CASE 49

GENERAL ELECTRIC'S PROPOSED ACQUISITION OF HONEYWELL

Teaching Note

Synopsis and Objectives

On March 1, 2001, the antitrust regulatory authority of the European Commission (EC) announced that it had initiated a review of the proposed takeover of Honeywell International Inc. by General Electric Company (GE). The student, taking the perspective of a merger arbitrageur holding a long position in Honeywell and a short position in GE, must assess the proposed bid for Honeywell and evaluate the probability that the merger would be approved by antitrust regulators. In this case, the primary task for the student is to recommend a course of action for the arbitrageur. The student must determine the value of Honeywell using a discounted cash flow (DCF) model as well as information on peer firms and transactions. Additionally, the student must develop investment returns for the arbitrageur's positions and assess the likelihood of regulatory approval, using an analysis of the price changes at earlier events in the contest for clues.

This case was prepared as a basis for classroom discussion with the following objectives:

- To exercise students' valuation skills. The opportunities in the case include valuing the firm using the DCF techniques and the data on comparable firms and transactions.
- Consider the ramifications of the differing approaches to merger regulation in the United States and the European Union.
- Assess sources of potential synergies and their effect on merger strategies.
- Explore the logic of the merger arbitrageur. The case affords the opportunity to interpret security returns for clues about market expectations and reveals the key value drivers for the arbitrageur.

This teaching note was originally prepared by Solomon Eskinazi under the supervision of Robert F. Bruner and with the assistance of Sean D. Carr. It was subsequently revised by Kenneth Eades. It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation.

Advance Assignment to Students

A Microsoft Excel spreadsheet for students, Case_49.xls, accompanies this case. The instructor could distribute this spreadsheet along with the case to students in advance of class, as well as the following questions:

1. Why did Jessica Gallinelli simultaneously buy shares in Honeywell and short shares in GE?
2. Consider the information in case Exhibits 4 through 10. What is a reasonable share value range for Honeywell?
3. What is the return on Gallinelli's arbitrage position to date?
4. How does the European Commission's recent announcement change the investors' outlook about the consummation of this deal?
5. What should Gallinelli do?

A separate Microsoft Excel spreadsheet, TN_49.xls, is available for instructor preparation to teach this case. Please do not distribute the contents of the instructor spreadsheet to the students.

Suggested Supplemental Readings

This case is effective without using supporting readings; however, depending on the instructor's objectives and the time available for student preparation, the following reading on merger arbitrage may deepen the students' engagement with this case: Robert F. Bruner, *Applied Mergers & Acquisitions* (New York: John Wiley & Sons, Inc., 2004), pp. 804–23.

Hypothetical Teaching Plan

The following questions give the outline of the instructor's leadership for a 75- to 90-minute discussion of this case.

1. What are the key considerations for Gallinelli's decision?
2. What is your assessment of the valuation estimates for Honeywell?
3. Has this been a good investment for Gallinelli? Why does she have the short and long positions? What is the return on investment (ROI) for this arbitrage position?
4. How do you think the market will react to the news from the antitrust regulators?
5. How should Gallinelli interpret the latest regulatory news? What should she do?

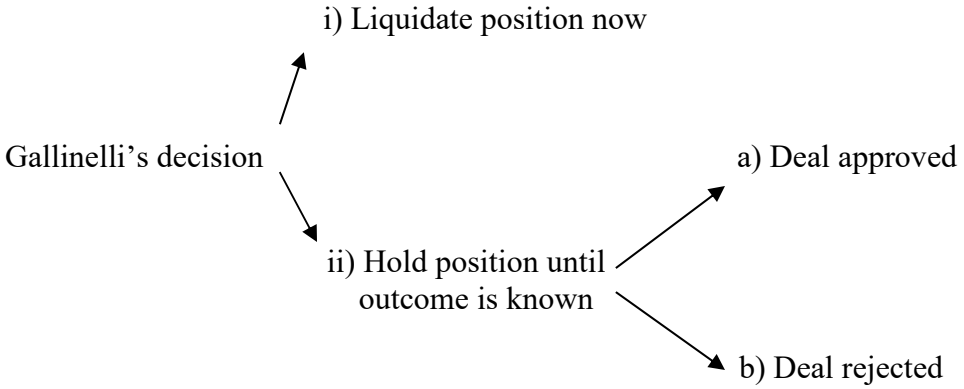
The instructor can close the discussion with a brief presentation of the epilogue and some concluding comments about the impact of control contests on corporate value.

Case Analysis

Gallinelli's decision

Discussion question 1: What are the key considerations for Gallinelli's decision?

Gallinelli must determine whether to liquidate her Honeywell shares and the associated short position in GE or to hold her position until the antitrust proceedings have been completed. If she sells now (on March 1, 2001), she will realize her return to date, whereas if she holds, her return will depend on how the share prices of Honeywell and GE respond to the decisions made by the U.S. Department of Justice (DOJ) and the EC. It is fair to assume that the fate of the case will not be known until early July 2001, after the EC's four-month review.



Valuation of the proposed deal

Discussion question 2: What is your assessment of the valuation estimates for Honeywell?

The main question is whether the EC's announcement on March 1, 2001, will justify a trading price for Honeywell different from its prebid price. Four points provide some basis for evaluating the proposed deal:

1. Case Exhibit 2 shows that Honeywell's share price closed at $41.82 on March 1, 2001, the day of the EC's announcement.
2. Case Exhibit 9 shows a DCF valuation estimate of $36.72 per share for Honeywell, which the students should be aware is highly sensitive to the growth assumption and other factors. This base case estimate was derived using Honeywell's "with-synergies" free cash flows discounted at Honeywell's weighted-average cost of capital (WACC). The constant growth model was used to estimate a terminal value. Case Exhibits 9 also

provides a range of other share price estimates for Honeywell's stand-alone and with-synergies value. For example, using the comparable transactions data provided in case Exhibits 5 and 6, the with-synergies valuations range between $26.83 and $291.77. Students should be encouraged to discuss the various valuation measures and which estimates should be considered as reasonable. In addition, students should be encouraged to discuss why the multiples for comparable firms given in case Exhibit 4 are appropriate for estimating Honeywell's stand-alone value whereas the comparable transactions in case Exhibit 5 and 6 are appropriate for estimating Honeywell's with-synergies value.

3. The case presents several arguments for the potential synergies that could be achieved through a merger of Honeywell and GE. Students should be encouraged to discuss their assessment of the economics of the aerospace market in general and of the GE-Honeywell combination in particular.
4. Jack Welch's contribution to GE's success can be highlighted. Students should assess Welch's value at GE and his value to the successful combination with Honeywell.

Return to the risk arbitrageur

Discussion question 3: What is the ROI on this arbitrage position?

The instructor should emphasize that Gallinelli's initial investment is sunk; and therefore, the key consideration to make in looking forward is incremental: How much will Gallinelli will receive in additional return if she continues to hold her position compared with selling and reinvesting the proceeds (the best alternative investment). A discussion of the arbitrageur's required rate of return should follow.[1]

Exhibit TN1 calculates Gallinelli's return over the holding period. Since taking the long position in Honeywell and the short position in GE on October 20, 2000, Gallinelli has made a 39% return on her investment (107% annualized). If either the DOJ or the EC does not allow the merger to occur, Gallinelli will not realize any upside on Honeywell's price, and therefore, will receive a smaller return by waiting four months than she would by cashing out her positions now.

Exhibit TN1 also shows that if Gallinelli holds her position until the end of the EC's four-month review, after which the EC allows the deal to go through, her total return from October to July (assuming that GE's stock price remains constant) will be 45%, which is an annualized return of 64%—a disappointing return for an aggressive arbitrageur. Her return will increase proportionately with GE's stock price, but even if GE's stock reached the overly optimistic price of $100, her return would still only be 71% for the period and 102% annualized, less than her 107% annualized return from October 1999 to March 1, 2000.

[1] Arbitrageurs ("arbs") are known to demand significant returns, although most arbs would argue that they take large risks in pursuit of such returns. For further discussion on arbitrageurs' required rates of return, see Robert F. Bruner, *Applied Mergers & Acquisitions* (New York: John Wiley & Sons, Inc., 2004), pp. 808–09.

Interpreting the market's reactions

Discussion question 4: How do you think the market will react to the news from regulators?

This segment of the discussion aims to build the students' ability to interpret the developments of a contest for corporate control. The key here is to interpret the arbitrage spread, which is the difference between the bidder's offer price and the target's market price. When the arbitrage spread is negative, the target's share price is above the bidder's offer, which suggests that arbitrageurs and other investors expect a higher offer to be forthcoming soon. When the arbitrage spread is positive, the target's share price is below the bidder's offer, which suggests that arbitrageurs believe it unlikely that the offer will be topped. It may even suggest that arbitrageurs question whether the deal will be consummated at all. Thus, the arbitrage spread provides an indication of the market's beliefs about the likelihood that the deal will take place.

To formalize that intuition, let the current share price reflect two possible outcomes weighted by their probabilities: (1) the deal is consummated and the shareholder receives the bidder's offering price with probability, *prob*, or (2) the takeover attempt fails and the target's share price subsides back to its value on a stand-alone basis with probability (1 − *prob*). In mathematical terms:

$$P_{Current} = (prob \times P_{Bid}) + [(1 - prob)P_{Stand\text{-}Alone}], \text{ where:}$$

$P_{Current}$ is Honeywell's current stock price;

prob is the probability that the deal goes through;

P_{Bid} is the price GE will pay for Honeywell if the deal goes through;

$P_{Stand\text{-}Alone}$ is Honeywell's stand-alone value.

In a public-company takeover situation, the current price is readily observable. The target's prebid price is a useful starting point as to what that stand-alone value might be, although DCF and other stand-alone valuations provide additional estimates. It is straightforward to solve for *prob*, the probability that the takeover succeeds; in which case, the arbitrageurs receive P_{Bid}:

$$prob = [P_{Current} - P_{Stand\text{-}Alone}] / [P_{Bid} - P_{Stand\text{-}Alone}]$$

Thus, the probability equals the ratio of the current market premium [$P_{Current} - P_{Stand\text{-}Alone}$] to the bid price premium [$P_{Bid} - P_{Stand\text{-}Alone}$].

Exhibit TN2 presents a sensitivity analysis of *prob* using different values of $P_{Stand\text{-}Alone}$ prior to March 1, 2001. The $P_{Stand\text{-}Alone}$ values from $30 to $50 represent a broad range from which to value Honeywell. The $P_{Stand\text{-}Alone}$ value of $32.86 is the average of Honeywell's stock prices reported in case Exhibit 2 for the days preceding the deal announcement (September 1

through October 19, 2000). The $P_{Stand\text{-}Alone}$ value of $35.30 is the median of the low value estimates based on comparable firm multiples reported in "Stand-Alone Valuation Summary." The value of $47.16 is the average of low and high comparable firm multiple value medians reported in "Stand-Alone Valuation Summary."

If Gallinelli believes that Honeywell's intrinsic value is approximated by the average preannouncement stock price of $32.86, then as of March 1, 2000, *prob* equals 0.8126. Therefore, there is an implied 81% chance that the deal will survive the antitrust regulators' scrutiny. If Gallinelli believes that there is a greater than a 81% chance that the deal will go through, she should consider the potential returns from continuing to hold her position. On the other hand, if she believes there is a less than a 81% chance of the deal going through, then she should close out her position. The estimates of *prob* for which $P_{Stand\text{-}Alone}$ is greater than Honeywell's stock price result in nonsensical *prob* values and are therefore displayed in the shaded cells in **Exhibit TN2** as "N.Ap." Ignoring these nonsensical results, the table demonstrates that if the market views Honeywell's stand-alone value as being less than $40 per share, there is an expectation that the deal will go through with a high probability.

Final recommendation

Discussion question 5: What should Gallinelli do?

In the final segment of the class discussion, the instructor should aim to draw all the elements into a final recommendation. Gallinelli must consider many factors before nailing down an opinion as to the likelihood of deal consummation. Until the EC initiated its phase II proceedings on March 1, 2001, the consensus was that the deal would proceed without too many problems arising from the firms' complementary rather than overlapping product lines. Jack Welch stated from the beginning that this "is the cleanest deal you'll ever see." Those who expressed doubts assumed that the EC rather than the DOJ would stall or block the deal.

Since September 1990, when the EC's merger regulations came into force, the EC had blocked only 14 mergers. The attempted WorldCom-Sprint merger was the only prior combination of two American companies that was blocked by the EC. That proposed deal was also blocked by the American regulators. Therefore, assuming that the DOJ accepted the GE-Honeywell deal, there was little chance the EC would block the deal.

Other factors affecting the attitude of the EC included Mario Monti's reputation for disliking large-scale mergers; Monti's sensitivity for his reputation as a regulator; Europe's concern for the welfare of EU-based companies such as Rolls-Royce and Thales; and the tense trade relationship between the United States and Europe. Despite those concerns, the EC's historical leniency toward mergers between American companies and Welch's experience getting deals through regulators could compel Gallinelli to ascribe more than a 44% probability of success to the deal.

Assuming a constant GE stock price of $41.60 as assumed in **Exhibit TN1**, however, Gallinelli's incremental annualized return from March to July would be 19%, which is an insufficient return for a merger arbitrageur. The incremental return is limited mainly by the long investment horizon

and by the fact that the price paid for Honeywell, assuming the deal goes through, is tied to GE's stock price. Even if Gallinelli came to the conclusion that both the DOJ and the EC would approve the merger, the returns do not justify her continued investment and she should liquidate her position and invest her funds elsewhere.

Epilogue

On May 2, 2001, the DOJ approved the GE–Honeywell merger with minimal concessions, notably the sale of Honeywell's helicopter engine business. After intense negotiations with GE and Honeywell, however, the EC disagreed with the DOJ's analysis and rejected the proposed merger on July 3, 2001, four months after initiating phase II proceedings on March 1. Upon issuance of its decision, the EC's Mario Monti said, "The merger between GE and Honeywell, as it was notified, would have severely reduced competition in the aerospace industry and ultimately resulted in higher prices for customers, particularly airlines."[2] U.S. government officials sharply criticized Monti and the EC for its decision.

The EC argued that GE was a dominant supplier of large commercial and regional aircraft and that Honeywell was the leading supplier of avionics, nonavionics, engines for corporate jets, and engine starters. Thus, the EC regulators were concerned that GE's ability to bundle engines, avionics, and nonavionics, while offering varied financing services (its potential to become a one-stop shop for both manufacturers and airlines) would foreclose competition in the European aerospace market, "thereby eliminating competition in these markets, ultimately adversely affecting product quality, service, and consumers' prices."[3] In response to the EC's concerns, GE proposed divesting operations of $2.2 billion a year and selling part of GE Capital Aviation Services (GECAS), which proved insufficient for the EC regulators.

Since the proposed GE–Honeywell deal, the EC has worked to make its merger review more similar to the review process followed in the United States. In late 2003, the EC recommended seven major changes to its merger regulations. The following were among the changes: (1) making its dominance test closer to the American "substantial lessening of competition" test; (2) allowing officials different from those who reviewed a deal in phase I to give their input in phase II; (3) extending phase II proceedings by up to 35 days; and (4) notifying firms of likely problems earlier in the review process. Many observers expected that EC merger enforcement would continue to become more similar to the U.S. approach over time.

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[2] "Defeated Merger Illustrates 'Global' Aerospace Industry," *Business & Commercial Aviation,* August 2001. p. 17.

[3] "Why All Buyers Should Care about the GE/Honeywell Misfire," *Mergers and Acquisitions,* September 2001, p. 6.

Exhibit TN1

GENERAL ELECTRIC'S PROPOSED ACQUISITION OF HONEYWELL

Estimation of ROI on Risk-Arbitrage Position

Assumptions			
Position opened		20-Oct-00	20-Oct-00
Position closed		1-Mar-01	1-Jul-01
Days in holding period		132	254
Position and Payoff in Target Shares			
Buy target shares at		$41.46	$41.46
Value of target shares at end of holding period[1]		$41.82	$43.89
Gross spread per share on target shares		$0.36	$2.43
Total value of gross spread on target shares (× no. of shares)[2]	100	$36.00	$242.80
Position and Payoff in Buyer Shares			
Short buyer shares at		$47.08	$47.08
Value of buyer shares at end of holding period[3]		$41.60	$41.60
Gross spread per share on buyer shares		$5.48	$5.48
Total value of gross spread on buyer shares (× no. of shares)[2]	100	$548.00	$548.00
Total Assets of the Arbitrage Position		$4,146.00	$4,146.00
Short position in buyer shares		$4,708.00	$4,708.00
Borrowed shares of buyer		($4,708.00)	($4,708.00)
Debt @ % of assets	70%	$2,902.20	$2,902.20
Capital employed		$1,243.80	$1,243.80
Total Liabilities and Capital of the Arbitrage Position		$4,146.00	$4,146.00
Net Spread Calculation			
Gross spread		$584.00	$790.80
- Interest @	15%	($157.43)	($302.94)
- Short dividends foregone		$16.00	$32.00
+ Long dividends received		$37.60	$37.60
Net spread		$480.17	$557.46
Days in holding period		132	254
Results			
Return on capital for holding period only		39%	45%
Return on capital annualized		107%	64%

[1] If the deal is consummated by July 1, Honeywell shareholders will receive $43.89 per share, which is 1.055 per GE share: $43.89 = 1.055 × $41.60.
[2] The choice of 100 shares is arbitrary.
[3] Assumes no change in GE's future share price.

Exhibit TN2

GENERAL ELECTRIC'S PROPOSED ACQUISITION OF HONEYWELL

Sensitivity Analysis of the Probability of Merger Consummation

				$P_{Stand\text{-}Alone}$									
				$30.00	$32.86	$34.00	$35.30	$38.00	$40.00	$42.00	$44.00	$47.16	$50.00
Date	**Honeywell Share Price**	**GE (US$)**	P_{Bid}					***prob***					
1-Nov-00	$48.22	49.17	$51.87	83.29%	80.79%	79.56%	77.95%	73.66%	69.22%	62.99%	53.59%	22.44%	N.Ap.
15-Nov-00	$46.54	47.42	$50.03	82.58%	79.69%	78.24%	76.32%	71.00%	65.22%	56.55%	42.14%	N.Ap.	N.Ap.
1-Dec-00	$45.18	46.06	$48.59	81.64%	78.31%	76.61%	74.33%	67.78%	60.28%	48.23%	25.69%	N.Ap.	N.Ap.
15-Dec-00	$43.31	44.99	$47.46	76.21%	71.56%	69.15%	65.85%	56.10%	44.34%	23.97%	N.Ap.	N.Ap.	N.Ap.
2-Jan-01	$40.03	39.64	$41.82	84.85%	80.03%	77.11%	72.55%	53.14%	1.65%	N.Ap.	N.Ap.	N.Ap.	N.Ap.
16-Jan-01	$43.31	42.93	$45.29	87.04%	84.07%	82.45%	80.17%	72.83%	62.56%	39.80%	N.Ap.	N.Ap.	N.Ap.
1-Feb-01	$43.19	41.89	$44.19	92.93%	91.15%	90.15%	88.71%	83.79%	76.06%	54.24%	N.Ap.	N.Ap.	N.Ap.
15-Feb-01	$44.05	43.48	$45.87	88.52%	86.01%	84.66%	82.77%	76.86%	68.98%	52.95%	2.67%	N.Ap.	N.Ap.
1-Mar-01	**$41.82**	**41.6**	**$43.89**	85.11%	81.26%	79.09%	75.92%	64.88%	46.81%	N.Ap.	N.Ap.	N.Ap.	N.Ap.

WALT DISNEY PRODUCTIONS, JUNE 1984

Teaching Note

Synopsis and Objectives

This case is set in the midst of the attempted takeover of Walt Disney Productions by the raider Saul Steinberg in June 1984. Disney's chief executive officer ponders whether to fight the takeover or pay "greenmail." One significant influence on the decision is the "true" value of the firm. The case offers, either directly or through analysis, several estimates of value. The valuation question invites a review of Disney's past performance and current competitive position. Other significant influences on the decision are the ethics and economics of paying greenmail. Ultimately, any judgment of Disney's true value hinges on expectations concerning the cash flows potentially available under a new and aggressive management team. The epilogue to the takeover attempt (summarized in **Exhibit TN6** and distributable to students at the instructor's discretion) highlights the actions taken to unlock that hidden value.

Suggested complementary cases: "Euro Disneyland S.C.A.: The Project Financing" (UVA-F-1034); **cases on the financial analysis of performance:** "Warren E. Buffett, 2005" (Case 1); "The Battle for Value, 2004: FedEx Corp. vs. United Parcel Service of America Inc." (Case 4); "Teletech Corporation, 2005" (Case 15); **cases on ethical dilemmas:** "Krispy Kreme Doughnuts, Inc." (Case 7); "Deutsche Brauerei" (Case 11); and "Victoria Chemicals Ltd. (A): The Merseyside Project" (Case 22).

The rich range of issues raised in the case (strategy, valuation, performance measurement, and ethics) helps make it an effective first case, review case, or final exam in a corporate-finance course. The case was written for the following purposes:

- To motivate a discussion of "excellence" from a corporate-financial point of view and of the ways in which excellence might be measured
- To review and compare various valuation methodologies and suggest some explanations for the disparities among the results
- To show that corporate value depends heavily on industry conditions and the strategic choices managers make

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- To estimate the economic costs of greenmail and discuss their influence on the morality of greenmail payment

Suggested Questions for Advance Assignment to Students

1. What are Disney's major business segments, and what is Disney's relative competitive position in each? How well has Disney performed in the segments and in the aggregate? What criteria should you use to judge performance?
2. What is Disney's apparent business strategy?
3. Is Disney a "growth company"? What should define a growth company?
4. Why was this "excellent company" the target of a takeover attempt?
5. Should Disney repurchase Saul Steinberg's shares?
    a. If so, what should the repurchase price be? How will the price of Disney's shares respond to the purchase announcement? Does the repurchase represent a transfer of wealth?
    b. If not, and if Steinberg completes his takeover, what are the wealth consequences for Steinberg? For the former public shareholders?

Hypothetical Teaching Plan

An 80-minute discussion of this case could have many possible structures. The following is one outline, which the author has used with some success. As a means of accelerating the discussion and focusing it on the underlying valuation problem, one could begin the class with the various Disney share values given in the case already listed on a chalkboard (see **Exhibit TN1**). One could then ask the following questions:

1. *As Disney's CEO, would you buy back the Disney shares from Saul Steinberg? If so, why and at what price? If not, why not?*

    The instructor could call on three or four students to express views and make recommendations. Opening this way is an excellent "ice breaker" for classroom discussion and can trigger an animated exchange of views. Before the discussion becomes repetitive, the instructor could take a vote as a way of gaining a preliminary sense of the audience. This vote could be repeated toward the end of the discussion, affording a chance to assess the cause for changes in sentiment.

2. *What is the meaning of these different valuations? Why not just ask an accountant to tell us what Disney is worth? How, in an efficient stock market, can there be a valuation discrepancy this big?*

This question provides an opportunity to compare and contrast accounting and finance views of value and, more generally, to explore different kinds of valuation. In this segment, the instructor might develop an asset valuation of Disney along the lines of **Exhibit TN2**.

3. *Ron Miller, the CEO, said, "We have created unique value along with competitive and strategic advantage." What are the unique value and advantage to which he refers? Please be as specific as possible for each business segment.*

   This segment of the discussion extends the preceding set of questions (i.e., questions 1 and 2) by drawing a contrasting view of value, defined less in financial terms, and more in terms of product quality, market franchise, and competitive position. This view of value might be called *managerial*. Students ordinarily have much to say about Disney's products and strong market position. The instructor might prepare to list strengths for each of Disney's main business segments. The positive view of Disney developed in this segment provides half of the central paradox of this case. The next segment provides the other half.

4. *Is Disney excellent in financial terms? How do you define excellence? Why is operational success not automatically accompanied by financial success?*

   This segment can be accompanied by a detailed review of case Exhibit 6. The evidence is that Disney's performance declined over the 18 years following Walt Disney's death. The instructor could benchmark this performance against U.S. Treasury-bill yields (also given in case Exhibit 6) with a graph (such as in **Exhibit TN3**) showing that, in recent years, stockholders could have done better investing in risk-free T-bills than in Disney stock. Plainly, the operational value to which Ron Miller refers has become decoupled from financial value. Some students will be startled to discover that a company that is excellent operationally is not also excellent financially. The disparity leaves a lasting impression.

5. *Should Ron Miller pay greenmail?*

   The instructor can take a vote of the class again. If time permits, the instructor could explore the ethical considerations in paying greenmail.

   a. Pick a "Yes" voter: *At what price? What will happen to the share price of the remaining shares? Why? How does management's interest differ from the shareholders' on this question?*

   b. Pick a "No" voter: *Why not? What are the eventual payoffs to the public shareholders? To Steinberg? To the employees?*

Although unlikely to reveal a consensus, the closing vote is useful as a springboard to a brief survey by the instructor of Disney's history subsequent to June 11, 1984. The epilogue to the

takeover episode affords a dramatic conclusion to the discussion. (The epilogue, contained in **Exhibit TN6**, could simply be distributed to students for reading on their own or mined as a source for the instructor's own closing comments.) In essence, the epilogue suggests that the image of operational excellence before 1984 was a mirage and that it was possible not only to run the company even better than it had been, but also to realize the goals of both operational and financial excellence. The contrast between the preraid and postraid years should challenge students to sort out the various definitions of value, performance, and excellence and to assess the merits of a lively and watchful capital market.

This case could be used as a springboard for team or class analyses of Disney's performance since the date of the case. The dramatic improvement in performance in the 1980s and early 1990s would be an excellent focus for financial analysis. Disney's Web site would be an interesting source of information for the students. See http://www.disney.com/.

Case Analysis

Valuation problem

Discussion Question 2

As students work to establish the true value of Walt Disney Productions, the range of values given in **Exhibit TN1** frames the main dilemma in the case. Students should quickly delete from the list book value per share and the April 1983 stock price on the grounds that they reflect past performance or outdated investor expectations. Steinberg's bid prices may be driven more by bargaining strategy than by intrinsic values, although the acquisition of Gibson Greetings is to Steinberg a value-destroying investment. On the other hand, Steinberg's cost basis ($63.25/share) is an extremely useful reference point because it reveals the foundation on which he believed he could still make a profit. The estimates of securities analysts at C. J. Lawrence ($64.00-$99.00/share) and Goldman, Sachs ($75.00/share) support the views that Steinberg did not overpay for his shares and that the shares might be worth considerably more than he paid.

Students may choose to augment this range of values with their own estimates. For instance, multiplying the forecasted EPS of $3.10 (David Londoner, case Exhibit 13) to $3.25 (Richard Simon, case text) by P/E multiples of 15 to 20 times gives share values ranging from $46.50 to $65.00. Students sometimes choose to capitalize profits or dividends at the difference between the cost of equity capital and the expected growth rate. The resulting share values are ordinarily quite low.

The disparity among the valuations exists simply because Disney is worth one thing on a business-as-usual basis and something much higher if restructured, which is the gist of the article in case Exhibit 13.

Another way to rationalize the disparity in valuations is to adjust Disney's book value of equity for the wide differences between historical cost and current estimated value of certain assets, such as Disneyland, the film library, and the firm's enormous holdings of raw land. The calculation in **Exhibit TN2** suggests that, based on certain assumptions, the current book value of the company is $66.52 per share, not $40.58 per share as the balance sheet implies. This adjusted book value is still at the lower end of the range of asset-based valuations ($64.00-$99.00) suggested by C. J. Lawrence & Company. Furthermore, the calculation in **Exhibit TN2** ignores any benefits that could be gained from exploiting Disney's existing unused debt capacity. Even recognizing that the adjusted book-value estimate may be conservative, Disney's stock price before the takeover play began ($52.625) is considerably lower than the adjusted book value. The market-to-book-value ratio based on these two values is only .79.

Assessment of strategy and competitive position

Discussion Question 3

Did Disney "create unique value along with competitive and strategic advantage"? As Disney's large fund of creative capital suggests, it had in the past. The real question is how well management would use that capital for the survival of the firm and prosperity of its stakeholders. **Exhibit TN3** presents a model chalkboard layout for the history and current position of Disney's businesses. Plainly, the company has to respond to changing consumer demographics in filmed entertainment and to the combination of growing capacity and maturing demand in theme parks. Real estate development, however, requires different skills from those of the past and a different commitment of financial capital. It is a related business only in the sense that it may effectively and profitably integrate the theme parks into their surrounding areas. Walt Disney Productions may have been taking a large leap into this new area, however, possibly at the expense of new creative projects and effective use of its existing creative capital (e.g., the artistic staff and film library). The current strategy might be characterized as an evolution away from operations based on creative capital and toward operations based on real property.

One might argue that Disney Productions has been paying its dues over the past 15 years for this strategic refocus and is now poised for lift-off into profitability based on real estate. The Florida theme parks are in place, and the nearby raw land remains to be developed. According to this argument, Saul Steinberg waited to raid Disney until the heavy-investment phase was completed; if only the development revenues were arriving more quickly, the stock market would see the firm's tremendous potential.

Securities analyst Richard Simon implies in the case that there is a more profitable alternative to the real estate-based strategy: refocus on creative capital with particular emphasis on filmed entertainment and communications (e.g., pay-TV). Obviously, this route carries large risks as well as potentialities. Cable-programming services are proliferating (see case Exhibit 4). Theme-park attendance appears to have leveled off for Disney (case Exhibit 7) and, for the industry, growth is low and mature (see case Exhibit 11). As a film distributor, Disney's market share is low and declining (case Exhibit 9). The profitability of film production is highly volatile (see case Exhibit 8),

and film inventory is large in relation to film revenues. This situation would not seem to be one in which to make much money. The main counter argument is that film entertainment was a profitable strategic focus at one time in Disney's past and perhaps it could be so again.

The issue of excellence

Discussion Question 4

As the opening quotation of the case suggests, Peters and Waterman (*In Search of Excellence* [Harper & Row, 1982]) included Disney in their pantheon of "America's Best-Run Companies." Most consumers of the firm's services would be prone to agree with this assessment; in discussions of this case, several students will usually comment glowingly on the firm's animated films and theme parks. In this context, one of the larger questions the case poses is why this excellent company is the target of a takeover attempt.

The answer depends heavily on what we mean by excellence in business. In their highly popular book, Peters and Waterman focus on aspects of the *process* of managing rather than on goal achievement. Business excellence, they say, is characterized by a simple organization, a lean staff, a bias for action rather than analysis, and an emphasis on product quality based on respect for individual workers, fawning attention to customers, etc. Disney ranked high on several of these criteria. This approach is a means-oriented view of excellence, however, that says little about the achievement of ultimate objectives.

From an administrative point of view, the goals of the firm should be to create investment value for shareholders, to create value (or meaning) for employees, and to deliver value to customers. These competing goals must be balanced. A strategy of profiting any two stakeholder groups at the expense of the third is unsustainable in the long run; eventually, the slighted party will react.

Excellence defined in terms of value creation and delivery is a subject about which corporate finance has much to say. The value-creation framework suggests that premium (i.e., above-book-value) stock prices result from achieving large positive spreads between realized returns on equity and the returns required by equity holders. Stocks selling below book value are associated with negative spreads. Thus, the value-creation framework focuses attention on the fundamental opportunities and constraints of the firm, together with the choices managers make.

The ratio of stock price to adjusted book value is an appealing measure of performance. Intuitively, market-to-book ratios greater than 1 suggest that each dollar of profit retained in the firm is converted into more than a dollar of market value—which is *value creation*. Conversely, a market-to-book ratio less than 1 suggests that each dollar retained amounts to less than a dollar in market value—*value destruction*. The sources of value creation and destruction have been discussed at length elsewhere (see William Fruhan, *Financial Strategy* [Irwin, 1979]); simply stated, however, the essential ingredient in value creation is the ability to earn rates of return in excess of those required by investors. As **Exhibit TN4** shows (over a sample of firms), higher market-to-book ratios

are associated with higher "spreads" (i.e., positive differences between realized returns and required returns).

Defining excellence in *corporate financial terms* suggests that Disney was not excellent, at least with respect to delivering value to investors. Disney seems to have succeeded in satisfying employees and customers, but not shareholders. Indeed, the opportunity to unlock the latent, undelivered value for shareholders finally became sufficiently apparent to entice a raider into play. In other words, Disney was attacked because it was *not* excellent. **Exhibit TN5** compares Disney's realized returns on equity with the returns required by Disney's equity holders (i.e., the cost of equity). Equity costs may be calculated by using the data in case Exhibit 6 in the capital-asset-pricing model; returns on equity are also available in case Exhibit 6. **Exhibit TN5** shows that, for a considerable time, Disney failed to perform up to the standard set by its shareholders. Worse yet, over the years 1981 to 1983, Disney even failed to earn the rate of return available on one-year U.S. Treasury bills.

There are several possible explanations for this performance. One is that the company may have foundered in the absence of a strong and creative leader. Walt Disney died in 1966, the last year of true supernormal performance. The commentaries quoted from *Newsweek* and *Business Week* in the case lend some support to this view. In terms of the value-creation framework, one could argue that Walt Disney's personal creative genius was the source of the firm's high realized returns. Other examples of this phenomenon in business history—such as Thomas Edison and Edwin Land—indicate that this "Great Leader Theory" is serious and meaningful, although the case gives no specific guidance about the areas of leadership failure after 1966.

An alternative interpretation of this performance is that it reflects managerial inefficiency, i.e., the failure to employ assets in their highest-valued uses. Substantial evidence in Disney's history supports this interpretation. Case Exhibit 6 shows that, from 1965 to 1971, Disney's asset-utilization ratio fell to a third of what it had been. This decline coincided with the firm's investment in Florida and development of Disney World. Another shock occurred in the early 1980s when the firm's pretax profit margin fell from 27.12 percent (1980) to 12.5 percent (1983). This decline coincided with the opening of EPCOT Center and various setbacks in the firm's filmed-entertainment division. The case indicates that the film segment once showed a 56 percent pretax return on investment; now its returns are negative. Similarly, theme parks returned 15.7 percent on assets (pretax) in 1978, compared with a 10 percent pretax return at the time of the case. The case suggests that, at the margin, the investment in parks is, in fact, even lower: EPCOT was returning $80 million (pretax) on assets of $1.9 billion. The fact that Walt Disney personally approved the firm's massive entry into Florida dampens some of the force of the Great Leader Theory. Plainly, the firm was taking major gambles that were not paying off.

Paying greenmail

Discussion Questions 1 and 5

Greenmail is the payment of a premium share price by a takeover target to a hostile buyer for the buyer's accumulated shares in the target. Paying greenmail is considered unethical for four main reasons. First, it is a discriminatory payment; not all public shareholders enjoy the right to sell their shares to the company at the price paid to the green mailer. This fact is especially painful to professional arbitrageurs. Second, it is viewed as the triumph of agents' self-interest: senior managers rarely welcome the consequences of a hostile takeover and, so it is argued, sacrifice shareholders' wealth to preserve their jobs. Third, it is believed to effect significant transfers of wealth from the remaining public shareholders to a more powerful raider. Fourth, greenmail payments (like blackmail) are actions not freely conceived and may set the pattern for further intimidation; expediency is a bad precedent. Against such a list, no conditions appear to exist under which management would be justified in paying greenmail. The objective of any class discussion of the ethics of paying greenmail should be to show that such a conclusion is not strictly true.

Circumstances may exist in which public shareholders would be better off after the greenmail payment *even if* they were discriminated against, their agents acted in self-interest, and the action was not freely taken. A decision involves weighing the evident costs of greenmail versus the potential benefits. Some students may argue that to place a price on discrimination or the loss of free choice is impossible and that managerial self-interest is always bad. Yet, in many ways every day, individuals submit to discrimination or loss of choice to enhance their own welfare. Furthermore, managerial self-interest is not harmful per se to shareholders; managerial self-interest and shareholder self-interest undoubtedly coincide in a wide range of decisions.

The key question is whether shareholders receive any benefits to offset the costs of greenmail. Specifically, will the remaining shareholders be better or worse off after the payment than before? The facts in the Disney case imply that management may have had an estimate of the intrinsic value of the firm that was materially higher than the ex ante share price or a potential greenmail price per share (see **Exhibit TN1**). Under this circumstance, any repurchase of shares at a price less than intrinsic value will transfer wealth from the selling shareholders (i.e., the green mailer) *to* the remaining public shareholders. The amount of the wealth transfer per share remaining will be:

$$\frac{[(\text{Intrinsic value/Share} \times \text{Cash paid/Share}) \times \text{Shares bought}]}{\text{Shares remaining outstanding}}$$

The numerator of this equation suggests that the total wealth transferred depends on the difference between what the green mailer (e.g., Steinberg) would have received had he "bought and held" versus what he actually received. If the wealth transfer is positive and material, managers could be "right" to pay greenmail.

The instructor will want to hedge any strong statement in favor of greenmail because managers actually do have alternatives to paying it. The first alternative is to announce and execute a restructuring of the firm along the lines the raider would have to do to unlock latent value. This move allows both the raider and the public to participate in the benefits. The second alternative is to offer to repurchase shares from the public instead of the green mailer, as happened in the case of T. Boone Pickens's attempted raid on Unocal. This move siphons cash to the public at the expense of the raider and, in fact, enhances the freedom of choice of the public shareholder: he or she can elect to receive the green mailer's price per share or hold onto the shares in hopes of eventually receiving the intrinsic value per share.

Because these alternatives exist in theory, the instructor may want to dwell briefly on the effects they might have on the firm, its shareholders, and the raider. The decision to pay greenmail versus the alternatives ultimately depends on the wealth-creation/wealth-transfer effects each choice may have. Because the case presents no details on the wealth effects of the alternatives to greenmail, the class is left to speculate, the chief virtue of which is to temper any seemingly doctrinaire support in favor of paying greenmail.

The chief objection to this wealth-transfer-based line of analysis is that stock prices usually *fall* after greenmail is paid. This scenario could happen for two reasons. First, greenmail payment takes a target company "out of play" (i.e., it removes the immediate threat of takeover). Terminating the action process induces frantic selling by arbitrageurs. The market in the firm's stock is equilibrating away from one highly opportunistic clientele back toward long-term investors. A second explanation for the price decline is an inevitable information asymmetry: investors cannot know as much as managers about a firm's prospects. The problem is essentially one of signaling or investor relations, which, by and large, firms do poorly. Even if management *never* talks to shareholders, however, and instead waits for intrinsic value eventually to become manifest in operating performance, paying greenmail still makes economic sense if the wealth transfer to the remaining shareholders is positive.

Should Ron Miller pay greenmail to Saul Steinberg? The answer is "yes," assuming that (1) the price paid per Steinberg share is less than the intrinsic value, (2) Miller makes realizing the intrinsic value for remaining shareholders a top priority (via operational changes and better investor relations), and (3) the effect on share price is superior to restructuring or other defenses. What should the price be? It should be as low as possible consistent with an incentive for Steinberg to sell—certainly no higher than the estimated intrinsic value. Raiders and arbitrageurs look for annualized rates of return above 50 percent. Assuming Steinberg bought his shares on March 1, 1984, his holding period to the date of the case was 103 days. Thus, he would seek an interim gain of 14 percent in order to achieve an annualized gain of 50 percent. Steinberg's apparent cost basis was $63.25, suggesting a greenmail price of $72.11 (114 percent of cost). At a greenmail price of $77.45, Steinberg would receive an annualized rate of return of 77.96 percent.

The decision to pay greenmail is difficult because of ambiguity and the conflicting tugs of various arguments; but wrestling with these unenviable problems is what chief executives are paid to

do. Although the economic analysis outlined here sheds light on the consequences of paying greenmail, nothing in the analysis should be construed as suggesting that the decision can be reduced to a simple rule.

Exhibit TN1

WALT DISNEY PRODUCTIONS, JUNE 1984

Selected Values and Bids for Disney Stock

$84.38	Stock price in April 1983
$64.00-$99.00	C. J. Lawrence estimate
$75.00	Goldman, Sachs estimate
$72.50	Steinberg's bid if Gibson not acquired
$67.50	Steinberg's bid if Gibson acquired
$63.25	Steinberg's apparent cost basis
$54.25	Stock price on June 11, 1984
$47.50	Stock price on November 10, 1983
$40.58	Book value/share on December 31, 1983

Exhibit TN2

WALT DISNEY PRODUCTIONS, JUNE 1984

Calculation of Disney's Adjusted Book Value per Share

Book value of equity as reported September 30, 1983[1]	$1,400,528,000
Disneyland[2]	120,000,000
Film library[3]	275,000,000
Raw land[4]	500,000,000
Adjusted book value	$2,295,528,000
Number of common shares	34,509,171
Adjusted book value per share	$66.52

[1]Case Exhibit 2.

[2]Case text. Disneyland was carried on the books at $20 million, although it was estimated to be worth $140 million.

[3]Film library was apparently carried at zero historical cost, consistent with industry practice of rapid amortization of film-production costs (balance sheet, case Exhibit 2, shows no value broken out for film library). However, case Exhibit 10 suggests that the film library was worth $275 million. The annuity value of old but successful films is immediately apparent from case Exhibit 3, which presents the annual revenues from releases of *Snow White.*

[4]Most of Disney's raw land was acquired in the mid- to late 1960s as part of its Florida projects. The general level of prices (e.g., Consumer Price Index) rose approximately three times between the late 1960s and the mid-1980s. The assumption here is that the raw land was acquired at one-third of its value estimated today. The case mentions that the raw land is believed to be worth $300-$700 million. Assuming the $700 million value and a $200 million cost (about one-third), the valuation adjustment would be $500 million.

Exhibit TN3

WALT DISNEY PRODUCTIONS, JUNE 1984

Business Segments and Strategy

	Filmed Entertainment	Theme Parks	Consumer Products	Real Estate
Entry	Animation, 1928 AWonderful World@ (TV), 1961-81 Disney Channel, 1979 Touchstone Films, 1979	Disneyland, 1954 Disney World, 1972 EPCOT, 1982 Tokyo, 1983	Gibson Greetings, 1984	28,000 acres in Orlando, 1968 Arvida, 1984
Industry Situation	Changing demographics Consolidation in films Heavy competition in cable Large risks	25 parks Saturated demand Low growth	Highly competitive Easy entry	
Disney Position	Dominant family brand Trademarked animated characters Valuable film library	Leading franchise Well-positioned in Florida and Southern California	Ancillary	Huge position in Florida Determines land values around Orlando
Strategy	Shift to target more mature audiences Exploit film library	Spend aggressively to maintain/improve existing parks	Protect trademarks Exploit characters	Develop slowly and selectively
Red flags	Erosion of creative talent Recent big film losses	Flat growth, even with EPCOT		Huge capital requirements Long time to pay off

Exhibit TN4

WALT DISNEY PRODUCTIONS, JUNE 1984

Profitability and Value of DJIA Companies, Winter 1984

ALD (Allied Corp.)
AA (Aluminum Co. of America)
AMB (American Brands)
AC (American Can)
AXP (American Express)
T (American Telephone)
BS (Bethlehem Steel)
DD (Du Pont)
EK (Eastman Kodak)
XON (Exxon Corp.)
GE (General Electric)
GF (General Foods)
GM (General Motors)
GT (Goodyear Tires)
IBM (International Business)
N (Inco Limited)
IP (International Paper)
MRK (Merck)
MMM (3M)
OI (Owens Illinois)
PG (Procter & Gamble)
S (Sears Roebuck)
SD (Standard Oil)
TX (Texaco)
WX (Westinghouse)
UK (Union Carbide)
UTX (United Technologies)
X (U.S. Steel)
Z (F.W. Woolworth)

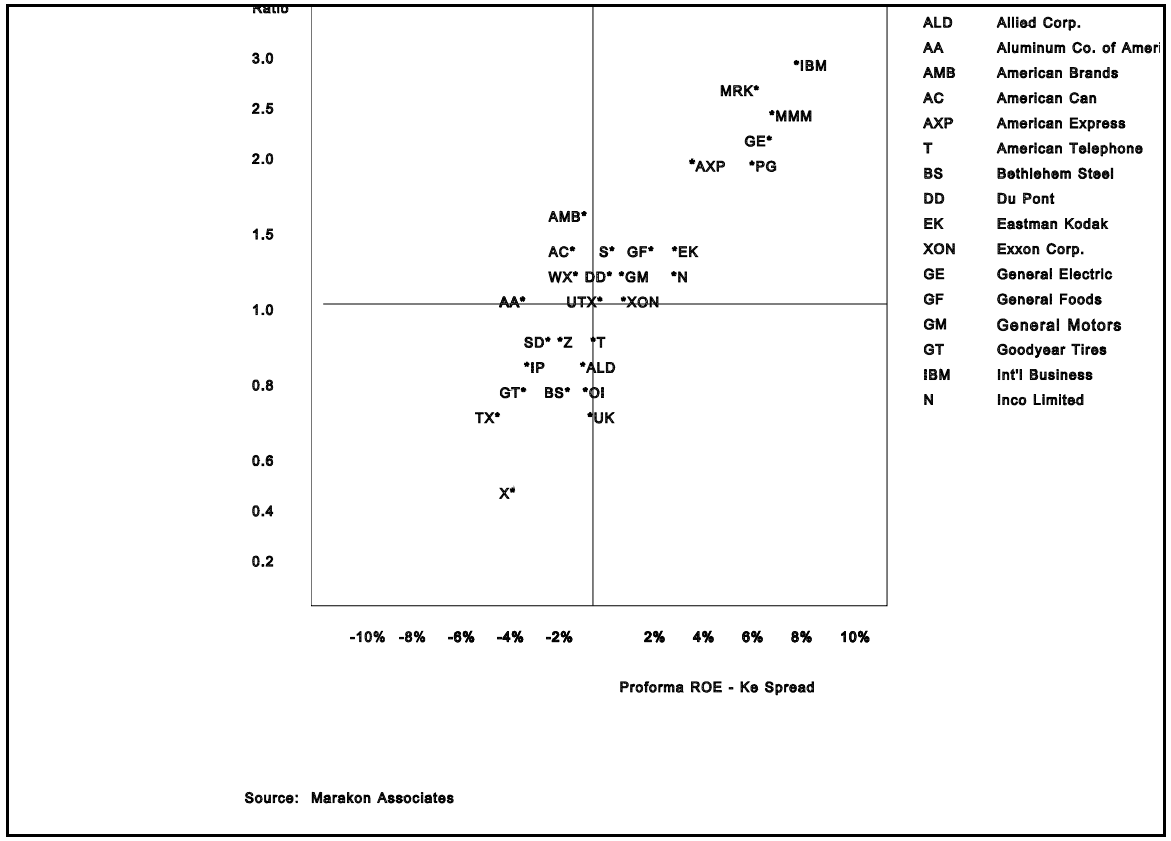
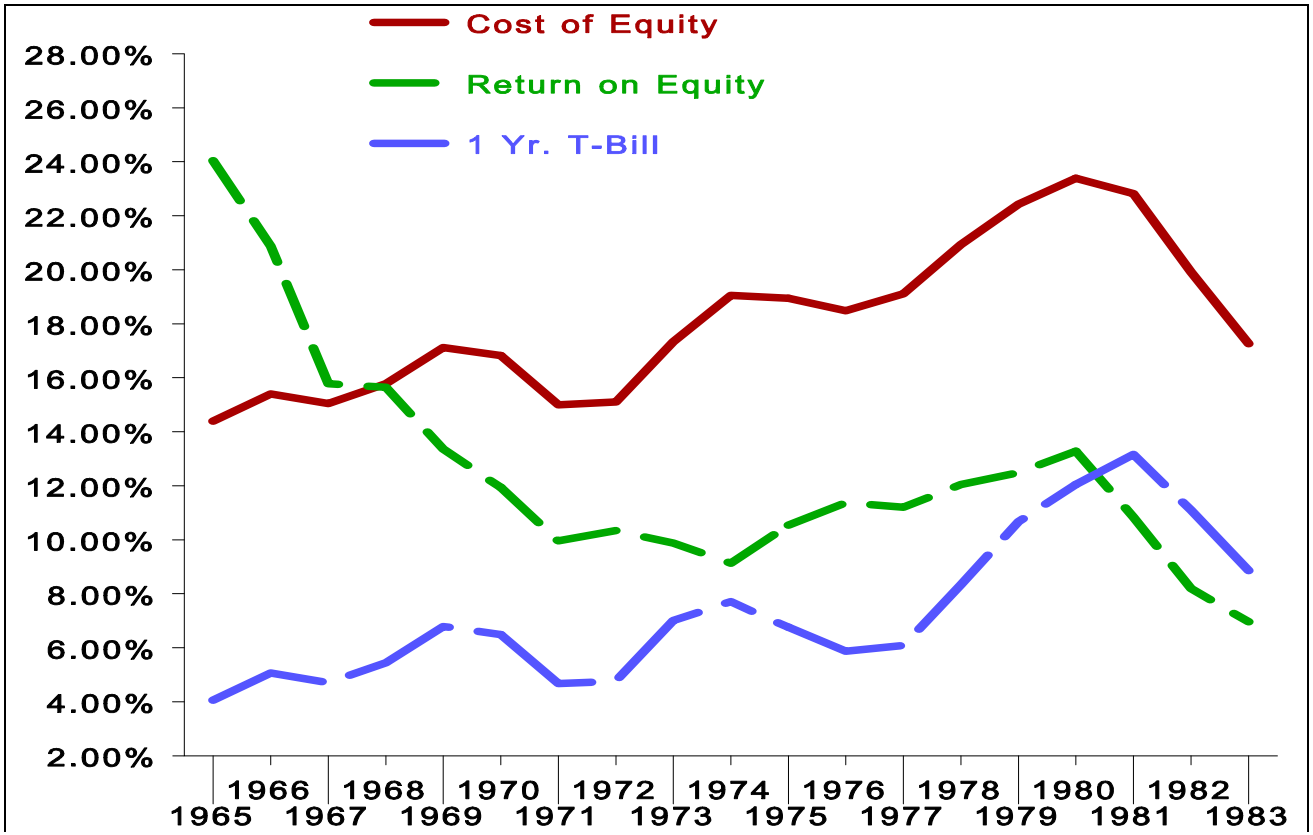


Exhibit TN5

WALT DISNEY PRODUCTIONS, JUNE 1984



Walt Disney Productions Annual Return on Equity Compared to Cost of Equity

Exhibit TN6

WALT DISNEY PRODUCTIONS, JUNE 1984

The Epilogue

Resolution of the Takeover Fight

On June 12, 1984, Disney's chief executive officer announced an agreement to buy Steinberg's 4.2 million shares for $325.3 million, or $77.45 per share. On that day, Disney shares closed at $49.00, down $5.25, or 9.7 percent, from the previous close. Two days later, the first of many shareholder lawsuits protesting the payment was filed. The lawsuits had virtually no effect on the greenmail payment. Later, Steinberg's general counsel explained why Steinberg quit the takeover effort:

> Saul Steinberg envisioned taking many of the same steps to improve Disney's performance as were later adopted by the new management team, such as raising the price of admission at the theme parks. But also, if Reliance had acquired control of Disney, it had planned to retain the theme parks, develop Disney's real estate holdings in conjunction with other investors, and sell its film library. While Reliance would have preferred to have acquired control to Disney, it felt that under the circumstances it had little choice but to sell its stock to Disney. In particular, Disney had threatened to make a leveraged self-tender for the 51 percent of Disney shares not being sought by Reliance, thus leaving the company saddled with what Reliance viewed as an untenable debt burden.[1]

On July 17, Irwin Jacobs, charging that Disney was overpaying for Gibson Greetings, announced a hostile tender offer. A month later, Disney canceled its planned acquisition of Gibson Greetings, but Jacobs continued with his tender offer. The Bass family then undertook a series of actions to defuse Jacobs. The Bass group had been a major investor in Arvida and then in Disney after Disney acquired Arvida. First, the Bass group purchased 1.52 million shares at $60.00 each ($3.25 more than the stock was trading for at the time) from Michael Milken and Ivan Boesky.[2]

[1]Letter of December 5, 1991, to Brandon Carry.
[2]Ron Grover, *The Disney Touch* (Homewood, Ill.: Business One Irwin, 1991), 23.

Exhibit TN6 (continued)

Jacobs then offered to buy the Bass holdings for $65.00 per share. Bass declined, and counter-offered Jacobs $60.00 per share for his 7.7 percent stake in the company. Bass ultimately purchased Jacobs's shares for $61.00 per share, raising the Bass group's stake to 24.8 percent of the company. With Jacobs's departure, the directors could focus their attention on underlying problems at the company.

A Change in Management and Strategy

Apparently sensing that the two raids indicated fundamental problems in management, the board of directors fired Ronald Miller as chief executive officer on September 7, 1984. Two directors who helped in the takeover defense quit in January 1985. The chief financial officer, the head of the pay-TV division, and other managers left within a year of Miller's departure. Thus, a major management housecleaning took place following the raids.

More importantly, the focus of the firm's strategy shifted from real property back to creative capital with the hiring of the new chief executive officer, Michael Eisner, from Paramount. While campaigning for the CEO position, Eisner is reported to have said to Sid Bass, "It's going to take a creative person to run this company. Look at the history of American companies. They have always gotten into trouble when the creative people are replaced by the managers. Walt Disney Productions can't allow that to happen to it."[3]

Eisner's appeal to return to the creative origins of the company was successful. He was hired at an annual salary of $750,000 plus call options on 500,000 Disney shares, exercisable at $55.60, as well as a percentage of any increase in net income.[4] Usually arriving at his office before 7:00 a.m. and leaving in the evening, Eisner brought an intense work ethic to Disney. "If you don't come in on Saturday, then don't bother coming in on Sunday," became a motto signaling the end of the easygoing Disney work culture.

The main elements of Eisner's new strategy for Disney emerged rather quickly:

X Rapidly expand film production (both live-action and animation)

X Return to television

[3]Ibid., 23.
[4]Ibid., 51-52.

Exhibit TN6 (continued)

- X Exploit the extensive library of films, TV shows, and cartoons through theater rereleases, videocassette sales, and TV syndications
- X Expand the theme parks
- X Expand the consumer-products business, especially through dedicated retailing
- X Shed the Arvida Land Company
- X Finance innovatively and aggressively

Accomplishments by 1993

Film production

In November 1984, losing no time, Disney management announced aggressive film-production plans: a target of 15 releases per year (up from 4 films per year), which would put Disney back in the class of major producers. The films were to be financed through limited partnerships. The renewed emphasis on films was prescient: the late 1980s saw a rising consumer appetite for movies and home-video entertainment. Disney quickly became a powerhouse in the motion-picture industry, rising from a small 4 percent market share in 1984 to market leadership by 1986, all of this the result of Disney's goal of releasing 15 films a year. In the early 1990s, Disney announced that it would more than double the number of soundstages to accommodate its large number of film projects. Owning Touchstone, Buena Vista, and Hollywood Pictures, Disney put out such hits as *Good Morning Vietnam* ($123 million in ticket sales), *Pretty Woman* ($377 million), *Dick Tracy* ($105 million), and *Three Men and a Baby* ($168 million in its first six months). Disney employed a strategy of tight cost control and limited sharing of profits with actors and directors. In 1988, Disney established contractual terms with theater owners for a per capita minimum payment for Disney movies shown. This agreement reduced theater owners' ability to offer discounts on Disney movies and ensured Disney a larger portion of the box office receipts than it had previously received. By the end of 1992, filmed entertainment[5] represented over $3.1 billion in revenues and 35 percent of Disney's profits.

[5]Filmed entertainment included live-action and animated films, TV programs, rereleases of old films and TV shows, and video sales.

Exhibit TN6 (continued)

Home video

Reversing a policy of lengthy delays before releasing films on video, Disney began releasing its films on video only six months after their box-office debuts. The home-video market had become a significant industry by the mid-1980s, with gross sales of $2 billion; but Disney had yet to begin exploiting its film library through videocassette sales. Disney's managers had feared cannibalizing Disney's theatrical rerelease program. The economics in favor of the videocassette strategy, however, were compelling: four theatrical releases of the movie *Pinocchio*, for instance, would net Disney $75 million over 28 years. On the other hand, video release would net $100 million over two years. Comparing present values of the two alternatives, the executives decided to proceed with an aggressive videocassette program.[6] These releases included animated hits such as *The Little Mermaid* and *Aladdin* as well as full-feature films such as *Ruthless People* and *Three Men and a Baby*. With the release of such animated classics as *Snow White, The Jungle Book,* and *Fantasia* in addition to new productions, Disney claimed a 30-percent share of the $3.7-billion home-video market in 1992.

Rereleases

Disney undertook a program of carefully scheduled rereleases of its films through theaters. The rereleases provided Disney with additional revenues at virtually zero marginal cost. Some rereleases were enormously profitable: the 1987 reissue of *Snow White* grossed $20 million in its first ten days in theaters.

Production of animated TV programs

Planning to invest $550 million through 1995 in new cartoons, Disney founded an animated-television-show unit in 1984. In contrast to other producers of Saturday-morning children's television programming, Disney developed cartoons emphasizing character, humor, and quality of animation rather than violence and cheap production techniques. By 1989, *Duck Tales* was the most widely watched cartoon series in the world, with a daily viewing audience of 25 million in 56 countries. Other Disney successes followed, including *Goof Troop, New Adventures of Winnie the Pooh, Dark Wing Duck,* and *A Pup Named Scooby Doo*. By 1993, the cartoon unit had created as much animated entertainment as the company had produced in the years 1920 to 1950, when all the classic Disney cartoons were made.

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[6]Grover, *The Disney Touch,* 141.

Exhibit TN6 (continued)

Production of live-action TV programs

Exploiting its expertise in producing filmed entertainment, Disney undertook an aggressive strategy of producing syndicated network programming. By the 1991-92 season, it was the leading producer of such programming, with offerings including *The Golden Girls, Empty Nest, Blossom, Dinosaurs, Nurses,* and *Home Improvement*.

Syndication of films and TV programs

Paralleling its aggressive strategy of rereleasing films to theaters, Disney sought to syndicate its film and TV-programming library to television broadcasters. Syndication was a valuable strategy for Disney because it allowed the company to negotiate directly with local broadcasters (and their advertisers) and thus avoid the three major networks; the result was increased control for Disney over when and where the shows were broadcast. Disney energetically marketed its syndicated cartoons to networks for prime-time viewing. The company demanded that stations not broadcast any non-Disney animated series directly before or after the prime 3-5:00 p.m. time slot. Furthermore, in 1990, Disney aggressively lobbied the Federal Communications Commission to relax the prime-time access rules in order to allow Disney to sell off-network programs to network affiliates for airing in the early-evening access period.

The Disney Channel

Founded in 1983, the pay-TV business unit generated surprisingly large losses, in part because of the expenses involved in reaching the breakeven number of subscribers, and in part because of poor programming. The poor programming generated an extremely low retention rate of customers—20 percent—from one year to the next. With an 80 percent annual "churn" of customers, the channel might never turn a profit. Eisner brought in a new chief for The Disney Channel, who bought more popular programming and lowered subscription rates significantly. By 1990, the channel had over 5 million subscribers and was earning over $20 million a year.[7]

Sunday-night television

In February 1986, nearly three years after the demise of its predecessor, *The Disney Sunday Movie* began broadcasting on the ABC network. Eisner believed that the cost to Disney in making the show could be recouped by reusing it on The Disney Channel and, later, by syndicating it. Ratings for the show, however, were weak. In 1988 Disney moved the show to NBC and renamed

[7]Ibid., 149-50.

Exhibit TN6 (continued)

it *The Magical World of Disney*. The ratings did not improve—the show ranked 76th out of 96 series in 1989—and NBC retired the program in 1990.[8]

Theme parks

Shortly after his appointment as chief executive officer, Eisner directed that the theme parks raise the one-day ticket prices by $5.00 over two years, from $17.00 to 22.00. For every one-dollar increase in its theme-park ticket prices, Disney's net income would increase by $31 million a year.[9] Attendance increased in the wake of the price rises, partly in response to a major advertising campaign (which had never before been conducted for the theme parks). Eisner also pursued a series of agreements by which major corporations would sponsor pavilions at EPCOT Center—by 1986 Disney was receiving $193 million annually from such participation agreements.[10] Eisner also initiated a major investment program for new rides at Disneyland and Disney World, reaching $280 million in 1987, more than double the level of investment in 1984.[11]

In 1985, Eisner signed an agreement with MGM/United Artists to build a Hollywood-film theme park at Disney World. In 1987, Disney agreed to develop a massive theme park in France, to be known as Euro Disneyland. It opened on schedule in April 1992 but sustained an $87.7 million loss owing to lower rates of attendance than expected. To enhance Euro Disneyland, a MGM-Disney theme park was scheduled to open in 1995. On the other side of the globe, building on the success of Tokyo Disneyland, Disney and the Oriental Land Company (a private investor group that developed Tokyo Disneyland) announced negotiations to open a Japanese version of the MGM-Disney theme park.

In 1992, theme-park revenues topped $3.3 billion and represented 45 percent of Disney's profits. Operating margins on theme parks, however, declined from 1989's 30.3 percent to 19.7 percent in 1992.

[8]Ibid., 158-62.
[9]Ibid., 66.
[10]Ibid., 78.
[11]Ibid., 79.

Exhibit TN6 (continued)

Land

Disney sold the Arvida Land Company for $404 million in 1988. Having acquired Arvida in 1984 as part of a series of maneuvers to evade Saul Steinberg, Disney decided to sell the residential-, resort-, and business-property development company because of a desire to concentrate on its entertainment and leisure divisions. Arvida's 20,000 acres exposed Disney to the cyclical volatility of the real-property industry. Disney sold the company just before the national contraction in property values.

Consumer products and retailing

Capitalizing on the value of its animated characters, Disney launched a retail chain in 1987; by 1990, when the fiftieth store opened, each store was generating an average of more than $600 per square foot of selling space per year, more than twice the industry average. The stores enabled Disney to promote movies, theme parks, and other ventures. By March 1992, 126 outlets were in business. Looking forward to 1996, Disney announced plans to operate over 500 stores, 200 of them overseas. Consumer products, sold through retail stores and by mail, were Disney's fastest-growing segment and represented, by 1992, over $1 billion in sales and 20 percent of the firm's profits. Disney opened two restaurants called Mickey's Kitchen in 1990. By 1993, Disney had exited the restaurant business after realizing only break-even results from its restaurants.

Other creative activities

Under the general rubric of investing in creative activities, one could cite Disney's attempted purchase of rights to Kermit, Miss Piggy, and the rest of Jim Henson's Muppet characters for $150 million. Disney's purchase of KHJ, a TV station serving Los Angeles, for $320 million would also fall under this heading.

Financing

Between 1985 and 1991, Disney raised almost $2 billion to finance films through the Silver Screen partnerships and Touchwood Pacific Partners I. These obligations were off-balance-sheet financings of Disney's films. In 1987, Disney consummated an innovative agreement to finance Euro Disneyland through an initial public offering of 51 percent of the project's shares that would leave Disney in control of the project. Disney monetized royalty payments from Tokyo Disneyland just when the yen/dollar exchange rate was at its peak, collecting about $720 million from Japanese investors at 6 percent, a cost of funds lower than the U.S. government was paying. The company was able to show the transaction on its books as a gain but list it as a loan for tax purposes. In 1990, Disney issued $2.25 billion in 6 percent zero-coupon convertible bonds; investors could convert the

Exhibit TN6 (continued)

bonds into Disney shares in Euro Disneyland. In 1992, Disney raised $400 million in a private placement to finance 18 new films: investors were promised returns of between 2.9 percent and 10 percent, depending on the success of the films.

Share-Price Performance, 1984-93

For 1984-93, Disney showed a ninefold increase in net income: from $107.8 million in 1984 to an expected $980 million in 1993. Adjusting for two four-for-one stock splits (in 1986 and 1992), Disney shares traded well above the prices mentioned in the case. For instance, as of May 7, 1993, Disney's closing price was $47.87 per share, or an adjusted $765.92 per share. The compound annual growth in stock price from June 1984 to May 1993 was 34 percent. In comparison, Disney's cost of equity over the same period averaged 15 percent.[12]

[12]The cost of equity was estimated annually using betas from *Value Line* and the average 10-year Treasury-bond yield for each respective year.