $750 million, of which $450 million was a note from the buyer payable in 10 years. Proceeds from the sale were used to reduce Allied's bank debt and to provide an equity contribution toward Campeau's acquisition of Federated Department Stores. On February 8, 1989, Allied sold the Ann Taylor division to Ann Taylor Holdings, Inc., for $420 million in cash and $10 million of paid-in-kind preferred stock.[4] Allied used the proceeds to purchase shares of a Campeau subsidiary called Federated Holdings, Inc., of which Federated Department Stores became a subsidiary after Campeau acquired it in May 1988.

Federated Divestitures

Before the Campeau buyout, at the end of fiscal year 1987, Federated operated 238 department stores, 76 mass merchandise stores, and 232 specialty stores in 38 states and 129 supermarkets in California and had approximately 135,200 employees. Federated had 10 department store divisions, 1 mass merchandising division, 3 specialty store divisions, and 1 supermarket division. Currently, Federated consists of 5 store divisions that operate 132 stores in 19 states and has about 60,300 employees. Federated's divisions retained and sold since the LBO, their geographic location, and number of stores are shown in table V.8.

[4] Preferred stock for which dividends are paid in additional shares of preferred stock.

Table V.8: Federated Department Stores, Inc., Divisions Retained and Sold After the LBO

	Principal geographic location	Number of stores as of 01/30/88
Divisions retained		
Abraham & Strauss	NY, NJ, PA	14
Bloomingdale's	Nationwide	16
Burdines	FL	29
Lazarus	OH, IN, KN, WV	43
Rich's (including Goldsmith's)	GA, SC, AL, TN	26
Total		**128**
Divisions sold or transferred for $4.2 billion		
Bullock's/Bullock's Wilshire	CA, NV, AZ	29
The Children's Place	Nationwide	190
Filene's	New England	18
Filene's Basement	New England, PA, NJ	22
Foley's	TX, OK, NM, AZ	38
Gold Circle and Richway	Southeast, OH, NY	76
I. Magnin	Nationwide	25
MainStreet	IL, MI	20
Ralph's (transferred to a Campeau subsidiary)	CA	129
Total		**547**

Source: GAO analysis based on company data filed with SEC.

As part of the agreements under which Campeau acquired Federated, Federated sold its Filene's and Foley's divisions and certain accounts receivable of Filene's Basement to the May Company for $1,133.1 million in cash and $400 million of May notes. In addition, Federated sold its Bullock's/Bullock's Wilshire and I. Magnin divisions to Macy for $696.8 million in cash and other consideration and $400 million of Macy notes. The gross purchase price, however, was reduced by $60 million in cash with respect to fees and expenses incurred by Macy in connection with its attempt to acquire Federated.

As part of the Campeau-Federated merger, the assets and liabilities of the Ralph's division, a California food store chain, were transferred to a newly formed subsidiary, and the subsidiary was merged into another Campeau subsidiary. The allocated cost of the Ralph's division was $1.02 billion out of which $0.9 billion was transferred to Federated.

Furthermore, at the time of the merger, Federated sold its Filene's Basement division to a corporation formed out of its management and other investors for approximately $125 million. During the months after the merger, Federated divested the Gold Circle, MainStreet, and The Children's Place divisions for a total of $535.3 million.

Post-LBO Organization Consolidated Headquarters and Maintained Centralized Support Services

After the LBOs of Allied and Federated, Campeau consolidated the companies' headquarters and continued to provide central support services for the store divisions. The store divisions' managements continued to be responsible for the divisions' day-to-day operations.

Before its LBO, Allied operated by having each store division's management responsible for day-to-day operations. The New York headquarters maintained a specialized staff to provide promotional, financial, and general support services. Although the number of store divisions was reduced, Campeau kept this structure after the LBO. However, after the 1988 Campeau acquisition of Federated, Campeau moved Allied's headquarters to Cincinnati but maintained central support offices in Cincinnati, New York, and Atlanta.

Before the Campeau LBO of Federated, each of Federated's divisions operated autonomously with respect to its conduct of business, personnel, merchandising, and purchasing. Its headquarters in Cincinnati provided various support services such as economic forecasting and research; personnel, finance, and accounting policies; legal and insurance assistance; and real estate development and electronic systems development advice. After the LBO, the corporate headquarters remained in Cincinnati, and each of the retained divisions continued to operate under its own management.

Capital Spending Was Reduced After the LBOs

After the LBOs, capital spending in relation to net sales, an indicator of a company's commitment to remain a viable and competitive business, fell at both Allied and Federated. The levels of advertising spending in relation to the volume of goods available for sale by the companies, however, continued at pre-LBO levels.

Allied's Capital Spending

Allied's post-LBO capital spending plan fell short of its pre-LBO plan. At the end of fiscal year 1985, Allied had planned to expand its higher profit store divisions into suburban shopping malls. The expansion plans called for approximately $600 million of capital expenditures over the next 5 years. During fiscal year 1985, the year before the LBO, Allied spent $115 million on property and equipment and opened 7 new department stores and 32 specialty stores. For fiscal year 1987, the first full year after the LBO, Allied's capital expenditures were $77 million, and it opened nine new stores. For fiscal year 1988, Allied's capital expenditures were $71.5 million, and it opened six new stores. In fiscal year 1989, capital expenditures were $66.7 million, most of which was spent to maintain and remodel existing facilities; one new store was opened. Allied's spending on property and equipment before the LBO was 2.8 percent of net sales; for the 3 years after the LBO, it varied between 1.9 and 2.5 percent of net sales.

Spending on advertising also fell after the LBO, but its level in relation to the cost of goods sold, except for fiscal year 1987 when it fell, remained stable. After the LBO, spending on advertising fell from $155 million at the end of fiscal year 1985 to $115 and $113 million for fiscal years 1988 and 1989, respectively. However, over this period advertising spending as a percentage of the cost of goods sold by Allied was 5.5 percent before the LBO, fell to 3.0 percent the first fiscal year after the LBO, and was between 5 and 6 percent for the next 2 years.

Federated's Capital Spending

Federated's capital expenditures declined after the LBO. Its capital spending was almost $500 million in fiscal year 1987; it fell to $156 million for 1988 and to $111 million for 1989. In a November 1988 prospectus, Federated stated that although its bank agreements limited capital expenditures, those limitations were not more restrictive than its capital budget, which provided for expenditures that were comparable to historical levels in the retained divisions. However, in 1987 Federated's capital spending was 4.4 percent of net sales. In 1989, the year after the LBO, Federated's capital spending fell to 2.3 percent of net sales.

Federated's advertising expenditures also fell after the LBO—from $346 million in fiscal year 1987 to $126 million in 1988 to $180 million in 1989. However, the level of advertising spending in relation to the cost of goods sold was slightly higher after the LBO. Before the LBO, in fiscal year 1987, Federated's advertising was 4.2 percent of the cost of goods sold, while after the LBO, advertising rose to 4.9 percent in fiscal year 1988 and 5.1 percent of the cost of goods sold in fiscal year 1989.

Top Management Changed After LBOs

After the LBO, Allied's executive direction and management changed. Federated's management, on the other hand, was dominated by executives from the old Federated.

Allied

By the end of January 1987, the month following the merger with Campeau, Allied's two top officials, its chairman and CEO and its president and chief operating officer, had retired. By the end of Allied's 1987 fiscal year, only six former board members and executive officers remained, and five of them were in charge of the divisions of Allied that were retained by Campeau. By the end of fiscal year 1988, three of the executives of old Allied remained, and by the end of fiscal year 1989, only two old Allied executives remained. At the end of fiscal year 1989, all of Allied's other executive positions were held by people who had held similar executive positions with Federated, which Campeau acquired in May 1988.

The Allied executives who left after the LBO did not walk away empty handed. Allied's chairman and CEO received a lump-sum payment of about $4.5 million and a trust deposit of about $4.3 million, equal to the actuarial value of the retirement allowance payable to him. The president and chief operating officer received a lump-sum payment of about $1.3 million in addition to his annual retirement allowance. The lump-sum payments were provided by "change of control" agreements effected before the LBO, on September 23, 1986.

Federated

Federated's management after the LBO remained dominated by executives from the old Federated. As of April 1, 1989, nearly 1 year after the Campeau acquisition, 8 of 19 executive officers were still serving in the capacity they had with the old Federated. Eight executive officers were people who were new to their positions but had served with Federated for more than 1 year. Three executive officers had served for 1 year or less. On May 1, 1990, 15 of the 19 old Federated executive officers were still serving while 4 were new to their positions but had prior service with Federated. One new addition was Mr. Allen I. Questrom, chairman of the board and CEO of Federated. Mr. Questrom was elected chairman and CEO of Federated and Allied on February 2, 1990. He also had been with old Federated as an executive vice president and head of the Bullock's division but had left after the Campeau buyout to become president and CEO of Neiman-Marcus.

Top executives of Federated were compensated for the change of control effected with the merger of Campeau and Federated. According to its fiscal year 1988 filings with SEC, Federated made payments totalling about $22.6 million to executives of old Federated with the change of control. About $18.2 million of this amount was paid to executives who left Federated after the LBO.

Bondholders Emerge as Losers in LBOs' Aftermath

Holders of Allied's and Federated's bonds did not lose value in their investments directly as a result of the LBOs. However, the value and ratings of the bonds later fell with the decline in the companies' financial statuses.

Allied

How holders of old Allied's bonds fared in the takeover is less apparent than how stockholders fared, because old Allied's bonds were not consistently traded and, therefore, listed during the period of the takeover and merger. Available data, shown in table V.9, indicate that the values of bonds and notes issued before the Campeau takeover were stable after the LBO. The record on Allied's post-LBO, 11-1/2-percent subordinated debentures, however, shows the effects of Allied's later financial woes. The debentures, with a face value of $1,000, were priced at about $870 in December 1987, $190 in October 1989, and about $70 in January 1990, the month after Allied's bankruptcy filing.

Table V.9: Allied Stores Corporation Bond Prices for Selected Months/Years

Issue	Issue price	Current price for selected month/year 03/86	12/86	12/87	10/89	01/90
Pre-LBO debt						
10-3/8-percent notes due in 1990	$1,000	$1,020	$1,010	[a]	[a]	[a]
6-percent discount notes due in 1992	570	[b]	[b]	$870	$870	$870
Post-LBO debt						
10-1/2-percent senior notes due in 1992	1,000	[c]	[c]	[b]	500	410
11-1/2-percent senior subordinated debentures due in 1997	1,000	[c]	[c]	870	190	70

[a] In connection with the December 31, 1986, merger of Allied with Campeau, the 10-3/8-percent notes were terminated and removed from the company's balance sheet.

[b] No price for this month was listed in Moody's Bond Record.

[c] Bond was not issued yet.

Source: Moody's Bond Record.

Ratings of Allied's bonds also did not diminish until several months after the LBO was completed. According to Moody's Bond Record, Allied's issues of senior notes were rated A2 throughout the period of the takeover from the end of March through December 1986. (Moody's bond ratings are explained in appendix III, footnote 26.) By October 1989, after Allied and Campeau's liquidity problems were publicized, Allied's then outstanding notes and bonds received a rating of Caa.

Moody's ratings of Allied's bonds at selected dates after the Campeau tender offer and LBO are shown in table V.10. As shown, Allied's bonds went from a moderately high rating to a low rating.

Table V.10: Allied Stores Corporation Bond Ratings for Selected Months/Years

Issue	03/86	12/86	12/87	10/89	01/90
Pre-LBO debt					
10-3/8-percent notes due in 1990	A2	A2	B1	[a]	[a]
6-percent discount notes due in 1992	A2	A2	B1	Caa	Caa
Post-LBO debt					
10-1/2-percent senior notes due in 1992	[b]	[b]	B2	Caa	Caa
11-1/2-percent senior subordinated debentures due in 1997	[b]	[b]	B3	Caa	Ca

[a]In connection with the December 31, 1986, merger of Allied with Campeau, the 10-3/8-percent notes were terminated and removed from the company's balance sheet.

[b]Bond had not been issued yet.

Source: Moody's Bond Record.

Federated

While Federated's stockholders could have gained a hefty premium from the Campeau buyout, pre-LBO bondholders lost as a result of the LBO. According to prices listed in Moody's Bond Record, the prices of Federated's various bonds ranged from about $880 to $1,030 at the end of December 1987, from about $780 to about $1,000 in May 1988, and by October 1989, after Federated's liquidity problems became widely known, ranged from about $510 to $930. For example, Federated's 10-1/4-percent sinking fund debentures due in the year 2010 were priced at about $1,010 in December 1987, about $890 in May 1988, and about $560 by October 1989. Prices of Federated's bonds at selected dates are shown in table V.11.

Table V.11: Federated Department Stores, Inc., Bond Prices for Selected Months/Years

Issue	Issue price	Current price for selected month/year 12/87	05/88	01/89	10/89	01/90
Pre-LBO debt						
8-3/8-percent s.f.[a] debentures due in 1995	$1,000	$970	$900	$930	$930	$930
7-1/8-percent s.f. debentures due in 2002	1,000	880	860	760	760	760
10-1/4-percent s.f. debentures due in 2010	990	1,010	890	820	560	510
10-5/8-percent s.f. debentures due in 2013	1,000	1,030	1,000	890	890	890
9-1/5-percent s.f. debentures due in 2016	1,000	960	780	720	510	510
7-7/8-percent notes due in 1996	990	900	820	730	580	500
11-percent eurobonds due in 1990	1,000	1,020[b]	990[b]	980[b]	930[b]	[c]
10-1/8-percent eurobonds due in 1995	1,000	980	920	870	700	520
Post-LBO debt						
16-percent senior subordinated debentures due in 2000	1,000	[d]	[d]	[e]	[e]	[e]
17-3/4-percent subordinated debentures due in 2004	430	[d]	[d]	[e]	130[f]	[e]

[a]s.f. = sinking fund.

[b]One month old bid price.

[c]Bond-issue had matured.

[d]Bond had not been issued yet.

[e]No price was listed in Moody's Bond Record.

[f]Bond price is from Standard and Poor's Bond Guide because, according to a Moody's official, the price published in Moody's Bond Record for 10/89 was incorrect.
Source: Moody's Bond Record.

Moody's ratings of Federated's bonds also fell from a high-quality, low-risk category to a low-quality, high-risk category. In December 1987, Federated's bonds were generally rated Aa2, in May 1988 they were rated B2, and by October 1989 they were rated Caa. Ratings of Federated's bonds are shown in table V.12.

Table V.12: Federated Department Stores, Inc., Bond Ratings for Selected Months/Years

Issue	12/87	05/88	01/89	10/89	01/90
Pre-LBO debt					
8-3/8-percent s.f.[a] debentures due in 1995	Aa2	B2	B1	Caa	Caa
7-1/8-percent s.f. debentures due in 2002	Aa2	B2	B1	Caa	Caa
10-1/4-percent s.f. debentures due in 2010	Aa2	B2	B1	Caa	Caa
10-5/8-percent s.f. debentures due in 2013	Aa2	B2	B1	Caa	Caa
9-1/5-percent s.f. debentures due in 2016	Aa2	B2	B1	Caa	Caa
7-7/8-percent notes due in 1996	Aa2	B2	B1	Caa	Caa
11-percent eurobonds due in 1990	Aa2	B2	B1	Caa	[b]
10-1/8-percent eurobonds due in 1995	Aa2	B2	B1	Caa	Caa
Post-LBO debt					
16-percent senior subordinated debentures due in 2000	[c]	[c]	[d]	Caa	Ca
17-3/4-percent subordinated debentures due in 2004	[c]	[c]	[d]	Caa	Ca

[a]s.f. = sinking fund.

[b]Bond issue had matured.

[c]Bond had not been issued yet.

[d]No rating was shown in Moody's Bond Record.
Source: Moody's Bond Record.

Post-LBO Employment Fell

At both Allied and Federated the total number of employees fell by more than 50 percent after the LBOs, but this does not necessarily mean that all of the employees became unemployed. The large number of divestitures is probably responsible for much of the employment decrease, and many of these employees might have been rehired by the acquiring companies. However, there were other reasons for employment decreases, such as reorganizing the retained divisions and implementing measures designed to cut costs.

After the LBOs, both Allied and Federated divested divisions, reorganized divisions, and implemented plans to streamline operations and improve efficiency. Each of these factors to some extent affected the number of employees that the companies maintained. For example, during fiscal year 1988, after the tender offer, Federated introduced cost-cutting measures that eliminated over 5,000 primarily administrative positions. The companies, which became affiliated after the Federated LBO, also took steps to lower advertising, travel, and supply costs. Table V.13 shows the number of Allied and Federated employees at selected dates before and after the LBOs. However, without information from Allied and Federated officials, we were unable to determine the extent to which the number of employees changed as a result of the divestitures, reorganizations, and other changes.

Table V.13: The Number of Allied and Federated Employees on Selected Dates

Date	Allied employees	Federated employees
Feb. 1, 1986	65,000	[a]
Mar. 1, 1987	61,800	[a]
Jan. 30, 1988	[b]	135,200
Mar. 1, 1988	27,000	[a]
Mar. 1, 1989	37,300	63,700
Mar. 1, 1990	31,500	60,300

[a]Date not applicable to Federated LBO.

[b]Date not applicable to Allied LBO.

Source: Company data filed with SEC.

LBOs' Effect on Communities Uncertain

We did not determine how the communities where Allied's and Federated's stores were located were affected by the LBOs because of the companies' sizes and geographic dispersion. Pre-LBO Allied had stores in 46 states, the District of Columbia, and Japan. Similarly, pre-LBO Federated had stores in 36 states. Each of the companies' store divisions probably had millions of customers, thousands of employees, and hundreds of vendors. Each was also located in diverse metropolitan economies where community effects would be difficult to isolate.

Financial Indicators Show Decline in Company Performance After the LBOs

After the Campeau LBOs, Allied and Federated became heavily burdened with debt, and their financial situations deteriorated. The companies' decline is reflected by the changes in debt-to-equity ratios and in their ability to service debt, their liquidity, and their profitability.

The Companies Took on High Levels of Debt

Allied

Changes in debt burden are reflected by ratios of debt-to-equity, which measure the amount of debt held per dollar of equity. The pre-LBO fiscal year 1985 ratio of Allied's long-term debt to stockholders' equity was about 0.5, and after the LBO, for fiscal year 1987, it increased to about 11.9. Similarly, Allied's ratio of total debt (measured as total liabilities) to stockholders' equity for fiscal year 1985 was about 1.2 while for 1987 it rose to about 20.8. As shown in table V.14, Allied's post-LBO debt per dollar of equity was substantially higher than before the LBO, when it held less debt to equity than the industry average of 21 department store companies. After the LBO, Allied's total debt-to-equity ratio was almost 6 times the industry average. Allied's pre-LBO total liabilities of $1.5 billion increased to $3.8 billion while stockholders' equity of $1.3 billion fell to $184 million.

Table V.14: Allied Stores Corporation and Industry Debt Per Dollar of Equity Before and After the LBO

	Pre-LBO[a]	Post-LBO		
Ratio	**1985**	**1987**	**1988**	**1989**
Total liabilities/equity				
Allied (fiscal year)	1.2	20.8	21.4	[b]
Industry (calendar year)	3.3	3.4	3.4	4.8
Long-term debt/equity				
Allied (fiscal year)	0.5	11.9	11.7	[b]
Industry (calendar year)	0.8	0.8	0.8	1.2

[a]Data for 1986, the year of the acquisition and merger, were not included because data covered part of fiscal year and were not consistent.

[b]Not meaningful because of negative stockholders' equity.

Sources: GAO analysis based on company data filed with SEC and industry data produced by Media General Financial Services, Inc. Industry data are based on the average of 21 department store companies for calendar years 1985 to 1989.

After the LBO, Allied had planned to reduce its bank debt through asset divestitures. The divestitures of store divisions and shopping centers provided proceeds of about $2.6 billion, most of which was used to reduce Allied's bank debt. However, even with this reduction in bank debt Allied's debt-to-equity ratio did not decline, because after the LBO and divestitures Allied's stockholders' equity declined about proportionately with Allied's debt.

Federated

The changes in Federated's debt condition are highlighted by changes in Federated's debt-to-equity ratios. Before the LBO, at the end of fiscal year 1987, the ratio of Federated's long-term debt to equity was about 0.4. In other words, Federated had about 40 cents of debt for every dollar of equity. After the LBO, at the end of fiscal year 1988, this ratio was about 2.7; Federated had $2.70 of debt for every dollar of equity. Before the LBO, Federated had $1.30 of total liabilities to every dollar of equity, and after the LBO it had $6.00 of total liabilities per dollar of equity. At the end of Federated's 1989 fiscal year, Federated's stockholders' equity fell to a negative amount while its liabilities rose to almost $6.9 billion, over twice the amount of its pre-LBO liabilities of $3.4 billion. These debt-to-equity ratios are shown in table V.15.

Table V.15: Federated Department Stores, Inc., and Industry Debt Per Dollar of Equity Before and After the LBO

	Pre-LBO	Post-LBO	
Ratio	1987	1988	1989
Total liabilities/equity			
Federated (fiscal year)	1.3	6.0	[a]
Industry (calendar year)	3.4	3.4	4.8
Long-term debt/equity			
Federated (fiscal year)	0.4	2.7	[a]
Industry (calendar year)	0.8	0.8	1.2

[a]Not meaningful because of negative stockholders' equity.

Sources: GAO analysis based on company data filed with SEC and industry data produced by Media General Financial Services, Inc. Industry data are based on the average of 21 department store companies for calendar years 1985 to 1989.

Federated attempted to reduce its LBO-related debt through asset divestitures. At the time of the Campeau acquisition, Federated sold the Bullock's/Bullock's Wilshire, Filene's, Foley's, and I. Magnin divisions. About $1 billion of the cash proceeds from these sales was used to reduce a bank loan for working capital, and about $750 million was used to complete the merger with Campeau. After the merger, proceeds of about $535 million from the sale of Gold Circle, MainStreet, and The Children's Place were used to repay bank loans. In addition, about $753 million of the bridge loan from First Boston was repaid from financing associated with the transfer of Ralph's from Federated to another Campeau subsidiary.

The proceeds from these divestitures, however, were not adequate to reduce Federated's overall debt burden. At the end of fiscal years 1988 and 1989, Federated's total liabilities were about $6.8 billion and $6.9 billion, respectively.

Allied and Federated Could Not Generate Cash Flow and Earnings to Service Debt

Allied

An indication of a company's ability to service debt, such as that incurred by an LBO, can be shown by comparing ratios of cash flow from operations and operating earnings to interest expense. Measures of Allied's ability to service its debt are shown in table V.16. For fiscal year 1985 the ratio of Allied's cash flow from operations before interest expense to interest expense was 4.4, which indicates that at that time Allied had sufficient cash flow from operations to cover its interest expense by at least 4 times. For the year after the LBO, this ratio fell to less than 1, which indicates that Allied was not able to meet interest expense out of cash generated from its operating activities. Before the LBO, cash flow from operations before interest was about $353 million, and interest expense was about $80 million. After the LBO, at the end of fiscal year 1987, Allied's cash flow from operations before interest was $320 million while interest expense was $457 million. The next year, fiscal year 1988, Allied generated just enough cash flow from operations before interest to cover its $251 million of accrued interest expense. For fiscal year 1989, the year of the bankruptcy filing, Allied's cash flow from operations before interest fell to a $109 million deficit while its accrued interest expense was $298 million.

Another measure of ability to service debt is the ratio of operating earnings before interest and taxes[5] to interest expense. This measure, although similar to cash flow from operations, takes into account amounts for depreciation. This ratio shows that before the LBO, Allied had operating earnings of $4.60 for each dollar of interest expense. After the LBO, the large increase in interest expense in relation to operating earnings left Allied incapable of covering its interest expenses for 1987 and 1989, and just able to cover the 1988 interest expense. In addition, before the LBO, Allied's ratio of earnings before interest and taxes to interest expense was well above the industry average, but after the LBO it fell below the average.

[5]We calculated earnings before interest and taxes as net income plus income taxes and interest expense.

Table V.16: Allied Stores Corporation and Industry Ability to Service Debt

Measure	Pre-LBO 1985[a]	Post-LBO 1987	1988	1989
Allied (fiscal year)				
Cash flow from operations before interest expense per dollar of interest expense	4.4[b]	0.7	1.0	[c]
Earnings before interest and taxes per dollar of interest expense	4.6	0.4	1.5	[c]
Industry (calendar year)				
Earnings before interest and taxes per dollar of interest expense	1.6	1.9	1.6	1.5

[a]Data for 1986, the year of the acquisition and merger, were not included because they covered only part of that fiscal year and were not consistent.

[b]Number for cash flow from operations used in this calculation was not adjusted for 1987 changes to accounting procedures for reporting cash flows and therefore may only approximate cash flow from operations under the new procedures.

[c]Not meaningful because of negative cash flow from operations and earnings before interest and taxes.

Sources: GAO analysis based on company data filed with SEC and industry data produced by Media General Financial Services, Inc. Industry data are based on the average of 21 department store companies for calendar years 1985 to 1989.

After the LBO, in an effort to improve the generation of cash flow and earnings, Allied began cost-reduction and performance improvement programs. During the first full year after the LBO, Allied reduced the size of its central office because of the reduction of operations related to the divested divisions. It also consolidated Jordan Marsh-Florida into Maas, Inc., and Read's into Jordan Marsh-New England to reduce administrative costs.

During fiscal years 1988 and 1989, a centralized buying function and development of private label merchandise were introduced to reduce costs. An enhanced sales service program, focusing on development of selling skills and incentive compensation was implemented to improve sales performance. According to documents filed with SEC by Allied, the improved selling program, at the end of fiscal year 1989, had not generated sufficient sales to cover the added short-term expenses of the program.

Allied's selling, general, and administrative expenses of $1.01 billion for fiscal year 1985, the year before the LBO, fell to $900 million for fiscal year 1987, the first full fiscal year after the LBO. These expenses fell to $771 million for fiscal year 1988 and to $631 million for fiscal year 1989. However, without Allied's involvement we could not ascertain how much of the reduction in Allied's costs was associated with the cost-reduction efforts separate from the asset divestitures.

Federated

Federated's inability to service its higher post-LBO debt level was also evident in its ratios of cash flow from operations before interest expense to interest expense and earnings before interest and taxes to interest expense. For fiscal year 1987, Federated had about $7.10 of cash flow from operations before interest per dollar of interest expense, which indicates that Federated at the time had sufficient cash flow from operations to meet its current level of interest expense by about 7 times. Cash flow from operations before interest was $765 million while interest expense was $109 million. After the LBO, Federated's cash flow from operations before interest was negative, and Federated did not generate sufficient cash flow from operations to cover interest expense.

Federated's ratio of earnings before interest and taxes to interest expense also fell after the LBO to less than 1, indicating that operating earnings, allowing for the replacement of capital, were inadequate to cover interest expense. Before the LBO, Federated had $5.90 of earnings before interest and taxes per dollar of interest expense, which was about 3 times larger than the industry average ratio of 1.9. (See table V.17.)

Table V.17: Federated Department Stores, Inc., and Industry Ability to Service Debt

Measure	Pre-LBO 1987	Post-LBO 1988	1989
Federated (fiscal year)			
Cash flow from operations before interest expense per dollar of interest expense	7.1[a]	[b]	[b]
Earnings before interest and taxes per dollar of interest expense	5.9	0.7[c]	[b]
Industry (calendar year)			
Earnings before interest and taxes per dollar of interest expense	1.9	1.6	1.5

[a]Number for cash flow from operations used in this calculation was not adjusted for 1987 changes to accounting procedures for reporting cash flows and therefore may only approximate cash flow from operations under the new procedures.

[b]Not meaningful because of negative cash flow from operations and earnings before interest and taxes.

[c]Calculation based on earnings for 9 months of fiscal year ended January 28, 1989, after acquisition by Campeau.

Sources: GAO analysis based on company data filed with SEC and industry data produced by Media General Financial Services, Inc. Industry data are based on the average of 21 department store companies for calendar years 1985 to 1989.

After the LBO, as part of its strategy to generate cash flow, Federated introduced cost-cutting measures that eliminated about 5,000 administrative positions and took steps to lower advertising, travel, and supply costs. By merging Goldsmith's into Rich's it sought to reduce administrative overhead operations in those divisions.

Through its affiliation with Allied, Federated also took part in a central merchandising strategy involving the increased use of private label merchandise and enhanced selling services. According to documents filed with SEC by Federated, the enhanced selling program had not generated sufficient sales to cover the added expense for the program at the end of fiscal year 1989.

Companies' Liquidity Deteriorated After LBOs

Allied

A company's liquidity, i.e, its ability to meet short-term obligations, is indicated by the current ratio and the quick ratio. The current ratio compares the levels of current assets to current liabilities while the quick ratio includes only cash, marketable securities, and receivables as current assets to provide a more immediate measure of a company's short-term debt paying ability.

Allied's liquidity suffered after the LBO. Pre-LBO and post-LBO liquidity measures are shown in table V.18. Both ratios show a decline in Allied's liquidity after the LBO.

Although Allied's liquidity declined after the LBO, it was during 1989, the fiscal year in which it filed for bankruptcy, that Allied's liquidity problems attained critical proportions. On September 15, 1989, Allied failed to make an interest payment on its 11-1/2-percent senior subordinated debentures. Although the payment was made a few days later—after Campeau obtained a $175 million loan from Canadian developer Olympia and York, Ltd.—other payments and obligations were coming due that would stress Allied's liquid resources to the breaking point.

Table V.18: Allied Stores Corporation and Industry Liquidity Ratios

	Pre-LBO	Post-LBO		
Ratio	**1985[a]**	**1987**	**1988**	**1989**
Allied (fiscal year)				
Current ratio	2.3	1.2	1.5	4.0[b]
Quick ratio	1.4	0.8	1.7	2.5[b]
Industry (calendar year)				
Current ratio	2.3	2.0	2.0	1.8
Quick ratio	1.4	1.2	1.2	1.2

[a]Data for 1986, the year of the acquisition and merger, were not included because they covered only part of the fiscal year and were not consistent.

[b]The improvement in the ratios for 1989 reflected accounting changes that reclassified current liabilities in Allied's 1989 debtor-in-possession financial statements, not improved performance.

Sources: GAO analysis based on company data filed with SEC and industry data produced by Media General Financial Services, Inc. Industry data are based on the average of 21 department store companies for calendar years 1985 to 1989.

Federated

Federated's ability to meet short-term obligations, as indicated by the liquidity ratios shown in table V.19, also deteriorated after the LBO. Federated's pre-LBO liquidity, as shown by the current ratio, was almost twice the level of its post-LBO 1988 liquidity. Its pre-LBO quick ratio, however, which focuses on the most liquid assets, indicated that before the LBO Federated was more than able to meet its short-term obligations, and after the LBO it was less able. Federated's liquidity ratios for 1989 increased substantially as a result of the reclassification of Federated's liabilities with the bankruptcy filing.

Table V.19: Federated Department Stores, Inc., and Industry Liquidity Ratios

	Pre-LBO	Post-LBO	
Ratio	**1987**	**1988**	**1989**
Federated (fiscal year)			
Current ratio	1.8	0.9	3.8[a]
Quick ratio	0.9	0.4	2.2[a]
Industry (calendar year)			
Current ratio	2.0	2.0	1.8
Quick ratio	1.2	1.2	1.2

[a]The improvement in the ratios for 1989 reflected accounting changes that reclassified current liabilities in Federated's 1989 debtor-in-possession financial statements, not improved performance.

Sources: GAO analysis based on company data filed with SEC and industry data produced by Media General Financial Services, Inc. Industry data are based on the average of 21 department store companies for calendar years 1985 to 1989.

Like Allied, Federated's liquidity problems intensified during 1989. On September 19, 1989, Federated entered into an agreement with Campeau Corp. whereby Campeau agreed to make, or cause to make,

$150 million available to the company until September 18, 1991. These funds were to satisfy working capital requirements. The loan became necessary because of liquidity and working capital needs that Federated experienced during the summer of 1989.

Funds for the Campeau loan were from the same Olympia and York loan to provide Allied funds pursuant to a September 12, 1989, agreement. The loan agreements contained provisions relating to a proposed financial restructuring of Campeau and its subsidiaries—including Federated, the creation of a restructuring committee, and changes in the senior management of Campeau Corporation U.S. Olympia and York also purchased 15.6 million series A warrants of Campeau and, as a result, beneficially owned 45.3 percent of Campeau.

Profitability Disintegrated After LBOs

Allied

The overall financial performance of Allied's stores, which were on shaky ground in the years immediately following the LBO, as indicated by profitability data shown in table V.20, faltered during fiscal year 1989. Allied suffered a net loss for fiscal year 1987, the first full fiscal year after the LBO, recuperated slightly the next year, earning $51 million, then reported a disastrous loss of $925 million for fiscal year 1989. The loss was driven by losses associated with Allied's equity holdings of Federated Department Stores, the tremendous interest expense that Allied faced, and its general poor operating performance. Allied's profit margin (net income as a percentage of sales), which was well above the industry average of department stores before the LBO, reflected the same post-LBO pattern as net income. Allied's gross margin, measured as net sales minus the cost of goods sold as a percentage of sales, fell by over 4 percentage points immediately after the LBO and fell even further during fiscal year 1989. This fall in gross margin reflects lower net sales and possibly Allied's discounting of its prices on goods sold. Before the LBO, Allied's gross margin almost equaled the industry average and fell below the industry average after the LBO.

Table V.20: Allied Stores Corporation and Industry Profitability Measures (Dollars in Millions)

Measure	Pre-LBO 1985[a]	Post-LBO 1987	1988	1989
Allied (fiscal year)				
Net income (loss)	$159	($169)	$51	($925)
Profit margin	3.9%	[b]	1.7%	[b]
Gross margin	31.9%	27.5%	28.7%	27.2%
Industry (calendar year)				
Profit margin	2.5%	3.1%	2.5%	2.2%
Gross margin	32.0%	31.7%	31.1%	28.8%

[a]Data for 1986, the year of the acquisition and merger, were not included because they covered only part of the fiscal year and were not consistent.

[b]Not meaningful because of net loss.

Sources: GAO analysis based on company data filed with SEC and industry data produced by Media General Financial Services, Inc. Industry data are based on the average of 21 department store companies for calendar years 1985 to 1989.

Federated

Federated's overall financial performance, although mediocre the year before the LBO, as indicated by the profitability data shown in table V.21, disintegrated after the LBO. Net income became a net loss after the LBO. Gross margin, which was below the industry average before the LBO, improved slightly for the 9 months of fiscal year 1988 after the LBO, then fell for fiscal year 1989.

Table V.21: Federated Department Stores, Inc., and Industry Profitability Measures (Dollars in Millions)

Measure	Pre-LBO 1987	Post-LBO 1988[a]	1989
Federated (fiscal year)			
Net income (loss)	$313	($156)	($233)[b]
Profit margin	2.8%	[c]	[c]
Gross margin	26.3%	28.5%	27.0%
Industry (calendar year)			
Profit margin	3.1%	2.5%	2.2%
Gross margin	31.7%	31.1%	28.8%

[a]Calculations based on earnings for 9 months of fiscal year ended January 28, 1989, after acquisition by Campeau.

[b]Loss before unusual item of $1.15 billion write-down of the excess of cost over net assets acquired and reorganization items.

[c]Not meaningful because of net loss.

Sources: GAO analysis based on company data filed with SEC and industry data produced by Media General Financial Services, Inc. Industry data are based on the average of 21 department store companies for calendar years 1985 to 1989.

Companies Blame Bankruptcy on LBO Debt

As a result of the companies' heavy debt burden and poor financial performance, Allied and Federated and several of their subsidiaries filed separate petitions for relief under the U.S. Bankruptcy Code. According to the companies' filings with SEC for fiscal year 1989, the bankruptcy filings were precipitated by the cash flow and liquidity problems of the third and fourth quarters of 1989, due in part to the highly leveraged capital structure of the companies after the mergers with Campeau. Also significant in the companies' decisions to file for bankruptcy protection, according to the filings, was that major portions of the companies' debts were due to mature in the first half of 1990. This, combined with ongoing general speculation about the companies' ability to meet their obligations as they became due, adversely affected the availability of trade credit and other financing.

After the bankruptcy filings, the companies continued in possession of their respective properties and operated and managed their respective businesses as debtors-in-possession. Shortly after the filings, the bankruptcy court approved post-petition credit agreements under which the companies would finance general working capital requirements such as purchases of inventories. Chemical Bank acted as the agent for providing the post-petition credit for Allied; Citibank acted as the agent for Federated's credit plan.

Events Since the Bankruptcy Filings

Press accounts provide a record of events that occurred with the companies after the January 1990 bankruptcy filings. In March 1990, Campeau failed to make interest payments and defaulted on $705 million of loans from DeBartolo and Olympia and York. On March 31, 1990, Federated Stores, Inc., the parent firm of Allied and Federated, formerly called Campeau Corporation U.S., filed for Chapter 11 protection. In May 1990, August 1990, and again in February 1991, Allied and Federated were granted extensions by the bankruptcy court on the deadline for filing their reorganization plans. A reorganization plan for both of the companies was filed with the bankruptcy court on April 29, 1991. The plan proposed to merge Allied and Federated into a single company and resolve $8.2 billion in creditor claims with a combination of cash payments and issuances of notes and stock in the reorganized company. The plan saw the company emerging from bankruptcy early in 1992.

Case Study: Recapitalization of Phillips Petroleum

On March 28, 1985, under an offer dated March 4, Phillips Petroleum Company exchanged a package of debt securities totalling $4.5 billion for 72.58 million shares of its outstanding common stock. The exchange, a defensive tactic against the second hostile takeover attempt of Phillips in less than 3 months, more than doubled Phillips' long-term debt from $2.8 billion at the end of its fiscal year before the exchange to $7.3 billion immediately after. During the next 5 years, management placed a high priority on reducing the firm's debt burden and implemented various measures designed to achieve this objective. These measures included selling assets, lowering operating costs by reducing the work force and restructuring the company, and reducing capital spending. By the end of 1989, management had reduced Phillips' long-term debt to about $3.9 billion—a level management considered manageable because it allowed the company a sufficient degree of financial flexibility. Because of these successful efforts to reduce debt, management revised its planning by placing higher priority on capital spending projects and enhancing stockholder value.

Although our study focuses on Phillips after its exchange offer, the company, as well as the U.S. oil industry, had already been restructuring itself in response to a changing economic environment that created uncertainty about oil's future profitability.[1] According to an Office of Technology Assessment (OTA) special report, restructuring of the U.S. oil industry during the 1980s resulted in fundamental shifts in the size and composition of the industry as a whole and in the internal organization and direction of individual companies.[2] Actions taken by Phillips, including its exchange offer and subsequent asset sales, work force reductions, and operational and organizational changes, paralleled events that were happening throughout the U.S. oil industry. According to comments provided by Phillips officials, the high debt burden following the takeover attempts and recapitalization accelerated the pace of Phillips' ongoing restructuring activities and caused the company's actions to be more severe than would otherwise have been required.

[1] According to U.S. Oil Production - The Effect of Low Oil Prices, Office of Technology Assessment, Special Report (Sept. 1987), prevailing conditions in the oil industry prompting restructuring included (1) a surplus capacity in oil production and refining and marketing operations due to higher oil prices and industry expansion in the 1970s; (2) a fall in oil consumption from 1979-83 due to higher oil prices, increased conservation efforts, and the 1982 recession; (3) a decline in oil prices beginning in 1981 due to excess oil production capacity, reduced demand, and the breakdown of the Organization of Petroleum Exporting Countries; and (4) relatively high finding costs and difficulty in finding and producing new domestic oil reserves.

[2] U.S. Oil Production - The Effect of Low Oil Prices, p. 99.

This case study is based primarily on public documents filed by Phillips with SEC. Officials at Phillips reviewed and commented on a draft of our study and also provided information on employment levels.

Recapitalization of Phillips

In December 1984 and February 1985, Phillips became the target of two separate hostile takeover attempts. The company fought these attempts through a recapitalization and thus remained independent while at the same time giving its stockholders a premium return on their investment. The company successfully defeated both takeover attempts, although in doing so it incurred a substantial amount of debt.

Phillips

Phillips, headquartered in Bartlesville, Oklahoma, is a fully integrated oil company, performing all the principal functions of the oil industry: exploration, production, refining, transportation, and marketing. The company engages in petroleum exploration and production on a worldwide basis and petroleum refining and marketing in the United States. In addition, Phillips also produces and distributes chemicals worldwide. Within the petroleum industry, Phillips is recognized as the largest producer of natural gas liquids in the United States and as one of the industry leaders in refining high-sulfur crude oils. Its corporate fiscal year, which we use throughout this report, is the same as the calendar year and thus ends on December 31.

Mesa Partners: First Hostile Bidder

Mesa Partners, a Texas general partnership formed in October 1984, tried to obtain control of Phillips and to acquire all, or substantially all, of Phillips' equity interest. The partnership had three general partners: Mesa Asset Co., an indirect wholly owned investment subsidiary of Mesa Petroleum Co., and two Texas corporations—Cy-7, Inc., and Jack-7, Inc. The two Texas corporations are wholly owned by Mr. Cyril Wagner, Jr., and Mr. Jack E. Brown, respectively, the sole partners of Wagner & Brown, a Texas corporation engaged in oil and gas exploration.

Icahn Group Inc.: Second Hostile Bidder

Icahn Group Inc., a Delaware corporation, was organized solely for the purpose of obtaining control of Phillips. Mr. Carl C. Icahn, an investor and, at the time of the offer, one of Phillips' largest shareholders with nearly 5 percent of the company's outstanding shares, controlled Icahn Group Inc.

Summary of Takeover Attempts and Recapitalization

Mesa Partners' Takeover Attempt

On December 4, 1984, Mesa announced it intended to file a tender offer and then merge or form some other business combination with Phillips so that remaining stockholders would receive a combination of cash and securities.[3] Some of Mesa's reasons for proposing a takeover may be gleaned from testimony given by Mr. T. Boone Pickens, Jr.,[4] in April 1984. Mr. Pickens cited various reasons why he considered mergers and acquisitions to be healthy for the energy industry, including producing more efficient management, and hence a more efficient company, as well as enhancing stockholder value. Phillips' board of directors opposed the proposal after concluding that Mesa's offer was not in the best interests of the company and its stockholders. On December 23, 1984, Mesa and Phillips agreed that Phillips would propose a recapitalization plan to its stockholders, Mesa would terminate its takeover attempt, and neither party would seek control of the other for 15 years. In addition, whether the plan was approved or not, Mesa agreed to sell its shares to either designated investment bankers or the company for not less than $53 per share in cash. On March 11, 1985, Mesa sold all its shares to Phillips for a profit of $89 million. Summary information on Mesa's takeover attempt follows:

- Percent of outstanding common shares owned at time of offer - 5.8;
- Percent of shares sought in tender - 14.9;
- Tender offer price per share - $60 cash; and
- Price per share for remaining shares outstanding for proposed merger - "approximately" $60 in cash and securities.

Icahn's Takeover Attempt

On February 4, 1985, Mr. Icahn stated that Phillips' proposed recapitalization plan, initiated according to Phillips' settlement agreement with Mesa, was inadequate, and if the plan was not improved he would attempt to take over the company. Icahn commenced a tender offer on

[3]Mesa announced its intentions on this date. However, because of ensuing litigation between Mesa and Phillips, Mesa never commenced a tender offer before entering a settlement agreement with Phillips.

[4]Mr. T. Boone Pickens, Jr., is president and chairman of the board of Mesa Petroleum Co., a Delaware corporation engaged in the exploration and production of natural gas, oil, condensate, and natural gas liquids in the United States.

February 14, 1985, conditioned upon stockholder rejection of the recapitalization plan, elimination of Phillips' stock rights, or poison pill,[5] and the ability to obtain financing. Upon completion of the offer, Icahn intended to merge with Phillips, and all remaining stockholders would exchange their shares for debt securities.

On March 3, 1985, Phillips announced that its initial recapitalization plan failed to receive stockholder approval and that it planned to improve the offer. The company then entered into a settlement agreement with Icahn under which Icahn agreed to terminate its takeover attempt and not to attempt another Phillips takeover for 8 years. Icahn's investment adviser, Drexel Burnham Lambert Inc., also agreed not to finance a Phillips takeover attempt for 3 years. Summary information on Icahn's takeover attempt follows:

- Percent of outstanding shares owned at time of offer - by Icahn Group - none, by Mr. Icahn - 4.85;
- Percent of shares sought in tender - 45.0;
- Tender offer price per share - $60 cash; and
- Price per share for remaining shares outstanding for proposed merger - $50 debt securities.

Phillips' Recapitalization

On March 4, 1985, Phillips presented its stockholders with an improved recapitalization plan. The plan proposed an exchange of debt securities, valued at $62 per share, for 72.58 million shares, or about 47 percent, of Phillips' outstanding common stock. After the exchange, Phillips intended to (1) increase annual common stock dividends $0.60 per share, before adjustment for any stock split; (2) split its common stock 3-for-1 through a 200-percent common stock dividend; and (3) issue a new series of redeemable preferred stock having an aggregate face value of $300 million as a dividend to remaining stockholders.

By March 15, 1985, about 86 percent of Phillips' outstanding stock had been offered for exchange. Stockholders who offered their stock before this date, called the proration deadline, were guaranteed that a percentage of the shares offered would be exchanged for the debt securities if more shares than sought in the offer were tendered. Because Phillips' offer only sought about 47 percent of the outstanding common stock, about 54 percent of the shares tendered by each stockholder before the

[5] A poison pill is any kind of action taken by a takeover target company to make its stock less palatable to an acquirer. Phillips' stock rights, distributed on February 18, 1985, gave stockholders the right to exchange one common share for a 1-year debt obligation with a face value of $62 if a person or group acquired 30 percent or more of the outstanding stock.

deadline were accepted for exchange. The rest of the shares were returned, and no shares tendered after the deadline were accepted for exchange.

On March 28, 1985, Phillips issued the following debt securities:

- $2.1 billion aggregate principal amount, floating rate senior notes, due in 1995;
- $1.3 billion aggregate principal amount, 13.875-percent senior notes, due in 1997; and
- $1.1 billion aggregate principal amount, 14.75-percent subordinated debentures, due in 2000.

Stockholder Premium

In 1983, Phillips' common stock traded between $29.38 and $38.88 a share, and for the first three quarters of 1984 it ranged between $33.38 and $45.25.[6] During the period that Phillips was fighting takeover attempts and formulating its recapitalization plan, the closing price for its common stock ranged from $42.88 to $55 a share, and stockholders had the opportunity to realize various premiums depending on when they sold their stock. For example, on the first trading day after Mesa announced it intended to acquire control of Phillips, stockholders could have received a premium[7] of 27.4 percent had they sold their stock on the market. The premium increased to 30.7 percent the day before Mesa and Phillips announced their settlement agreement. However, the first trading day after Mesa and Phillips announced their agreement, the market price of Phillips' common stock fell about 17.5 percent, and the premium dropped to 7.7 percent. Phillips' final recapitalization plan, valued at $62 a share, provided a premium of 47.6 percent for those shares tendered in the exchange offer.

Adviser Fees

Although the filings we reviewed did not indicate whether Mesa used advisers in its attempt to take over Phillips, they did show that both Icahn and Phillips enlisted the services of advisers to help achieve their respective goals concerning control of the company. Icahn retained Drexel as its investment banker for financial advisory services and to arrange financing for its tender offer. Icahn paid Drexel an initial fee of $1 million and, if the deal had been consummated, agreed to pay Drexel

[6] Amounts not adjusted for 3-for-1 common stock split, effective May 31, 1985.

[7] To reflect the stock value before the takeover might have influenced it, premiums were based on the closing stock price of $42 a share on November 2, 1984, 1 month before Mesa's initial announcement.

2 percent of the aggregate principal amount of the financing obtained, less the initial fee. Alternatively, if Icahn sold any of its shares for more than $46 a share, Icahn would pay Drexel 20 percent of the pre-tax net profits. Icahn also retained another financial adviser, the investment banking firm Donaldson, Lufkin & Jenrette, Inc., for a fee of $1.3 million.

Phillips paid fees totalling $35 million to its two financial advisers: Morgan Stanley & Co., Inc., and The First Boston Corporation. Of the $35 million, Morgan Stanley received $20 million: $2 million for advice on Mesa's offer, an additional $4 million upon execution of the Mesa settlement agreement, and $14 million for advisory services related to the exchange offer. First Boston received $15 million: $4 million for advice on the Mesa contest and another $11 million for services related to the exchange offer.

In addition to financial advisory fees, Phillips incurred other costs and expenses in its effort to remain independent. Some of these, which Phillips estimated to be about $75 million, included

- $25 million of the expenses incurred by Mesa in its attempt to acquire control of the company, according to the settlement agreement;
- $25 million of the expenses incurred by Icahn in its attempt to acquire control of the company, according to the settlement agreement;
- $12 million in attorney fees;
- $10 million in banking fees and commissions; and
- $3 million in other costs and expenses.

Impact of Recapitalization on Phillips

While Phillips' recapitalization enabled the company to remain independent, it also significantly increased the company's debt burden. This made it more vulnerable to swings in the economy, reduced its flexibility in deciding how to spend its available cash flow, and potentially limited its ability to obtain future financing. Although Phillips' top management changed somewhat after the exchange offer, all but one new executive had been promoted from within the company. The management team placed a higher priority on reducing debt and implemented various measures designed to decrease both debt and operating costs. Management faced additional pressure to cut the company's costs and increase its financial flexibility in 1986 when crude oil prices fell almost 50 percent because of on oversupply in world production.[8] After selling about $2 billion in assets, reducing the work force, restructuring the company, decreasing capital spending, refocusing research and development (R&D) efforts, and implementing other debt service measures, management had decreased Phillips' debt burden by the end of 1989 to a level they considered manageable. Phillips' bond ratings and prices reflected changes in the company's financial strength and flexibility.

Phillips' Capitalization Became Primarily Debt After the Exchange Offer

The exchange offer essentially shifted Phillips' main source of funding from equity to debt. Specifically, before the exchange offer, at the end of 1984, Phillips' long-term debt was about 30 percent of its capitalization,[9] which indicated that Phillips' principal means of raising capital was by issuing stock. Immediately after the exchange offer, Phillips' long-term debt increased to about 81 percent of its capitalization, which made borrowed funds the largest source of capital. By itself this change does not indicate that Phillips' financial position was greatly weakened. However, the increased debt placed more stress on Phillips because it required the company to pay interest on the debt that, unlike dividends, could not be deferred in times of poor operating results. According to OTA, oil companies with high debt levels raise two concerns: they may have less flexibility in deciding how to spend their available cash flow and, as assets are sold and capital expenditures are cut to pay off debt, they may have to reduce commitments to exploration and production activities.[10]

Management's retirement of debt after the recapitalization reduced the percentage of capitalization made up of long-term debt. However, long-term debt remained the primary source of Phillips' capitalization. In 1989, the last year management considered reducing debt a key objective, long-term debt was still about 65 percent of the company's capitalization.

[8]According to U.S. Oil Production - The Effect of Low Oil Prices, p. 25, the average price of oil fell from about $28 per barrel (bbl) in December 1985 to $14/bbl in April 1986 and for the rest of 1986, fluctuated between $10 and $18/bbl. Phillips' 1986 average price for U.S. and foreign crude oil declined 44 and 47 percent, respectively, from 1985.

[9]Capitalization is the total value of a corporation's long-term debt and preferred and common stock accounts.

[10]U.S. Oil Production - The Effect of Low Oil Prices, p. 114.

Continuity in Top Management After the Exchange Offer

After the exchange offer, Phillips retained continuity in its upper management by filling vacancies in top management positions[11] with individuals already employed by the company. Specifically, all officers who left the company after the exchange offer had retired, and all but one new officer had been promoted from within the company.[12] For example, in 1985, the year of the exchange offer, 6 of Phillips' 25 corporate officers retired. In the subsequent reshuffling, 5 existing officers assumed either vacated or new positions through promotions. Similar turnovers occurred from 1986 through 1989, although no more than two officers retired in each of these years, and in early 1988 Phillips created four top management positions because of a restructuring of the company. At the end of 1989, half of Phillips' top management positions consisted of the same individuals as in 1983, and all but one of the remaining individuals had been promoted from within the company.

Asset Sale Proceeds Used to Reduce Debt

A key element in management's plan to reduce debt was its asset sales program. The program, which was to be completed within 1 year of the exchange offer, was expected to yield $2 billion after taxes, all of which would be applied toward reducing Phillips' outstanding debt. Management met this objective through selling assets from each of the company's operating divisions and completed the program in 1986 after reaching its $2 billion goal. Some of the assets sold included Phillips' minerals operations, except certain coal properties; several oil and gas properties; gas gathering systems; a crude oil tanker; a fertilizer business; and equity interests in various gas and chemical plants.

According to the filings we reviewed, management did not expect the sales to significantly affect Phillips' ongoing business and expected only a minimal impact on net income. After completing its asset sales program, Phillips still retained its status as the largest domestic producer of natural gas liquids and an industry leader in refining high-sulfur crude oil. In addition, Phillips remained in the top 20 of 400 publicly traded U.S. oil and gas firms with respect to total revenues, U.S. and world liquid and gas reserves, and U.S. and world liquid and gas production.[13]

[11]These positions include chairman of the board, chief executive officer, president, chief operating officer, executive vice presidents, senior vice presidents, and vice presidents.

[12]One individual left in 1987 to be president of a new company formed by a subsidiary of Phillips and another corporation. The individual was reinstated as a vice president at Phillips in 1989.

[13]The Oil and Gas Journal has issued a report each year since October 17, 1983, containing financial and operational data for the top 400 publicly traded U.S. oil and gas firms. The Journal determines the top 400 on the basis of total assets and ranks them according to various performance measures.

Operating Costs and Expenses Reduced Through Work Force Reductions and Restructuring Operations

As part of its efforts to reduce debt, management planned to decrease operating costs and expenses.[14] Although the desired reductions in costs and expenses could be achieved in a myriad of ways, Phillips' annual reports cited work force reductions and restructuring of operations as two major ways it achieved reductions.

Reducing the Work Force Was a Key Element in Reducing Costs

Although management had been reducing Phillips' work force since late 1981, after the exchange offer reducing manpower costs through staff reductions became a key element in management's effort to reduce operating costs. Specifically, during 1985 Phillips' work force declined about 14 percent primarily because of two early retirement programs management offered employees.[15] In 1986, management reduced the work force another 14 percent and attributed most of the decline to a "Special Separation Program," which offered early retirement incentives and outplacement services. During this year, management also temporarily froze employee salaries. Management's actions concerning the work force in 1986 were shaped not only by Phillips' debt burden but also by an oil price collapse of almost 50 percent that was due to a worldwide oil glut. Finally, as part of a major cost-reduction program implemented in 1988, management reduced staff another 7 percent.

At the end of 1989, Phillips' payroll and employee benefit costs were about 11 percent less than in 1984 before the exchange offer. Phillips' gross payroll costs, including employee benefits, are shown in table VI.1.

Table VI.1: Phillips Gross Payroll, Including Employee Benefits (Dollars in Millions)

Year	Amount	Percent change from previous year
1984	$1,164	(2.3)
1985	1,130	(2.9)
1986	974	(13.8)
1987	998	2.5
1988	1,053	5.5
1989	1,039	(1.3)

Source: GAO analysis based on company data filed with SEC.

[14] At the time of the offer, management forecast that from 1985 through 1987 it would reduce previously planned overall operating costs and expenses by 10 to 15 percent. Without knowing what those planned costs and expenses had been, we could not determine whether Phillips attained the desired reduction.

[15] Of the 3,600 employees eligible, 2,570 participated in early retirement programs offered May 14, 1985, and August 2, 1985.

Restructuring and Streamlining Operations Helped Reduce Operating Costs

Before the exchange offer, at the end of 1984, Phillips had five operating groups: (1) exploration and production, (2) gas and gas liquids, (3) petroleum products, (4) chemicals, and (5) minerals. After the exchange offer, management restructured Phillips' operating groups twice in an effort to improve efficiency and lower operating costs. In the first reorganization, during 1985, management discontinued Phillips' minerals operations,[16] which had generated losses since at least 1979, and consolidated the operating groups in Phillips' downstream operations[17] —petroleum products and chemicals. Consolidating these operating groups enabled management to take advantage of Phillips' integrated oil operations: its petroleum products division supplied about two-thirds of the raw material and product needs of its chemicals division in the United States. According to the filings we reviewed, streamlining these operations led to increased operating efficiency and improved productivity, and it also enabled management to take a uniform approach to processing and marketing activities.

During 1988, management implemented a new cost-reduction program under which it consolidated Phillips' upstream operations[18] —exploration and production and gas and gas liquids. Management's objective was to make these operations profitable even under adverse market conditions and to further streamline procedures and reduce operating costs. This reorganization merged many common staff functions, which led to a 10-percent decline in the company's upstream work force.

Capital Spending Reduced After the Exchange Offer

Management also reduced capital expenditures in 1985 and 1986 to help meet debt obligations. However, the reduction in 1986—almost 40 percent below 1985—was not only management's response to Phillips' increased debt but also was largely due to the deterioration of oil prices that occurred in 1986 and adversely affected the entire oil industry. Management increased the level of capital expenditures from 1987 through 1989; however, they remained below the level that existed before the recapitalization. Table VI.2 illustrates the changes in capital expenditures.

[16]A substantial number of minerals operations were sold in the asset sales program. However, certain coal properties had been excluded, and in 1987 management reactivated those operations.

[17]Downstream operations generally include the refining, transportation, and marketing functions of the oil industry and offer products ranging from raw materials to motor fuels and plastics for sale to customers.

[18]Upstream operations are the businesses responsible for finding and producing oil and natural gas and for extracting the liquids from natural gas.

Table VI.2: Changes in Capital Expenditures (Dollars in Millions)

Year	Expenditure	Percent of average total assets
1983	$1,141	9.1
1984	1,364	9.1
1985	1,065	6.9
1986	646	4.9
1987	737	6.0
1988	797	6.6
1989	872	7.5

Source: GAO analysis based on company data filed with SEC.

Phillips' operations are capital-intensive and require significant expenditures over long periods. Consequently, in accordance with the decrease in capital expenditures, the company adjusted its capital spending plans. Various strategies outlined in Phillips' annual reports indicated that management became more selective in its capital spending projects and emphasized less-risky endeavors. For example, in Phillips' exploration and production division, management concentrated on developing existing oil and gas discoveries that could be brought onstream quickly in order to generate near-term cash flow. High-risk exploration projects were to be undertaken only if Phillips had a special advantage.

Furthermore, in 1986 management began increasing funding for its downstream operations while decreasing the amount directed to its upstream operations. According to Phillips' annual report, management began redirecting capital expenditures because of the 1986 oil price collapse, which had hurt the company's upstream operations. The collapse had the opposite effect on Phillips' downstream operations because it decreased raw material costs. As a result, the company began to shift its capital investments toward its more profitable downstream operations.

Research and Development More Focused on Phillips' Core Businesses After the Exchange Offer

Although R&D expenditures declined in 1985 and 1986,[19] Phillips management continued to emphasize R&D but focused its research efforts on the company's core businesses. According to Phillips' tender offer statement, management expected to reduce discretionary research projects as part of its effort to reduce operating costs. On the basis of its annual reports, Phillips continued to conduct R&D in the same areas it had

[19] R&D expenditures declined about 14 percent in 1985 and about 17 percent in 1986; relative to the size of the company—measured by dividing R&D expenditures by sales and by average total assets—any declines were less than 1 percent. Part of the 1986 decline might have been due to the fall in oil prices.

before the offer but concentrated its efforts more on developing new products and processes to enhance the profitability of its operations.

Phillips conducted less research in biotechnology and, despite having completed a new biotechnology facility in late 1984, ended most of its in-house pharmaceutical research in 1988. According to its annual report, those research efforts were refocused in more direct support of Phillips' core businesses. This aspect of Phillips' R&D involved developing various proteins that had potential use in the pharmaceutical industry and in various medical applications, including cancer and cardiovascular treatments and diagnosing human dwarfism. Consequently, the impact of Phillips' curtailing this research could have had an adverse effect on more than just the company's competitive position because potential discoveries and developments might have been lost.

Phillips received both U.S. and foreign patents each year after the exchange offer, leading the industry in the number of active U.S. patents it held. From 1987 through 1989, management increased Phillips' R&D expenditures. After a 32-percent increase in 1989, the level of expenditures at the end of that year was about 17 percent higher than in 1983 before the exchange offer.[20]

Surplus Funds in Pension Plan and Decreased Common Stock Dividends Helped Reduce Debt

Additional methods management used to help meet increased debt obligations included restructuring Phillips' primary retirement plan to obtain the surplus funds and decreasing the common stock dividend. Management implemented both measures in 1986 when it was taking actions to not only reduce Phillips' debt burden but also to increase the company's financial strength and flexibility in the wake of the oil price collapse. Through restructuring the retirement plan,[21] $379 million in surplus funds were returned to the company. Common stock dividends were reduced in April 1986 and remained low until they were increased in July 1988 and again in March and September of 1989 when Phillips' financial outlook continued to improve.

[20]Similar increases were reflected in R&D expenditures in relation to the size of the company as measured by dividing R&D expenditures by sales and by average total assets.

[21]On September 1, 1986, the retirement plan was separated into two plans: one for retirees and one for active employees. Annuity contracts were purchased to settle obligations for retiree benefits as well as those benefits accrued by active employees as of this date.

Bond Ratings and Prices Reflected Phillips' Changing Situation

Management's efforts to keep Phillips independent, reduce its debt, and increase its financial strength and flexibility were reflected by changes in the investment ratings of the company's bonds and, to a lesser degree, prices of those bonds. As Phillips' debt burden increased because of the exchange offer and was then successfully reduced to a level management considered manageable, Moody's Investors Service accordingly downgraded and upgraded the bonds' investment ratings.

For example, before the exchange offer, when management was fighting the two hostile takeover attempts and proposing to recapitalize the company, Moody's downgraded Phillips' five pre-exchange bonds twice: from Aa3 to Baa2 to Baa3. This downgrading indicated that, with the company's proposed incurrence of debt, Moody's considered the bonds' investment risk to have increased. Then in 1986, despite completion of the $2 billion asset sale program, Moody's downgraded Phillips' pre- and post-exchange bonds, which reflected the additional stress placed on the company by the collapse in oil prices and the continually high interest expense. As management's efforts to reduce debt began to make a difference and Phillips' financial situation improved, Moody's upgraded the ratings on all of Phillips' bonds to reflect the company's improved financial strength. Changes in the investment ratings are shown in table VI.3. (Moody's bond ratings are explained in appendix III, footnote 26.)

Table VI.3: Investment Ratings for Phillips' Bonds

	Date							
	12/84	01/85	03/85	05/85	02/86	09/88	01/89	03/90
Pre-exchange offer								
8.875-percent debentures due in 2000	Aa3	Baa2	Baa3	Baa3	Ba1	Baa3	Baa2	Baa1
7.625-percent debentures due in 2001	Aa3	Baa2	Baa3	Baa3	Ba1	Baa3	Baa2	Baa1
12.25-percent debentures due in 2012	Aa3	Baa2	Baa3	Baa3	Ba1	Baa3	Baa2	Baa1
11.25-percent debentures due in 2013	Aa3	Baa2	Baa3	Baa3	Ba1	Baa3	Baa2	Baa1
12.875-percent notes due September 1, 1992	Aa3	Baa2	Baa3	Baa3	Ba1	Baa3	Baa2	[a]
Post-exchange offer								
13.875-percent senior notes due in 1997	[b]	[b]	[b]	Baa3	Ba1	Baa3	Baa2	Baa1
Floating rate senior notes due in 1995	[b]	[b]	[b]	Baa3	Ba1	Baa3	Baa2	[c]
14.75-percent subordinated debentures due in 2000	[b]	[b]	[b]	Ba1	Ba3	Ba2	Baa3	Baa2

Note: Dates selected reflect all rating changes by Moody's from January 1984 through December 1990.

[a]In September 1989, Phillips called the entire issue of 12.875-percent notes, due on September 1, 1992.

[b]Moody's Bond Record did not list the securities issued in the March 1985 exchange offer until its June 1985 publication, which reflected bond data as of the end of May 1985.

[c]In 1988 Phillips retired $1.1 billion of these notes, due in 1995, and in 1989 redeemed all remaining notes.

Source: Moody's Bond Record.

Prices of Phillips' pre-exchange bonds generally stayed the same during the takeover fights and the company's subsequent recapitalization, but after the exchange offer the prices of Phillips' bonds increased as its financial and operational strength improved.[22] Selected prices are shown in table VI.4.

Table VI.4: Phillips' Bond Prices (Prices Are Rounded)

	Date							
	12/84	**01/85**	**06/85**	**12/86**	**12/87**	**12/88**	**12/89**	**12/90**
Pre-exchange offer								
8.875-percent debentures due in 2000	$750	$760	$790	$900	$860	$910	$970	$970
7.625-percent debentures due in 2001	660	670	700	800	770	820	880	840
12.25-percent debentures due in 2012	980	970	990	1,080	970	1,060	1,070	1,080
11.25-percent debentures due in 2013	900	860	930	1,030	980	1,030	1,060	1,050
12.875-percent notes due September 1, 1992	1,020	1,030	1,050	1,080	1,030	1,010	[a]	[a]
Post-exchange offer								
13.875-percent senior notes due in 1997	[b]	[b]	1,050	1,120	1,090	1,110	1,110	1,090
Floating rate senior notes due in 1995	[b]	[b]	980	900	930	1,000	[c]	[c]
14.75-percent subordinated debentures due in 2000	[b]	[b]	1,070	1,150	1,110	1,120	1,120	1,100
9.5-percent notes due in 1997	[d]	[d]	[d]	[d]	[d]	[d]	[d]	1,010

[22] Although other factors, such as interest rates, issue terms, and rumors of potential takeovers, also influence a company's bond prices, we generally linked any price trends to the financial and operational status of the company.

Note: Except for the period of time during the takeover fights, dates selected reflect year-end bond prices. All bonds have a $1,000 face value.

[a]In September 1989, Phillips called the entire issue of 12.875-percent notes, due in 1992.

[b]Moody's Bond Record did not list prices for the securities issued in the March 1985 exchange offer until its July 1985 publication, which reflected bond data as of the end of June 1985.

[c]In 1988 Phillips retired $1.1 billion of these notes, due in 1995, and in 1989 redeemed all remaining notes.

[d]These notes were issued in November 1990.

Source: Moody's Bond Record.

Financial Indicators of Phillips' Performance After the Exchange Offer

At the end of 1989, management indicated they had accomplished their debt reduction goals and improved the financial position of the company to an extent that enabled them to focus priorities on enhancing stockholder values rather than on planning further large debt reductions. Phillips' changing financial position is reflected by changes in the company's debt-to-equity ratios, ability to service debt, and profitability.

After Initial Increase, Phillips' Debt Burden Declined

Changes in Phillips' debt burden can be illustrated by the ratio of its debt to total common stockholders' equity (we refer to total common stockholders' equity as equity). As indicated in table VI.5, Phillips' debt-to-equity ratios increased significantly after the exchange offer and then declined as management's debt reduction efforts began to have an effect. Specifically, at the end of 1985, because of the large increase in long-term debt and a simultaneous decrease in equity, Phillips' total debt-to-equity ratio increased more than 4 times over the 1984 ratio while its long-term debt-to-equity ratio was about 10 times higher. Compared with industry ratios,[23] Phillips' pre-exchange offer debt-to-equity ratios were generally the same but were much higher afterward. For example, Phillips' 1985 total debt-to-equity and long-term debt-to-equity ratios were about 4 and 8 times higher, respectively, than the industry average. According to Phillips' chairman and CEO, who spoke to the National Association of Petroleum Analysts in April 1990, Phillips became the most highly leveraged company in the oil industry after its exchange offer.

[23]Industry ratios for 1985 through 1989 were obtained from an on-line database produced by Media General Financial Services, Inc. The industry data were compiled as of November 21, 1990, on the basis of 43 companies whose primary line of business was classified under the same Standard Industrial Classification (SIC) code as Phillips. Industry data for 1983 and 1984 were unavailable from Media General Financial Services Inc.'s on-line database. Industry ratios for these years were obtained from Financial Trends of Leading U.S. Oil Companies: 1968-1987, American Petroleum Institute, Discussion Paper #017R, and are based on aggregate financial data for 20 leading oil companies.

Table VI.5: Debt per Dollar of Total Common Stockholders' Equity

	Fiscal year						
	1983	1984	1985	1986	1987	1988	1989
Phillips							
Total debt/equity	1.1	1.6	7.4	6.0	6.4	4.7	4.3
Long-term debt/equity	0.4	0.4	4.0	3.3	3.4	2.3	1.9
Industry							
Total debt/equity	1.1	1.4	1.8	1.6	1.6	1.6	1.7
Long-term debt/equity	0.3	0.5	0.5	0.5	0.4	0.5	0.5

Sources: GAO analysis based on company data filed with SEC and industry data from the following two sources. We obtained industry data for 1985 through 1989 from an on-line database produced by Media General Financial Services, Inc. The database is based on data from 43 companies whose primary line of business was classified under the same SIC code as Phillips. Industry data for 1983 and 1984 were unavailable from this on-line database and instead were obtained from Financial Trends of Leading U.S. Oil Companies: 1968-1987, and are based on aggregate financial data for 20 leading oil companies.

From 1985 through 1989, management placed a high priority on reducing debt and decreased Phillips' debt burden each year.[24] By the end of 1989, management had reduced Phillips' total debt about 36 percent and its long-term debt about 46 percent from the amount outstanding immediately after the exchange offer. Furthermore, debt maturing in 1995—once $2.3 billion—had been reduced to about $450 million. Phillips' debt-to-equity ratios reflect the reduction. Although the ratios were still higher than both those before the exchange offer and the industry average, management no longer considered debt reduction its highest priority.

Phillips' Ability to Service Debt Maintained

To illustrate Phillips' ability to continue servicing its debt after the exchange offer, we calculated an interest coverage ratio and two measures of liquidity: current ratio and quick ratio. The ratios showed that Phillips could meet its expenses.

Phillips' Cash Flow Covered Increased Interest Expenses

As reflected in table VI.6, interest expense as a percentage of the company's earnings before interest and taxes increased considerably after the exchange offer—reaching a high of almost 70 percent in 1986.[25] Phillips' ability to cover its increased interest costs with internally generated cash flow—its interest coverage ratio—provides an indication of

[24]Phillips' 1987 debt-to-equity ratios slightly increased over 1986 because of lower earnings for the year, which decreased total common stockholders' equity. Debt had still been reduced—long-term debt about 6 percent and total debt about 1 percent.

[25]The high percentage in 1986 was due to the collapse in oil prices, which dampened Phillips' earnings. Interest expense had actually declined about 19 percent from 1985.

the company's ability to service its debt. After the exchange offer, Phillips' interest coverage ratio declined due to increased interest costs. However, the ratio remained above 1.0, indicating the company could cover all its interest expenses with internally generated cash. After 1987, as Phillips' financial position improved and its debt burden declined, its interest coverage ratio similarly rose. According to its annual report, at the end of 1989 management planned to redirect the majority of Phillips' internally generated cash flow from reducing debt to capital spending and stockholder distribution programs.

Table VI.6: Phillips' Interest Coverage

	Fiscal year						
	1983	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**
Interest expense as percent of earnings before interest and taxes	9.5	12.6	31.1	69.4	66.8	34.9	46.4
Cash flow from operations[a]/interest expense	[b]	5.7	2.2	1.9	1.6	2.7	2.6

[a]Cash flow from operations is not before interest expense because a breakdown of interest expense between cash and noncash interest was not included in the filings for all years.

[b]In 1988, Phillips adopted FASB Statement No. 95, "Statement of Cash Flows," which required a restating of previous cash flow data to conform to the new presentation. Restated 1983 data were not included in the filings we reviewed.

Source: GAO analysis based on company data filed with SEC.

Short-Term Liquidity: Current Ratio and Quick Ratio

An indication of a company's liquidity, or its ability to meet short-term obligations, is shown by the current and quick ratios. The current ratio compares the level of current assets with current liabilities while the quick ratio includes only cash, marketable securities, and receivables as current assets to provide a more immediate measure of a company's short-term debt-paying ability.

As indicated in table VI.7, Phillips' short-term liquidity position remained strong after the exchange offer. Its current and quick ratios remained at the same level or higher than before the offer and, from 1986 through 1989, were either equal to or greater than the industry ratios.[26]

[26]See note 23.

Table VI.7: Liquidity Ratios

	Fiscal year						
	1983	1984	1985	1986	1987	1988	1989
Current ratio							
Phillips	1.0	0.9	1.0	1.3	1.2	1.2	1.1
Industry	1.2	1.1	1.1	1.3	1.2	1.1	1.1
Quick ratio							
Phillips	0.7	0.7	0.8	1.0	1.0	1.0	0.8
Industry	0.8	0.7	0.7	0.8	0.8	0.7	0.7

Sources: GAO analysis based on company data filed with SEC and industry data from the following two sources. We obtained industry data for 1985 through 1989 from an on-line database produced by Media General Financial Services, Inc. The database is based on data from 43 companies whose primary line of business was classified under the same SIC code as Phillips. Industry data for 1983 and 1984 were unavailable from this on-line database and instead were obtained from Financial Trends of Leading U.S. Oil Companies: 1968-1987, and are based on aggregate financial data for 20 leading oil companies.

Inconsistent Profits Were Not Entirely Due to the LBO

The profitability of Phillips' operations is affected not only by internal management strategies but also by external conditions that are largely outside of management's control.[27] Table VI.8 contains selected indicators of profitability for both Phillips and the industry.[28] The indicators show that after the exchange offer Phillips' profitability fluctuated in a pattern similar to the industry: declining from 1985 to 1987, rising in 1988, and then falling again in 1989.

[27]Examples of external conditions that cause uncertainty in the petroleum industry include supply disruptions that affect the price of crude oil, the composition of world oil production, growth in world energy consumption, changes in energy efficiency, and government regulation.

[28]See note 23.

Table VI.8: Indicators of Phillips' Profitability (Dollars in Millions)

	Fiscal year						
	1983	1984	1985	1986	1987	1988	1989
Phillips							
Total revenues	$15,411	$15,756	$15,840	$10,018	$10,917	$11,490	$12,492
Earnings before interest and taxes	$2,615	$2,495	$2,717	$987	$1,091	$1,969	$1,391
Net income	$721	$810	$418	$228	$35	$650	$219
Profit margin	4.7%	5.1%	2.6%	2.3%	0.3%	5.7%	1.8%
Return on average stockholders' equity	12.3%	12.7%	14.7%	13.5%	2.1%	35.8%	9.5%
Industry							
Profit margin	4.8%	4.3%	3.7%	3.5%	3.1%	5.5%	4.8%
Return on average stockholders' equity	12.8%	11.4%	10.0%[a]	8.5%	8.1%	14.1%	13.0%

[a]Based on data from Financial Trends of Leading U.S. Oil Companies: 1968-1987.

Sources: GAO analysis based on company data filed with SEC and industry data from the following two sources. We obtained industry data for 1985 through 1989 from an on-line database produced by Media General Financial Services, Inc. The database is based on data from 43 companies whose primary line of business was classified under the same SIC code as Phillips. Industry data for 1983 and 1984 were unavailable from this on-line database and instead were obtained from Financial Trends of Leading U.S. Oil Companies: 1968-1987, and are based on aggregate financial data for 20 leading oil companies.

Phillips' profit fluctuations were due to both management actions, including the exchange offer and subsequent cost-cutting measures, and uncontrollable external factors of which the most significant was the 1986 worldwide collapse in crude oil prices. Specifically, in 1985 profitability declined despite increases in Phillips' total revenues and earnings before interest and taxes. According to its annual report, the large decrease in 1985 earnings was primarily due to higher interest expense incurred as a result of the exchange offer. Foreign currency losses and write-downs of assets held for sale also contributed to the 1985 decline in profitability. Phillips' profitability fell again in 1986. According to Phillips' annual report, the decline in crude oil prices was the single most important factor that affected the company's performance during 1986. Although profitability continued to decline in 1987, Phillips was still able to service its debt and elected to retire $230 million of debt and preferred stock early. Phillips reported that profitability increased in 1988 because of management's efforts to cut costs and increase operating efficiency through consolidating and streamlining operations. However, in 1989 profitability declined again partly because of a large write-down of Phillips' offshore California investments that was prompted by continuous delays in receiving regulatory approval to begin oil and gas production. A loss of sales due to an explosion and fire at its Houston Chemical Complex also contributed to Phillips' 1989 profitability decline.

Impact of Exchange Offer on Phillips Employees and Community

As discussed previously, Phillips continued to reduce its work force after the exchange offer as part of its efforts to reduce operating costs. At the end of 1989, Phillips employed 21,800 people, about 26 percent less than at the end of 1984 before the exchange offer and about 37 percent less than in 1981 when Phillips initially began its restructuring effort. The largest declines after the exchange offer occurred during 1985 when Phillips implemented its offer and during 1986 when oil prices plunged. The reductions, effected primarily through early retirement programs, reorganization of operations, and asset sales, paralleled what had been happening in the oil industry during the early 1980s as oil prices trended downwards. In response to the changing economic environment, the oil industry had undergone major restructuring resulting in a fall in overall industry employment from a high of 708,000 in 1982 to 425,000 in August 1986.[29] However, according to Phillips officials, the company's restructuring activities were more severe than would have been required in the downturn due to the high debt burden the company acquired through its recapitalization.

On the basis of the company's filings and changes that were occurring industrywide, employees of Phillips' upstream operations might have felt the brunt of the reduction as domestic production of oil and gas became less profitable. For example, in 1988 Phillips' upstream work force declined 10 percent because of a consolidation of upstream operations. Furthermore, after years of consolidating and streamlining the company, an increase in the work force of about 4 percent in 1989 was primarily in the company's expanding downstream operations.

Phillips regards its role as a corporate citizen to be a high priority—one not only requiring the company to contribute to the well-being of the communities where it is located but also promoting a higher quality of life for the nation as a whole. On the basis of an analysis of Phillips' charitable contributions, environmental expenditures, continual sponsorship of the U.S. Swimming and Diving teams, and involvement in public policy issues pertaining to energy and the environment, Phillips appears to have remained active in its citizenship role after the exchange offer.

[29] U.S. Oil Production - The Effect of Low Oil Prices, p. 96.

However, Phillips' streamlining and cost-cutting measures after its exchange offer did have an adverse effect on at least one of its local communities: Bartlesville, Oklahoma. Phillips' headquarters has been located in Bartlesville since 1917, and the company has been a significant factor in the economic base of the community. According to officials of the Bartlesville Area Chamber of Commerce, much of the industry in Bartlesville has been linked to oil, and Phillips has been the predominant employer, with about 31 percent of the town's work force working there at the end of 1984 before the exchange offer. Consequently, Phillips' actions after the exchange offer, in particular its reductions in work force, had a significant impact on the community as did the oil price decline in 1986. As indicated in table VI.9, Phillips' Bartlesville work force declined the greatest in 1985 and 1986.

Table VI.9: Phillips' Bartlesville Work Force

Year	Work force	Percent change in work force from previous year	Percent of Bartlesville's total work force
1984	7,779	(1.0)	31.1
1985	6,186	(20.5)	23.3
1986	5,043	(18.5)	19.4
1987	5,352	6.1	21.2
1988	4,805	(10.2)	20.6
1989	5,301	10.3	23.6
1990	5,405	2.0	[a]

[a]Data on Bartlesville work force for 1990 were not available.

Source: A Phillips official provided data on Phillips' Bartlesville work force. The Bartlesville Area Chamber of Commerce provided data on Bartlesville's work force.

Chamber officials cited increasing unemployment, declining real estate values, declining city sales tax revenues, and failing retail and service businesses due to a decline in earning power as indicators of the adverse impact Phillips had on the community after its recapitalization.

In response to the impact Phillips was having on the community, the city of Bartlesville in conjunction with the Chamber established an economic development program in 1986 designed to lessen Bartlesville's dependence on both the company and the oil and gas industry by diversifying the local economy. A one-quarter-cent sales tax was passed by the voters of Bartlesville in 1986 and again in December 1990 to fund the program. According to Chamber officials, the program has been moderately successful in bringing in new industry, but most of its success has been in expanding already existing businesses. One official said Bartlesville's economy has rebounded from its slump as evidenced by positive reversals in the indicators previously cited. However, the turnaround paralleled Phillips' own improving situation, which contributed to Bartlesville's upswing. Chamber officials recognize that Bartlesville is still very dependent on Phillips and oil in general, and efforts to diversify the economy are ongoing.

Current Status of Phillips

At the end of 1989, management reported that it considered Phillips' level of debt to be manageable and consequently, during 1990, concentrated more on capital spending projects and less on reducing debt. For example, Phillips' 1990 capital expenditures were almost 50 percent greater than the level in 1989 and, on September 30, 1990, Phillips' long-term debt was about $4 billion, the same level that existed at the end of 1989. The debt incurred in Phillips' 1985 exchange offer no longer appears to be a major factor behind changes in the company's operations, structure, or work force. According to comments made by Phillips' chairman and CEO to the National Association of Petroleum Analysts in April 1990, debt reduction must now compete with other corporate uses for cash flow. Consequently, management has been able to focus on enhancing the company's operations and its value to stockholders. Phillips has also taken various steps designed to deter future takeover attempts, including amending its Certificate of Incorporation to make it more difficult and time-consuming to change control of the board of directors and issuing preferred share purchase rights that are exercisable when a person or group acquires 20 percent or more of the company's outstanding common stock. The rights enable the holder to buy additional shares of Phillips' common stock at a discount with the effect of substantially diluting ownership by the party attempting to take over the company on terms not acceptable to the board of directors.

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