Taxes and Business Strategy

Class 21: Taxation of Business Reorganizations II: The Transformation of Westinghouse

Goals for the day

1. Illustrate the difference in taxation of different reorganizations
2. Understand the interaction between tax and nontax factors in reorganizations
3. Develop “clientele” arguments for different types of M&A transactions
4. Examine the importance of net operating losses in M&A transactions

Important: This handout is not a self-contained description of the changes at Westinghouse. It should be read in conjunction with the reading materials on the various transactions. For the sake of brevity, the readings do not cover every transaction. The class plan is to discuss the questions and issues raised in the handout. Of course, I encourage you to form your own questions about the Westinghouse transformation (in terms of both tax and nontax issues).

Transforming Westinghouse: A Case Study in M&A Tax Planning

This section begins with some general information on the acquisition and divestiture strategy at Westinghouse during the last several years. After this introduction, the reorganizations are viewed from a tax planning and cash management perspective. We will also discuss some of the alternative transactions (some of these were reported in the press and later discarded) and why these alternatives may have been less tax efficient than the transactions chosen by Westinghouse. Rather than provide detailed calculations of the tax benefits of each transaction, the goal is to see how each of the transactions fit into the broader plan for the firm. In class 22, we will make more detailed calculations for a specific transaction.

Time for a turnaround at Westinghouse. In 1993, Michael Jordan took over as CEO of Westinghouse. His mandate was to turn the company around. Over time, Westinghouse had become an oversized conglomerate. Its main operations were in heavy industry, especially in power generation equipment and refrigeration equipment. The company also had a long history in broadcasting with radio and TV stations dating to the early stages of the industry. Other divisions included defense contracting, furniture manufacturing, watchmaking, home security systems, and government operations (a provider of nuclear services to the government). During the 1980s, Westinghouse had made several ill-fated
attempts to enter the financial service and real estate businesses. While Westinghouse once manufactured consumer appliances, it had exited this business by the early 1980s.

"A legacy of losses. Westinghouse’s performance during the early in 1990s was dreadful. It reported losses of $1.1 billion in 1991, $1.4 billion in 1992, and $326 million in 1993. To put this in perspective, the book value of shareholder’s equity was about $2 billion in 1993. The company has not paid U.S. Federal income taxes since 1990. At one point, it had NOLCFs of almost $3.0 billion. The firm also suffered from severely underfunded pension plans and litigation regarding potential environmental liabilities (mainly from the manufacture of nuclear power plants).

"Choice of business strategy. As the new CEO, Jordan had to decide which divisions should grow and which should shrink. With the exception of Thermo King, a manufacturer of refrigeration systems, the industrial divisions were weak. The broadcast division was the most profitable part of the business but was a small component of the overall firm. Jordan decided that media and information was the future of Westinghouse. Thus, he set out to convert the industrial giant, long associated with its sponsorship of a prestigious high school science contest, into a media and entertainment firm.

"An overview of the acquisitions. The table below lists the major acquisitions that have transformed Westinghouse from an industrial conglomerate to a media company.

<table>
<thead>
<tr>
<th>Date (announcement)</th>
<th>Company</th>
<th>Form of Transaction</th>
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<tbody>
<tr>
<td>July 1995</td>
<td>CBS (television network)</td>
<td>Cash purchase of stock</td>
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<tr>
<td>June 1996</td>
<td>Infinity Broadcasting (radio stations)</td>
<td>Stock for stock merger</td>
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<tr>
<td>February 1997</td>
<td>Part of Gaylord Entertainment (cable operations, mainly country music related)</td>
<td>Morris Trust (form of “tax-free” divestiture)</td>
</tr>
<tr>
<td>September 1997</td>
<td>American Radio Systems (98 radio stations)</td>
<td>Cash and assumption of debt</td>
</tr>
<tr>
<td>Fall 1999</td>
<td>King World (producer of syndicated television shows)</td>
<td>Stock for stock merger</td>
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An overview of divestitures. The next table lists some of Westinghouse’s divestitures over the last several years.

<table>
<thead>
<tr>
<th>Date (announcement)</th>
<th>Division</th>
<th>Buyer</th>
<th>Form of Transaction</th>
</tr>
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<tbody>
<tr>
<td>July 1995</td>
<td>WCI Communities (land development)</td>
<td>Newly-formed limited partnership</td>
<td>Cash and assumption of liabilities</td>
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<tr>
<td>January 1996</td>
<td>Defense Equipment</td>
<td>Northrop Grumman</td>
<td>Cash for assets (and assumption of liabilities)</td>
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<td>March 1996</td>
<td>Knoll Furniture</td>
<td>Warburg, Pincus Ventures, LP</td>
<td>Cash for assets</td>
</tr>
<tr>
<td>December 1996</td>
<td>Westinghouse Security Systems</td>
<td>Western Resources</td>
<td>Cash for assets (and assumption of liabilities)</td>
</tr>
<tr>
<td>January 1997</td>
<td>Wittnauer (watchmaker)</td>
<td>Management buyout</td>
<td>Not disclosed (probably cash)</td>
</tr>
<tr>
<td>September 1997</td>
<td>Thermo King</td>
<td>Ingersoll-Rand</td>
<td>Cash for assets</td>
</tr>
<tr>
<td>November 1997</td>
<td>Power Generation</td>
<td>Siemens AG</td>
<td>Cash for assets</td>
</tr>
<tr>
<td>May 1998</td>
<td>Westinghouse Process Control</td>
<td>Emerson Electric</td>
<td>Cash for assets</td>
</tr>
<tr>
<td>June 1998</td>
<td>Westinghouse Electric Company</td>
<td>Morrison Knudson and BNFL (joint venture)</td>
<td>Cash for assets and (mainly) assumption of liabilities</td>
</tr>
<tr>
<td>November 1998</td>
<td>Infinity Broadcasting</td>
<td>“Public”</td>
<td>Partial (20%) spin-off / IPO</td>
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A general theme in the tax planning associated with these transactions is that Westinghouse was willing to recognize taxable gains from divestitures in order to accelerate the use of its NOLCFs. As discussed below, this willingness to use a taxable transaction meant that the buyer could often benefit from the step-up in basis for the assets (see, especially, the example of Northrop Grumman). A second tax-planning theme was that Westinghouse was interested in paying down
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debt since it received little benefit from further interest deductions. Furthermore, it had strong incentives to reduce its debt, in terms of lower interest rates, from the conditions of its creditors in the CBS acquisition that entailed a substantial increase in debt.

"Viacom merges with CBS." In September 1999, Viacom and CBS announced a merger. Viacom acquired CBS in a stock-for-stock merger. CBS was valued at $37 billion. Viacom was valued at $35 billion. The combined firm is to be worth about $72 billion making it the second largest media company in the U.S. (behind Time Warner).

"General tax planning issues:

- Tax treatment to all parties, current and future
- Similarities between tax planning incentives for mergers and acquisitions and capital structure decisions
- Clientele issues: who is the right buyer or seller?
- Price effects: does the form of the transaction affect the price?

"Strategic issues:

- Overall business plan
  # Industry analysis: changes in environment (regulation)
  # Firm-specific advantages
- Capital structure and cash management issues

"Chronological Order of Transactions:

"July 1995: Westinghouse acquires CBS

Purchased stock from shareholders. The Tisch family (in part through Loews) was a major shareholder). Westinghouse paid a total of $5.4 billion ($81 per share). At the time, CBS had many suitors. Also, July 1995 was a tumultuous time in the media business; for example, the Westinghouse-CBS transaction was within one week of Disney acquiring
Westinghouse financed the purchase with debt. This debt was mainly from banks with future interest rates tied to levels of debt outstanding. Given Westinghouse’s financial position, how much advantage does debt have over equity for tax purposes? What alternative forms of financing could Westinghouse have used?

July 1995: Westinghouse sells WCI Communities

- WCI Communities was a land development subsidiary of Westinghouse. It was part of Westinghouse’s ill-fated real estate foray of the 1980s. The sales price was approximately $556 million with Westinghouse receiving cash proceeds of $382 million.

- For financial reporting purposes, the sale resulted in an after-tax loss of approximately $75 million.

- The buyer was a newly formed limited partnership.
January 1996: Westinghouse sells defense business to Northrop-Grumman

- As part of the overall consolidation of the defense industry, Westinghouse dropped out of the industry and Northrop-Grumman grew larger.

- Total consideration was about $3.6 billion of which $3.0 billion was cash and $600 million was the assumption of pension liabilities. Along with the sale of Knoll Furniture, these transactions would result in an after-tax gain of between $1.2 and $1.4 billion; however, most of the gain will be sheltered by the company’s NOLCF.

- Northrop-Grumman as a buyer? Considerable step-up in basis on the asset purchase and an ability to pass pension liability through on government contracts.

- From a tax planning perspective, is it surprising that Westinghouse had unfunded pension liabilities? Are there any advantages to assuming pension liabilities as part of the transaction? What will happen (in terms of taxes) when Northrup-Grumman “pays” for these assets by funding the pension liability?

- Price was higher than analysts thought it would be.
March 1996: Westinghouse sells Knoll Furniture

- Cash price was $565 million from a LBO group. This price was twice what analysts had estimated a year earlier: “Anybody who gets nearly $600 million for Knoll ought to get the Nobel Prize” -- Robert Monks Sr. (See CFO Magazine article in April 1996)

- The buyout group was a partnership. Is this an attempt to move assets to the noncorporate form?

June 1996: Westinghouse acquires Infinity Broadcasting

- Stock-for-stock transaction. Westinghouse assumed $1 billion in debt and paid the equivalent of $3.9 billion.

- What does the stock-for-stock transaction do to Westinghouse’s leverage ratios?

- The deal was structured to take advantage of the NOLCF. Westinghouse had an NOLCF but Infinity did not. If Infinity had acquired Westinghouse, the merged entity would have faced more limits on the future use of these NOLCFs than occurred under the actual transaction.
"December 1996: Westinghouse sells Westinghouse Security Systems

- Sales price was $425 million with the proceeds going toward paying down the corporation’s debt.

- The buyer, Western Resources, is a diversified energy company with interests in other security businesses, including ADT.

"January 1997: Westinghouse sells Wittnauer Watches

- Management buyout group probably paid about $34 million (small potatoes for Westinghouse). The acquirer was Composite Holdings, L.L.C.

"February 1997: Westinghouse acquires part of Gaylord Entertainment

- In a “tax-free” Morris Trust transaction (the subject of class 22), Westinghouse acquired the cable operations -- TNN and CMT -- and some broadcast operations from Gaylord Entertainment. From Westinghouse’s perspective, this deal was a stock-for-stock transaction for the divisions that it wanted.

- Gaylord retained some operations, including Opryland (a theme park), the
Grand Ole Opry, and some radio and TV broadcast operations (including the NBC affiliate in Nashville). Neither Gaylord nor its shareholders paid taxes on the transaction.

- Did Westinghouse get a step-up in basis? How strong is Westinghouse’s preference for a step-up in basis (relative to other potential acquirers)?

"September 1997: Westinghouse acquires American Radio Systems"

- ARS is a network of 98 radio stations mainly in midsize cities. Westinghouse, one of several potential buyers, paid cash for ARS’s stock and assumed debt. The total consideration was $2.6 billion of which $1.6 billion was cash. The cash price was less than the $2.0 billion predicted by analysts in August 1997. ARS would simultaneously spin-off its radio tower business.

"September 1997: Westinghouse sells Thermo King to Ingersoll-Rand"

- Ingersoll-Rand, a diversified industrial equipment firm, paid $2.56 billion in cash for the Thermo King division, a manufacturer of refrigeration units. Thermo King had been the “crown jewel” of Westinghouse’s industrial units.

- The sale replaced a steady source of cash with financial flexibility.
Thermo King had produced as much as $200 million in cash flow per year; however, if the proceeds were used to reduce debt, then Westinghouse could reduce its interest costs by $180 million per year.

"Westinghouse sells Power Generation to Siemens AG"

- Siemens, a German multinational, paid $1.525 billion (cash) for Westinghouse’s power generation equipment business.

- The other potential bidders were also MNCs. How does this affect the deal? How might multinational taxation affect the relative strength of the buyer’s desire for a step-up in basis?

"The Road Not Taken. In November 1996, Westinghouse announced that it would spin-off its industrial assets in order to separate the industrial and media businesses. This announcement came after selling the defense and furniture businesses. In the spin-off, Westinghouse planned for the media business to keep the NOLCFs. (See the Nov.13, 1996 press release for more details.) What are the advantages and disadvantages of this alternative?"
Additional transactions.

- **Like kind exchange.** After the Infinity acquisition, Westinghouse undertook some tax-free like-kind exchanges to satisfy regulators concerned with market power in specific media markets.

- **Deferred compensation.** Is it surprising that Michael Jordan was using deferred compensation contracts? In 1994-95 he deferred $1.8 million of compensation according to the *New York Times* (10/13/96).

- In November 1998, CBS announced that it is selling 20% of the equity of Infinity Broadcasting to the public.

- In September 1999, Viacom and CBS merged in a stock-for-stock transaction. The transaction was structured so that it deferred the taxes of current shareholders. This structure would also lead to a carryover of the existing tax basis in the assets of CBS.

"**Final Quote:** “If we pay taxes in 1997, I’d call that a grand slam.”  Fredric G."
Reynolds, CFO of Westinghouse, quoted in CFO Magazine, April 1996.