Strategies in Corporate Finance

Winter 2003

What About Going Private?

New York • San Francisco • Atlanta • Chicago

About Shattuck Hammond Partners

Shattuck Hammond Partners LLC is an independent full-service investment bank meeting the needs of healthcare organizations, middle market companies, and specialty not-for-profit institutions. With more than 40 investment banking professionals and offices in New York, Atlanta, Chicago and San Francisco, Shattuck Hammond Partners provides corporate and municipal finance services to clients nationwide, including: strategic advisory and capital planning services; valuations and fairness opinions; mergers, acquisitions and divestitures; restructurings; not-for-profit conversions; private placements of debt and equity; underwriting; and trading.

For additional information related to this Report, please contact Peter Hunt at 415-788-6900. For more general information, visit our website at *www.shattuckhammond.com* or contact any of the following senior professionals:

New York

630 Fifth Avenue
Suite 2950
New York, NY 10111
212.314.0400 tel
212.314.0444 fax

Timothy J. Barney
Joseph G. Beck
Philip J. Camp
Eric D. Coburn
Christopher L. Connelly
Keith Dickey
Michael S. Guernier
Michael B. Hammond
Herbert J. Horowitz
Mitchell L. Kornblit
Richard J. Lorenti
Harvey Morgan
Vinton L. Rollins
Barbara Z. Shattuck
James H. Whitcomb

San Francisco

601 California Street
Suite 2001
San Francisco, CA 94108
415.788.6900 tel
415.788.0822 fax

Mark G. Harrison
Peter A. Hunt
Cecilia C. Montalvo

Chicago

123 North Wacker Drive
Suite 930
Chicago, IL 60606
312.541.6400 tel
312.541.6444 fax

Grant R. Chamberlain
John F. Patek
Victoria Poindexter

Atlanta

3290 Northside Parkway
Suite 925
Atlanta, GA 30327
404.846.1800 tel
404.846.1801 fax

Joseph H. Estes
William B. Hanlon III

© **Shattuck Hammond Partners LLC, 2003**. **All rights reserved.** Additional information is available upon request. Information herein is believed to be reliable but Shattuck Hammond Partners does not warrant its completeness or accuracy. Opinions and estimates constitute our judgment and are subject to change without notice. Stock performance cited in graphs and charts of this Report are for illustrative purposes and are not indicative of any investment. Past performance is no guarantee of future results. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Shattuck Hammond Partners and its affiliates, directors and employees may have a position in securities of, or be a director of, any entity mentioned in this Report. Shattuck Hammond Partners and its affiliates may from time to time perform investment banking or other services for, or solicit investment banking or other business from, any entity mentioned in this Report.

Introduction

Shattuck Hammond Partners LLC ("Shattuck Hammond") is pleased to offer the following overview on the opportunity to go private. Shattuck Hammond encourages readers to distribute this report to colleagues and other interested parties. Additional copies will be provided upon request. Please contact Peter Hunt, at 415-788-6900, with requests for additional copies as well as with any comments that you may have.

Background

The past few years have witnessed tremendous turmoil in the equity markets. All major indices are substantially off their highs, as the technology bubble has burst and the economic and political climate has become less certain. Trading volatility has increased as day-to-day sentiment on war and the economy has vacillated, and corporate earnings performance has been increasingly inconsistent. Scandals have abounded with disastrous stock price consequences.

As a result, institutional investors have shied away from equity offerings, and investors have pulled substantial funds out of the markets. Companies have been unable to raise equity capital. Corporate governance has become front and center. The public's trust in corporate America has been shattered. Rigorous new disclosure requirements and increased governance measures (Sarbanes-Oxley Act of 2002) have been implemented.

Companies have seen their stock prices erode and their trading volume dry up. In fact, as of December 31, 2002, there were 2,473 companies with public market capitalizations of less than $75 million; 5,295 companies with stock prices under $2.00 per share; and 1,846 companies where the average trading volume in 2002 was less than 10,000 shares per day.[1] These companies struggle to create value for shareholders, even though many of them continue to meet or exceed operating and financial goals.

The demise in the stock market coupled with the increased requirements to operate a publicly traded company, have dramatically diminished the benefits of operating a public company.

Companies in this situation have a handful of alternatives to remedy their situation, including selling the company to a larger suitor, buying back stock in an effort to convince the market of the value in the company, or simply operating the company as if it were a private business, largely ignoring the public shareholder. Each of these alternatives can create value for shareholders if executed for the right reason. However, much of the time, these strategies result in a sub-optimal fix to the problem.

One common approach is to "take a company private," either through a leveraged buyout or by simply purchasing the publicly traded shares of the company. Under

[1] Moneycentral.com: Stock Screener.

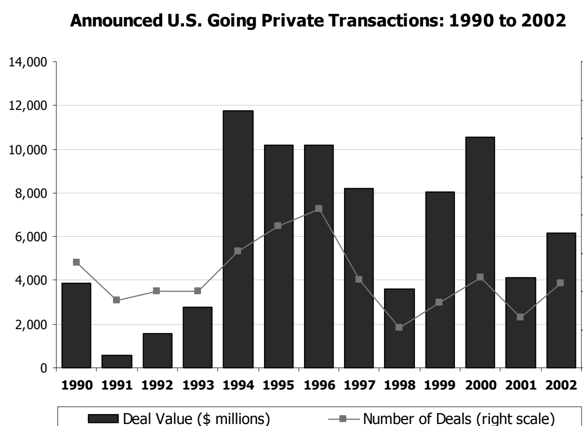
either scenario, the company is able to redirect its attention and capital to operating the business, allowing it to build long-term value for those shareholders that remain.

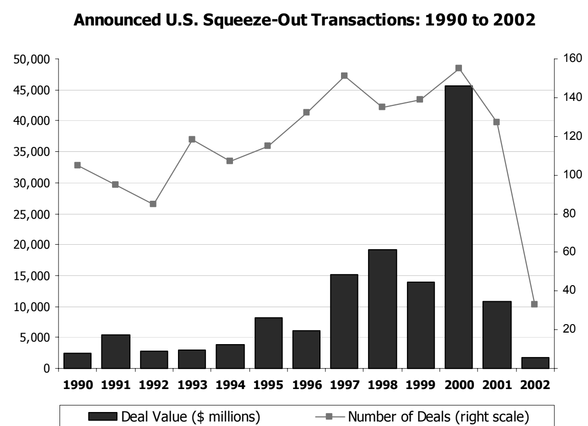
There are numerous reasons to take a company private, including:

- The management of a private company can focus on the long-term future of the business, as opposed to the quarter-to-quarter earnings pressure from Wall Street.
- As a private company, the rigorous filing and other requirements of the Securities Exchange Commission will not distract management from building firm value.
- Private companies do not have to bear the costs associated with being a public company, which in many cases can run in the hundreds of thousands to millions of dollars.
- A private company can re-align benefits packages without shareholder backlash.
- A private company can often create more value for shareholders than a public company that has a low market capitalization, poor trading volume, limited public float, low stock price and/or lack of Wall Street research coverage and institutional investor interest.

Going private transactions are quite common, in particular, traditional acquisitions of publicly traded companies by a private acquiror. Since 1990, there have been approximately 606 announced going private transactions representing $81.6 billion in dollar value. In 2002 alone, there were 44 going private transactions representing $6.2 billion in transaction value.

Announced Going Private Transactions: 1990 - 2002[2]





Source: Thomson Financial Securities Data (SDC).

[2] Thomson Financial Securities Data (SDC) defines a minority squeeze-out as a deal in which a company is acquiring the remaining minority stake which it did not already own, in a target company. The acquiring company must have already owned at least 50.1% of the target company and would own 100% of the target company at completion. SDC defines a going private transaction as a private acquiror ("private" meaning that none of the acquiror's ultimate parentage is public either) acquiring a public target and upon completion, it will become a private company.

Because a going private transaction is the acquisition of public shares of a company by a controlling shareholder, the issuer, or a third party typically in concert with management, there are unique issues and problems that arise that are somewhat different than those in third party, unaffiliated acquisitions. These issues, which are more thoroughly discussed below, include acquirer conflict, a higher standard of fairness, increased litigation risk, enhanced disclosure requirements and the need for an objective evaluation. When considering a going private transaction, one should be thoroughly informed of these issues.

What is a Going Private Transaction?

So, what does it mean when a public company goes private? Otherwise known as a Rule 13e-3 transaction, a transaction qualifies as a going private transaction if the following criteria are met as a result of the deal:

- The equity securities of the target are acquired by the issuer (the target) or an affiliate of the issuer;
- The equity securities of the target are acquired through a tender offer by the issuer or an affiliate of the issuer; or,
- The equity securities of the target are acquired through a proxy or consent solicitation, or the mailing of an information statement by the issuer or an affiliate of the issuer in connection with a merger, recapitalization, sale of assets to an affiliate of the issuer, or a reverse stock split in which the issuer acquires fractional shares.

In addition, the transaction qualifies as a going private transaction if, as a result of the previous criteria, the target is no longer subject to the reporting requirements of Section 12(g) or Section (15)d of the Securities and Exchange Act of 1934. Companies are no longer subject to these provisions if there are fewer than 300 shareholders of the target remaining after the transaction, or the target is delisted from an exchange or no longer quoted on the NASDAQ.

Two common forms to take a company private include a leveraged buyout and a minority squeeze-out.

Common Forms of Going Private Transactions

The two most common forms of going private transactions are leveraged buyouts and minority squeeze-outs. A leveraged buyout is the acquisition of the existing private or public stock of a company by a group of equity sponsors that is financed with debt and equity, with a plan to repay the debt using the cash flows of the acquired company. A minority squeeze-out occurs when a public company acquires its own shares of stock or those shares of a publicly traded subsidiary.

Leveraged Buyout

A leveraged buyout is the acquisition of the stock of a company by a group of equity sponsors that is financed with debt and equity, and uses the cash flows of the acquired company to repay the debt. The equity sponsors may include the management team of the company as well as third party financial firms. The assets of the company are pledged as collateral behind the assumed debt in the transaction.

A leveraged buyout has numerous benefits for shareholders and the company. First, the stock of the company is usually acquired at a premium to its current stock price, and therefore, selling shareholders derive a current return on their investment. Second, the new investors in the company that may include management, utilize the cash flows of the company to purchase stock from selling shareholders. As the debt used to finance the purchase is paid down, value is transferred to the new investors.

Pursuing a leveraged buyout can have numerous risks. First, the mere act of announcing the transaction may put the company in play and result in its being acquired by a third party suitor. Second, management's participation or sponsorship of the transaction presents certain unique conflicts of interests that need to be explored (see *Special Issues in Going Private Transactions* below).

Minority Squeeze-Out

A minority squeeze-out is the acquisition of the minority, or unaffiliated, shares of a private company by the remaining shareholders. Squeeze-outs typically relate to the acquisition by the majority shareholder of the shares of a publicly traded subsidiary that are not owned by the majority owner. The acquisition of minority shares in a squeeze-out transaction usually entails paying a premium to the public shareholders who sell their shares. This premium can vary depending on the circumstances of the transaction and whether the transaction is a cash tender offer or a stock merger.

Other Going Private Alternatives

While the leveraged buyout and minority squeeze-out are the most typical forms of going private transaction, there are other alternatives that can be used in certain situations. These options are driven by the classic definition of a going private transaction, i.e., if as a result of the transaction, the company is no longer subject to the reporting requirements of Section 12(g) or Section (15)d of the Exchange Act of 1934. In

other words, there are fewer than 300 shareholders remaining in the target post transaction or the target is delisted from an exchange or no longer quoted on the NASDAQ.

Given this definition, there are other ways to go private including a share repurchase, recapitalization or reverse stock split followed by an acquisition of odd-lot shareholders.

When Should a Company Go Private?

Characteristics of a Going Private Candidate

Companies go private for various reasons, and in many cases may show different characteristics. In general, candidates for going private transactions evidence one or more of the following attributes:

- Under-appreciated story in a strong sector
- Under-appreciated sector with strong performer
- Poorly performing stock price
- Low trading volume
- Low stock price
- Low market capitalization
- Lack of equity research coverage

In addition, leveraged buyout candidates should evidence the following additional characteristics:

- Strong cash flow dynamics
- Healthy balance sheet
- Good growth potential
- Attractive assets

Rationale for Going Private

There are multiple reasons to take a firm private:

- Public companies are subject to intensive monitoring from corporate governance prospective.
- Public companies are subject to enhanced disclosure requirements (i.e., Sarbanes-Oxley Act of 2002).

- Public companies bear the costs associated with being a public company, which in many cases can run in the hundreds of thousands to millions of dollars.
- Management of a private company can focus on the long-term future of the business, as opposed to the quarter-to-quarter earnings pressure from Wall Street.
- Becoming a private company will eliminate any conflicts that may exist between shareholder groups/board of directors or parent/subsidiary.
- Management can engage in richer compensation and benefit packages without shareholder backlash.
- Companies with low market cap, poor trading volume, limited public float, low stock price and lack of Wall Street research coverage make creating value in the public markets difficult.
- For companies with these characteristics, raising funds in the public market at current distressed levels is expensive to the company and dilutive to current shareholders.

Techniques for Going Private

The structure of a going private transaction will vary depending on the specific circumstances of the deal. It will depend on whether the transaction is undertaken by a controlling shareholder, the issuer, or a third party. The structure will also depend on whether the transaction requires shareholder approval, and whether the consideration is for stock or cash. The most common techniques for undertaking a going private transaction are a cash tender offer or a one-step (long-form) merger.

Cash Tender Offer Followed by a Second-Step Merger

In a cash tender offer, the public shares of the target company are acquired for cash. If the cash tender offer results in 90% ownership by the acquirer, a second-step merger "short-form" can be performed, which can be accomplished quite rapidly. A short-form merger is accomplished by filing a certificate with the secretary of state or corporation commission. The shares held by the remaining minority shareholders are cancelled without the need for a shareholder meeting or to solicit proxies. The transaction is subject to the tender offer rules as well as the going private rules.

One-Step Merger Voted on by Shareholders

In a one-step merger, shareholders vote on the transaction by virtue of a proxy that is mailed in advance of the transaction. In this case, it may be desirable to ask for a majority of the minority shareholders to vote in favor of the transaction, which can provide further evidence that the board of directors of the subsidiary as well as any special committee to the board of directors served their fiduciary duties to shareholders.

Special Issues in Going Private Transactions

Going private transactions give rise to some unique issues and problems that are somewhat different than those in a third party, unaffiliated acquisition.

Acquirer Conflict

Whether the acquirer is a large, controlling shareholder, an affiliate by virtue of a relationship with the target or its management, or the management itself, the acquirer has a conflict in acquiring the public shares of the company. A controlling shareholder often will have representation on the target's board of directors. As a board member, its fiduciary duty is to the shareholders of the company whose public shares it seeks to acquire. Consequently, it has a conflict of interest in that it wishes to acquire the public shares at as low a price as possible, while its duty is to ensure the shareholders receive as high a price as possible.

Higher Standard of Fairness

Going private transactions that involve an acquisition by a controlling shareholder are typically held to a higher standard than third party acquisitions. In merger situations, the going private transaction is subject to an entire fairness test rather than the standard business judgment rule. In going private mergers, the board has to establish that the transaction was conducted using a fair process, and that the consideration paid was fair.

Litigation

Going private transactions often lead to litigation because of the inherent conflicts of interest in the deal. The litigation usually surrounds the price that was paid by the acquirer in the transaction. Depending on the type of going private transaction, the public shareholders have varying ability to block or prevent a going private transaction.

Enhanced Disclosure Requirements

Going private transactions are subject to intense scrutiny as a result of the inherent conflicts in the transaction. The SEC has imposed strict disclosure requirements that articulate not only what information must be disclosed to the SEC and shareholders, but also how the information is disseminated. Rule 13e-3, among other SEC rules and regulations (see *Disclosure Requirements* below), governs the overall disclosure requirements of going private transactions.

Need for Objective Validation

Because of the unique issues surrounding going private transactions, it is typical for the board of directors of the target to appoint a special committee to represent the public shareholders. In addition, it is common for the special committee to obtain the advice of

a third party financial advisor who will provide it with a fairness opinion that opines on the fairness of the consideration to be received by the public shareholders.

Disclosure Requirements for Going Private Transactions

The disclosure requirements for going private transactions are governed by Rule 13e-3, *Going Private Transactions*, of the Securities and Exchange Act of 1934, which requires detailed disclosure about the going private transaction, including:

- Whether the company believes the transaction is fair to stockholders and the basis for that belief
- Whether the transaction is structured to require the approval of a majority of disinterested shares
- Whether the independent directors have retained an independent representative to negotiate on behalf of the public stockholders
- Whether the transaction was approved by a majority of disinterested directors
- Whether the company has received any report, opinion or appraisal from an outside party related to the 13e-3 transaction

SEC disclosure requirements are particularly strict about disclosure of third-party valuations that have been prepared within the last two years. In essence, the SEC seeks to force the party seeking to go private to disclose all information that might be relevant to a determination of whether the price being offered is "fair" to the stockholders.

The goal of Rule 13e-3 and the companion Schedule 13E-3 is to provide enough information to public shareholders that they can make an informed decision over whether the board of directors, management and / or the controlling shareholder are performing their fiduciary obligations to public shareholders in the going private transaction. The rule does not require that the board of directors establish an independent committee to review the going private transaction or other third-party offers. In addition, it does not require that the board obtain a fairness opinion to support the transaction. Rather, it mandates disclosure of the process the board took in evaluating the transaction and in establishing the fairness of the price paid. This would suggest, that even though a board is not required to take the aforementioned steps, it behooves them to do so, because if they cannot establish the fairness of process and price, they may be exposed to litigation.

Rule 13e-3 requires the filing of Schedule 13E-3 in conjunction with a going private transaction. The document contains the required disclosures regarding the transaction. The schedule must be filed with the SEC at the times that correspond to the type of going private transaction that is undertaken.

The Role of the Special Committee and Financial Advisor

Going private transactions are subject to intense scrutiny and often are held to a higher standard than other transactions. Consequently, it is common for the board of directors to put in place a process that ensures it is mindful of its fiduciary duties to shareholders.

The Special Committee to the Board of Directors

The special committee to the board of directors is set up as an independent entity to ensure the going private transaction is conducted in a fashion that is mindful of the public shareholders' interests. It is important to establish a committee that is independent, with few ties, financial or otherwise, to the target company, its board of directors or the controlling or affiliated shareholders. The special committee should be given a charter that is broad enough to enable it to retain its own financial advisor and negotiate the terms of the transaction with the acquirer without the influence of the board of directors.

Establishing a fully independent special committee is material to shifting the burden of fairness from the board of directors to the plaintiff having to establish instead that the transaction was unfair to shareholders. In order to establish the arms-length nature of the committee, it is important to document the process that the special committee and its advisors go through in negotiating the transaction. This information will help establish that the special committee was well informed and took care in making its decision on behalf of the public shareholders.

The Financial Advisor

The special committee will usually retain the services of a financial advisor to advise it with respect to the transaction and provide it with a fairness opinion. The advisor should be selected based on its competence in providing fairness opinions, and it should be determined whether there is any relationship between the advisor or its affiliates and the target, controlling shareholder or affiliates. To the extent there are current or prior relationships between the advisor and the parties involved in the transaction, there may be a real or perceived conflict of interest on the part of the advisor. Another item that can often come under question is the manner in which the advisor is paid for its work on the transaction. To the extent the fee is at all contingent on the success of the transaction, a perceived conflict may exist as the advisor has an incentive to provide an opinion that will allow the deal to get done.

The advisor will usually provide a fairness opinion for the special committee that opines on the fairness of the transaction. The opinion should state what due diligence the advisor did in coming to its conclusions, what information it relied upon, and what limitations, if any, were placed on its work. It should be remembered that the financial advisor's opinion as well as the analysis that is presented to the special committee will have to be disclosed.

Going Private Transaction Case Studies

Leveraged Buyout of MedCath Corporation

MedCath Corporation was founded in 1988 as an operator of mobile and stationary cardiac catheterization laboratories. The company went public in 1994 and began developing its first heart hospital, which opened in 1996. During this time, MedCath operated in an environment of intense media scrutiny centered upon the late licensure and slower than expected ramp up of this first hospital in McAllen, TX.

In 1996, MedCath opened the McAllen Heart Hospital, which became the first freestanding specialty heart hospital in the U.S. The hospital – which the company has since sold to Universal Health Services – was an equity partnership between MedCath and affiliated physicians. Despite skepticism concerning the viability of its concept, over the next three years MedCath opened seven additional heart hospitals in Arizona, Arkansas, California, New Mexico, Ohio and Texas.

Although the company grew substantially over the next two years, the periodic opening of additional hospitals on a comparatively small base of facilities contributed to a high degree of volatility in revenue and profitability resulting in a languishing MedCath stock through much of 1997 and 1998. As a result of what management considered an undervalued stock price, in July 1998 MedCath was taken private by the company's management group, and venture backers Kohlberg Kravis Roberts & Co. and Welsh, Carson, Anderson & Stowe. Stockholders received $19 per share, or 15.2% premium, in the transaction, which valued the company's equity at $250 million.

Three years after MedCath's going private transaction, the company went public again in July 2001. Between its LBO and "second IPO," MedCath opened five new heart hospitals and sold one, leaving it with a total of eight hospitals. The company is currently trading on the NASDAQ under the ticker MDTH, and the original investors, KKR and Welsh, Carson continue to maintain a majority ownership in the company.

Minority Squeeze-Out of Hertz Corporation by Ford Motor Company

On January 16, 2001, Ford Motor Co. announced that it had reached a decision to acquire the public shares it did not own of Hertz Corporation in a going private transaction referred to as a minority squeeze-out.

Hertz originally became a wholly owned subsidiary of Ford as a result of a series of transactions in 1993 and 1994. In 1997, Hertz completed a public offering of approximately 51.6% of the common stock as a means of unlocking the value of Ford's interest in Hertz as reflected in the price of Ford stock. At the time of the public offering, equity in car rental companies was valued at a much higher multiple of earnings than was the equity of automotive companies. It was believed, however, that the value of the stock in Hertz owned by Ford was not fully reflected in the price of Ford stock. Further, Ford believed that the higher level of transparency with respect to Hertz's results and

earnings potential as a result of the public float would result in a more reliable valuation of Hertz.

Since the public offering, a number of circumstances both within Ford and external to Ford occurred that prompted the company to complete the minority squeeze-out and are summarized below:

- Ford's business strategy had evolved to focus much more on the revenue stream of automotive related products and services down the value chain beyond the sale of vehicles. By owning 100% of Hertz's equity interests, Ford believed it would have greater operational flexibility and synergistic opportunities to make Hertz a key component of this strategy.
- The stock prices of car rental companies no longer traded at significantly different multiples of earnings than that of the automotive companies. Ford believed this decline reflected Hertz's prospects for future earnings growth due to the present economic and industry outlook affecting car rental companies generally and Hertz in particular.
- Ford believed that the capital structure of Hertz was no longer viable for the long-term due, in part, to the relatively small number of shares of Hertz owned by the public (the public float). Ford believed that the public float was too small to attract large institutional investors, which could have a negative effect on Hertz's stock price despite good financial performance. Likewise, Hertz's management compensation program was significantly tied to the performance of the stock, which made it difficult to retain and/or attract quality management.
- Ford's ownership of 100% of Hertz's equity interests would result in operational efficiencies being achieved and significant costs reductions associated with Hertz not being a publicly traded company.

The eventual offer was structured as a cash tender for the approximately 20 million shares that were publicly traded. The $35.50 offer was a 46% premium, over the pre-offer share price for Hertz. This price was also an increase over the original IPO price of $30.00 per share. The transaction had an aggregate value of approximately $734 million and resulted in 100% ownership of Hertz. Ford was represented by J.P. Morgan while the special committee to the board of directors of Hertz was advised by Lazard Freres. The transaction closed on March 19, 2001.

Ford pursued the transaction because it had concluded that the market valuations for car rental companies were not likely to improve in the near future. Ford believed that the transaction would result in a number of benefits to Hertz including providing increased operating flexibility with respect to its relationship with Ford, the elimination of certain expenses relating to Hertz being a public company, and alignment of Hertz's management goals and compensation programs with those of Ford, eliminating or reducing management retention problems that might have otherwise resulted.

Closing Thoughts

A going private transaction can be an effective means for a company to create long-term shareholder value. It allows the company to focus on the long-term management of the business rather than the day-to-day concerns of Wall Street. It allows a company to operate the business on a private basis and then realize optimal value for the organization unencumbered by the constraints imposed on the company due to low market capitalization, illiquid, poorly covered or underperforming stock. Finally, it allows companies to raise capital at their appropriate valuations rather than at prices pegged to their stock price that may not be an accurate reflection of value. In today's uncertain environment, operating as a private company may have substantial benefits over operating as a public company.

Shattuck Hammond Partners LLC
www.shattuckhammond.com

630 Fifth Avenue
Suite 2950
New York, NY 10111
212.314.0400 tel
212.314.0444 fax

601 California Street
Suite 2001
San Francisco, CA 94108
415.788.6900 tel
415.788.0822 fax

3290 Northside Parkway
Suite 925
Atlanta, GA 30327
404.846.1800 tel
404.846.1801 fax

123 North Wacker Drive
Suite 930
Chicago, IL 60606
312.541.6400 tel
312.541.6444 fax