



S&P 500: MERGERS & ACQUISITIONS, A QUEST FOR VALUE

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- While there are enormous resources available to both public and private concerns, **deals have not yet become expensive**, with investors accepting offers that have been limited by the lack of competitive process.
- Public companies remain timid of commitment, with private funds able to acquire companies with little completion and then make changes that may not have been publicly acceptable.
- The enormous size of the discretionary liquid assets in both cash and treasury shares speaks to **unused resources and potential future returns**.
- **Increased pressure to use the available resources should increase the number of deals, make them more competitive in nature, create higher premiums and raise the bar on the necessary return on invested capital.**
- When M&A is the product of excess liquid assets, the rationale for an acquisition may be more to satisfy short-term investor demands than produce long-term results.
- **Where will the future growth come from** since companies have already done significant cost cutting, maintained high margins, realigned their debt, and prudently managed growth and commitment?

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OVERVIEW

Mergers & acquisitions has always been an art more than a science. It requires not just the vision of combining two concerns, but the ability to work two managements into one, shedding the ones that no longer fit in and molding the new company into more than its parts. It permits companies to grow their business via associations with existing entities, a process that normally would take years to develop, as well as raise the risk of costly competition. It permits them to consolidate production, add to product and obtain efficiencies from duplicate management and back-office operations. Theoretically, the combined company is more efficient and more profitable, and produces a greater return for shareholders. The reality is that not all deals work out the way they are planned. Synergy has become a substitute for layoffs, efficiencies have become a substitute for outsourcing, and management consolidation is now an expense in the form of bonuses, contract buyouts and defined performance measurement incentives.

Over time, different characteristics dominated the M&A landscape. When stocks were high and optimism ruled, share deals were prevalent, with any short-term EPS dilution being part of the deal. When cash was plentiful and debt inexpensive, leveraged buyouts dominated, with low or negative coverage ratios expected to improve with earnings. **While historians debate and quantify the results of building up and spinning off, the basic argument comes down to value. Can one specific concern add value, in excess of the initial cost and associated risks, by acquiring another?**

M&A has been accelerating to record levels following a relatively slow period. After the mergers of the 1990s, the bear market of 2000-2002 plus the enormous number of dot.com failures produced gun-shy managements. Earnings deterioration, investor pessimism, market downturns and corporate governance all combined to create unsure corporate footing (balance sheets, income statements, product line) and deep concern for the near-term economy. As earnings started to recover, the general market started to pick up. Reflecting low rates, easy money, moderate labor costs, and a never-ending spending consumer, with the result being that companies improved their situations. Today, operating earnings in the S&P 500 have increased at a double-digit rate for 18 consecutive quarters; balance sheets have been redone with most long-term debt being refinanced at lower rates and moderate levels of debt being tied to the prime; share buyback expense has skyrocketed

to the level of capital expenditures; and cash on hand stands near an all-time high. Yet, M&A has only started to blossom, with both its landscape and its objectives having changed substantially.

Public concerns are starting to grow with respect to where the long-term profitability from M&A will come from. Most companies have trimmed down considerably since the bear market, with internal growth and commitment being contained. The slower pace of growth has invigorated private funds as investors yearn for larger returns, with many knowingly accepting the increased risks. As M&A increases, managers will need to be more resourceful and skillful in order to produce higher returns, and the competitive process will need to increase to create more efficient deals and payouts.

M&A: PUBLIC, PRIVATE, AND EVER THE TWO SHALL MEET

Current M&A is broken down into two participants: public and private. Publicly traded companies have built up enormous war chests in both cash on hand and treasury shares. The treasury share buildup is the result of eight consecutive quarters of enormous share buybacks (in excess of the normal needs for either M&A or employee option exercising). For the 12 months ending September 2006, S&P 500 issues spent slightly more on buybacks than on capital expenditures. These reacquired shares reside in the corporate treasury, where they remain a discretionary liquid asset to be utilized by management as it deems fit. There appears to be three alternative uses for these shares: the first is for their reissuance, which would dilute earnings per share and therefore be unacceptable to management; the second is for a secondary offering, but since cash is already at record levels this would not serve a purpose or add to performance; and the third, which S&P believes will be their eventual use, is increased M&A. In a deal, the initial EPS dilution is acceptable as a cost of the merger, and individuals (owners of the target company) usually prefer common shares to cash since they tend to be tax-deferred. When the existing treasury shares were combined with the cash on hand, the buying power represented 16% of the market value in a sub-set of the S&P 500 Industrials (Old). **The enormous size of this discretionary liquid asset is a major concern for investors, since it speaks to unused resources and potential future returns.**

In spite of these resources, public M&A still appears timid, with most deals showing a better fit upfront, than the promised synergies down the road. The recently completed AT&T and BellSouth merger, as well as the pending Bank Of New York and Mellon Bank deals illustrate this. Both were/are uncontested deals, where comparable fits would have been difficult to find in the public sector. While private offers were feasible, their ability to combine the target companies' operations with another, and therefore to add value, was missing. Asset deals now refer not to the old physical transfer of hard assets, but to a product line, which can be services, intellectual property, and the old type physical plant. The pending Freeport-McMoran offer for Phelps-Dodge and the Chicago Mercantile offer for CBOT illustrate this. Less common is the old non-aligned merger where a company ventured out into a slightly related or entirely new field.

The other public merger on the rise is for divisions or units. In these, companies are purchasing existing units that either augment or expand their current business. Johnson & Johnson's recent \$16 billion purchase of Pfizer's consumer division demonstrates this type. From the seller's side, the sale of a unit or the desire to shed a specific business segment appears to be company-specific (at least at this point). Initial indications suggest an increase in the purchase of foreign units, therefore permitting cheaper importation into the U.S. or more strategic locations for foreign sales. In general, public companies have less than two years to demonstrate some degree of success in a merger, with the main gauge being profits. Gains can come from reduced costs (headcount, location, back-office consolidation) or actual sales increase via new or extended products. A lack of progress can be costly to the share price. **S&P believes that public M&A will increase as pressure continues to mount for use of the available resources and earnings trend downward due to reduced consumer spending and the current economic cycle.**

Within the public domain are a small but growing trend to spin off or distribute a unit or division to current shareholders. Unlike sales (Eastman Kodak's sale of Onex), the company gets no direct proceeds for the unit. Current direct distributions include NCR's Teradata, Automatic Data Processing's brokerage unit, and Verizon's FairPoint. Spin offs differ in that there is no true acquirer, and at the time of distribution both (parent and child) share the same ownership. Existing management is actually taking the unusual step of

shrinking its domain. Some concern has been raised regarding the debt and resources that the distributed unit is allocated.

The other participant of M&A in the market today is private concerns, whether they are hedge funds, investment groups, or syndications. These funds are set up to take the additional risk in hopes of the additional reward. The timid (but growing) action by the public sector has left this group with a wider selection of target companies and fewer potential public competitors for their target. These private deals have grown quickly in both dollar size and the number of deals, and now represent an important component in the market. Private acquisitions are usually done with cash, therefore, once consummated, the acquired concern leaves the public sight and, to some extent, the regulatory reporting process. From a common shareholders' perspective, once the public common shares are purchased, the deal is completed and interest ends. How the deal was financed, the future of the entity, its employees and products are no longer a concern of the former shareholders.

One of the advantages of private deals is that once a company is closed to the public, changes that may not have been publicly acceptable can be made. These include layoffs, debt restructuring, cost cuts and benefit reductions. Many of these reduce short-term profits, which again may be acceptable to the small number of holders (taking the higher risk for the higher reward), but may not have been feasible if the company was still publicly traded. The goal of many of the current crop of private deals is to “fix” or “adjust” the concern, repackage it, and resell it back to the general public at a substantial profit. The base fact is that the concern was purchased in a competitive market, with a sharp risk of a negative return. The acquirer then took what it considered the necessary action to improve the profitability (or marketability) of the concern, and then attempted to return the concern to public ownership at a profit fitting the undertaken risk.

There are several sub-areas in this process that some have come under criticism of late. Public concerns remain timid of M&A and appear to have a lower threshold for risk; therefore they shy away from competitive bids. Private companies tend to negotiate with existing management, which, considering how most deals carry management payouts and work contracts, questions the arms-length validity of the deal. Private competing offers are rare, leading some to question if there is an unwritten gentlemen's agreement not to compete. Many of the deals are financed with debt that can quickly become - if it did not start out as -

speculative grade. Refinancing done during the transition stage (of private back to public) is sometimes used to pay off initial investors, and may not necessarily be for the benefit of the company as an ongoing concern. While public companies may want to do specific M&A, if a private company is willing to take the risk (with the intent of reselling the entity), public companies can always purchase the modified concern after the change (again, a risk-reward trade-off). A private company being redistributed or sold back to the public could have what appears to be a relative low price, but have higher levels of debt from the private restructuring, which increases the risk associated with the issue.

CURRENT TRENDS

As stated, the most important aspect of M&A is value. For the acquired concern, value is the purchase price, as defined in the competitive market. For the acquirer, it's the future company when combined, modified or restructured, which may be in terms of profit, resale or marketability. **While there are enormous resources available to both public and private concerns, deals have not yet become expensive or (in most cases) competitive.** Public concerns remain cautious, with private concerns concentrating on management negotiated deals. The result is that while premiums are paid for public stock, they are not out of line with historical values. Therefore, **while investors may accept current offers with respect to the current investment environment, conservative M&A has limited the competitive process and kept investor premiums at modest levels.**

Several aspects are now developing that may change this. As the economy slows and earnings growth decreases, public companies will need to increase product sales to increase earnings. Any decrease in EPS growth may also be magnified if buybacks, which have significantly increased EPS growth for over 20% of the S&P 500 issues, are reduced or limited. This need for increased earnings (via sales) should eventually modify management's current risk-reward trade-off in favor of more aggressive deals. Shareholders of public concerns may also become more vocal in their quest for higher returns, again pressuring management to re-examine their risk/reward trade-offs. Part of the danger here is that shareholder groups (many times led by a single large shareholder) tend to select and emphasize missed opportunities, and rarely consider the risks of any potential failed deals that were not undertaken in their discussion. While the theoretical results of the lack of deals

is an academic issue, there can be no doubt that just as some of the missed deals would have prospered, some would not have.

Private equity firms, meanwhile, continue to obtain more direct financing (cash), with interest costs for LBOs remaining relatively low. The need for them to create a return on these assets could also force them to become more aggressive, and may result in more competitive bidding.

MARKET CONCERN

The main difference, and an area of growing concern between public and private M&A, is the time frame with respect to returns. Public issues purchase a company with the long-term hopes of integrating the merged concern and enhancing the profits of the combined companies. The acquired company is an ongoing concern where short- and long-term goals must be measured against each other, as well as investor pressure to show positive results. **Private funds tend to have a much shorter time period and payout schedule, with their goals not necessarily being in line with long-term corporate profits.** The concern is that as long as private funds are able to turn around acquisitions on a short-term basis, their goal (justifiably) will be their own short-term profits. While this leads to “let the buyer beware,” another risk here is that the risk/reward trade off may not be fully appreciated by the general public and that short-term goals are usually not long-term solutions.

The biggest concern however, is the ability of both public and private companies to add value to the acquired company. In general, companies have done significant cost cutting, maintained high margins, realigned their debt, and prudently managed growth and commitment. Additionally, share count reduction and the prior expanding economy have aided EPS growth and, therefore, future expectations. The ability to enhance value in this situation requires long-term strategic planning and skills in both product and management. **Typically, public issues are given limited time to show positive results, and the goals of private concerns are becoming more short-term in nature.**

M&A is starting to have an impact on prices. Besides boosting the prices of the “usual list” of targets, public M&A is a vote of confidence in the future performance of the economy by those who vote with money. Public M&A still remains limited to reasonably justifiable matches with short-term integration plans, paying a relatively moderate premium

for the target company. Their purchases are long-term and, usually, the same management that makes the deal will be held responsible for its outcome (which may not be the same for the target company). Private cash deals, however, are now playing a larger role in the M&A market. This is due to three main factors: an enormous amount of available money is willing to take the additional risk for the additional reward; the ability to finance substantial portions of the deal remains readily available and relatively inexpensive (therefore shifting the risk), and the holding period from acquisition through resale (or repayment of the private investors) is declining.

MOVING FORWARD

Given the available resources, the speculative appetite on the private side for greater returns, and a need to maintain recent high profitability on the side of public entities, **we expect M&A to continue to increase in both the number of deals and their dollar size, as well as become more competitive in nature.** Currently, there is over \$350 billion in major actions pending in the S&P 500. The recently completed \$86 billion purchase of BellSouth by AT&T set a record in size, but expectations are for even larger deals in 2007. On the private side, separate offers for both Clear Channel Communications and Equity Office Properties each hover around the \$20 billion mark, which excludes debt assumption of over \$7 billion and \$15 billion respectively. Given the current environment, these (potentially) record-setting deals may not hold their high positions for long. Segment and unit sales are also increasing, with General Electric being involved in three major purchasing deals currently totaling over \$20 billion in value.

Overall, growing M&A should increase stock prices (via targets and speculations), continue to enhance the income statements of brokers and bankers, and add to debt. Since public issues are still less aggressive and often utilize repurchased shares for part of their acquisition cost, their debt may undergo less of a dramatic change. Private concerns, however, depend more on leveraged deals than public ones for the initial deal, with refinancing once the deal is complete being a common occurrence. This new debt, whether it is used to finance the acquisition, to repay the initial cash outlay, or as a payout or return to the private holders, is part of the new corporation and will likely stay with the corporation in

any resale or offering. **Once public, these higher debt levels pose a risk to equity investors due to their service and call-on assets.**

EFFECT ON THE INDEX

Within the S&P 500, public M&A **has not yet significantly changed the sector makeup** of the index. These mergers, as well as the unit sales, remain within the sector and, in many deals, within the sub-industry. This is **mostly due to the more conservative approach of staying within one's own expertise** and using M&A for expansion of current products or entrance into closely related ones. When both the acquirer and the target are either both in or both outside of the index (within the same business group), the change in aggregate representation is null. When they are on separate sides of the index membership list, the shift in representation adds to the realignment requirements of the index for proper market representation. Turnover within the S&P 500 has been growing over the last four years as M&A increased, but still remains 42% below the year 2000 level for issue changes and 49% below for aggregate dollar turnover. With M&A increasing, turnover in both issues and their values should increase in 2007. Among the current major deals, there are six public offers for issues within the S&P 500. The eight current private deals would remove over \$110 billion in equity from the index, which, in turn, would disrupt the current balance between the market and the index (whose goal is to replicate the market). Additionally, private, uncontested deals usually proceed quicker, which complicates longer-term replacement procedures.

CLOSING REMARKS

As pressure grows to utilize assets and enhance earnings, the risk/reward trade off should move higher up the scale in favor of increased returns, as well as increased risk. **Completion between both public and private concerns should increase, creating higher premiums and raising the bar on the necessary return on invested capital.** Competing private offers are rare, but recent bids for Tribune Co and Equity Office Property Trusts demonstrate the universal power of potential profits. Public concern bids have also been rare of late, but the recent battle for Caremark has escalated. **While competitive offers may**

grow, the situation is a long way off from the “name your price” Technology bubble of the late 1990s or the proxy fights of the 1980s.

In general, M&A helps the market and the economy. **However, when M&A is the product of excess liquid assets, the rationale for an acquisition may be more to satisfy short-term investor demands than produce long-term results.** Companies belong to their shareholders, with management having a duty to protect that ownership. On a long-term basis, management’s responsibility is to maximize shareholders returns. At times this may be counter to some investors desire for short-term gains. Having excess reserves (cash or shares) is a great position for a company to be in. Its very existence speaks to management’s ability to plan, implement and prosper. Whether a company decides to use cash dividends, buybacks or M&A for their excess reserves remains a judgment call. Shareholders have an obligation to monitor their management continuously to ensure that they are acting in the shareholders’ best interest. Corporate governance has become popular, but it is only as effective as managements make it, and managements are only as effective as shareholders make them.

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PUBLIC ACQUIRER	TARGET	EST. DATE	CASH MILLION	STOCK MILLION
Bank of New York (BK)	Mellon Bank Corp(MEL)	Q3 2007		\$48,000
Chicago Mercantile Exc (CME)	CBOT Holdings, Inc(BOT)	Mid-2007		\$9,100
Citizens Communications (CZN)	Commonwealth Telephone (CTCO)	Mid-2007	\$659	\$228
CVS(CVS)/Express Scripts(ESRX) battle	Caremark Rx(CMX)	Q2 2007		\$26,700
Freeport-McMoran Cp&Gld(FCX)	Phelps Dodge(PD)	Q1 2007	\$17,952	\$8,524
Huntington Bancshares(HBAN)	Sky Financial Group(SKYF)		\$2,880	\$720
LSI Logic(LSI)	Agere Systems(AGR)	Q1 2007	\$4,000	
Johnson & Johnson(JNJ)	Conor Medsystem(CONR)	Q1 2007	\$1,400	
National Grid(NGG)	Keyspan Energy(KSE)	Q1 2007	\$7,323	
McKesson(MCK)	Per-Se Technologies(PSTI)	Q1 2007	\$1,100	
Monsanto(MON)	Delta and Pine Land(DLP)	Q1 2007	\$1,500	
PNC Bank Corp(PNC)	Mercantile Bankshares(MRBK)	Q1 2007	\$2,062	\$3,525
Schneider Electric	American Power Conversion(APCC)	Q1 2007	\$6,100	
WPS Resources	Peoples Energy(PGL)	Q1 2007		\$1,800
	subtotal		\$44,976	\$98,597
PRIVATE ACQUIRER	TARGET			
Blackstone, Goldman, KKR	Biomet(BMET)		\$10,900	
Thomas Lee Ptns & Bain Cap	Clear Channel Communications(CCU)	Q1 2007	\$18,661	
Competing offers(consortium, Blackstone)	Equity Office Properties(EOP)	Q1 2007	\$22,300	
Apollo Mgt Gr & Texas Pacific Gr	Harrah's Entertainment Inc(HET)		\$16,700	
Private concern	Kinder Morgan(KMI)	Q1 2007	\$14,000	
Apollo Mgt	Realogy(H)		\$9,000	
Competing offers(Chandler,...)	Tribune Co(TRB)		\$7,800	
Silver Lake & Texas Pacific Group	Sabre Holding Corp(TSG)		\$4,316	
Consortium of private equity firms	Univision Communications(UVN)	Q2 2007	\$11,000	
	subtotal		\$114,677	\$0
COMPANY	ACTION			
Altria Corp(MO)	Kraft Foods			
Anadarko Pet(APC)	Sell LO Nat-Gas fields to Exco Res(XCO)	Q1 2007	\$1,600	
Automatic Data Processing(ADP)	Dstr of brokerage services business	Q2 2007		
Cardinal Health(CAH)	Sell drug & pkg unit to Blackstone Gr		\$3,300	
Citigroup Inc(C)	Egg banking(british credit-card unit)		\$1,113	
Eastman Kodak(EK)	Sell health group to Onex Corp		\$2,350	
El Paso Co(EP)	Sell some core pipeline asset to TransCanada		\$3,390	
Eli Liiy(LLY)	Acq Icos(ICOS)		\$2,300	
General Electric(GE)	Purch Vetco Intl oil and gas oper		\$1,900	
General Electric(GE)	Requests bids from plastic unit		\$10,000	
General Electric(GE)	diagnostics division of Abbott Labs(ABT)		\$8,130	
Marsh&McLennan(MMC)	Poweer Corp Cda to acq Putnam Invtns unit		\$3,900	
Medtronic Inc. (MDT)	Dstr of Emergency Response Sys Business	Q3-4 2007		
Merrill Lynch(MER)	Acq First Republic(FRC)		\$750	\$750
Morgan Stanley(MS)	Spin-off Discover credit card	Q3 2007		
Morgan Stanley(MS)	Puch of CNL Hotels		\$3,130	
National City(NCC)	Dutch tender for 75M shrs: \$35-\$38.75	2/28/2007	\$2,765	
NCR Corp(NCR)	Spin-off Teradata Data Whse unit			
News Corp(NWS.A)	Exch Direct TV for Liberty Media's News interest			\$11,000
Raytheon(RTN)	Onex & Goldman to acq aircraft mgf uniu		\$3,300	
Tyco Intl(TYC)	Separate into 3 entities	Q1 2007		
Verizon Comm(VZ)	Dstr FairPoint			\$1,000
	subtotal		\$47,928	\$12,750
TOTAL			\$207,581	\$111,347

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