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Cooper Industries, Inc.

In May 1972 Robert Cizik, executive vice president of Cooper Industries, Inc., was reviewing acquisition candidates for his company's diversification program. One of the companies, Nicholson File Company, had been approached by Cooper Industries three years earlier but had rejected all overtures. Now, however, Nicholson was in the middle of a takeover fight that might provide Cooper with a chance to gain control.

Cooper Industries

Cooper Industries was organized in 1919 as a manufacturer of heavy machinery and equipment. By the mid-1950s it was a leading producer of engines and massive compressors used to force natural gas through pipelines and oil out of wells. Management was concerned, however, over its heavy dependence on sales to the oil and gas industries and the violent fluctuation of earnings caused by the cyclical nature of heavy machinery and equipment sales. Although the company's long-term sales and earnings growth had been above average, its cyclical nature had dampened Wall Street's interest in the stock substantially. (Cooper's historical operating results and financial condition are summarized in **Exhibits 1** and **2**.)

Initial efforts to lessen the earnings volatility were not successful. Between 1959 and 1966, Cooper acquired (1) a supplier of portable industrial power tools, (2) a manufacturer of small industrial air and process compressors, (3) a maker of small pumps and compressors for oil field applications, and (4) a producer of tire-changing tools for the automotive market. The acquisitions broadened Cooper's markets but left it still highly sensitive to general economic conditions.

In 1966 Cooper began a full review of its acquisition strategy. After several months of study, three criteria were established for all acquisitions. First, the industry should be one in which Cooper could become a major factor. This requirement was in line with management's goal of leadership within a few distinct areas of business. Second, the industry should be fairly stable, with a broad market for the products and a product line of "small ticket" items. This product definition was intended to eliminate any company that had undue profit dependence on a single customer or several large sales per year. Finally, it was decided to acquire only leading companies in their respective market segments.

This new strategy was initially implemented with the acquisition in 1967 of the Lufkin Rule Company, the world's largest manufacturer of measuring rules and tapes. Cooper acquired a quality product line, an established distribution system of 35,000 retail hardware stores throughout the United States, and plants in the United States, Canada, and Mexico. It also gained the services of William Rector, president of Lufkin, and Hal Stevens, vice president of sales. Both were extremely

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knowledgeable in the hand tool business and had worked together effectively for years. Their goal was to build through acquisition a hand tool company with a full product line that would use a common sales and distribution system and joint advertising. To do this they needed Cooper's financial strength.

Lufkin provided a solid base to which two other companies were added. In 1969 the Crescent Niagara Corporation was acquired. The company had been highly profitable in the early 1960s but suffered in recent years under the mismanagement of some investor-entrepreneurs who gained control in 1963. A series of acquisitions of weak companies with poor product lines eroded Crescent's overall profitability until, in 1967, a small loss was reported. Discouraged, the investors wanted to get out, and Cooper—eager to add Crescent's well-known and high-quality wrenches, pliers, and screwdrivers to its line—was interested. It was clear that some of Crescent's lines would have to be dropped and inefficient plants would have to be closed, but the wrenches, pliers, and screwdrivers would play an important part of Cooper's product policy.

In 1970, Cooper further expanded into hand tools with the acquisition of the Weller Electric Corporation. Weller was the world's leading supplier of soldering tools to the industrial, electronic, and consumer markets. It provided Cooper with a new, high-quality product line and production capacity in England, West Germany, and Mexico. (Information on the three acquisitions is provided in **Exhibit 3**.)

Cooper was less successful in its approach to a fourth company in the hand tool business, the Nicholson File Company. Nicholson was on the original "shopping list" of acceptable acquisition candidates that Mr. Cizik and Mr. Rector had developed, but several attempts to interest Nicholson in exploring merger possibilities had failed. The Nicholson family had controlled and managed the company since its founding in 1864, and Paul Nicholson, chairman of the board, had no interest in joining forces with anyone.

Nicholson File Company

But Nicholson was too inviting a takeover target to be overlooked or ignored for long. A relatively poor sales and profit performance in recent years, conservative accounting and financial policies, and a low percentage of outstanding stock held by the Nicholson family and management all contributed to its vulnerability. Annual sales growth of 2% was far behind the industry growth rate of 6% per year, and profit margins had slipped to only one-third those of other hand tool manufacturers. In 1971, Nicholson's common stock was trading near its lowest point in many years and well below its book value of $51.25. Lack of investor interest in the stock was reflected in its low price-earnings ratio of 10-14, which compared with 14-17 times earnings for other leading hand tool companies. The stock was clearly selling on the basis of its dividend yield, with only limited hopes for capital appreciation. (**Exhibits 4** and **5** show Nicholson's operating results and balance sheets.)

What made Nicholson so attractive were its basic competitive strengths, which the family-dominated management had not translated into earnings. It was one of the largest domestic manufacturers of hand tools and a leader in its two main product areas. Nicholson held a 50% share of the $50-million market for files and rasps, where it offered a broad, high-quality line with a very strong brand name. Its second product line—hand saws and saw blades—also had an excellent reputation for quality and held a 9% share of this $200-million market. Only Sears, Roebuck and Company and Disston, Inc., had larger market shares.

But Nicholson's greatest asset was its distribution system. Forty-eight direct salespeople and 28 file and saw engineers marketed its file, rasp, and saw products to 2,100 hardware wholesalers in the

United States and Canada. These wholesalers in turn sold to 53,000 retail outlets. Their efforts were supported by heavy advertising and promotional programs. Overseas the company's products were sold in 137 countries through 140 local sales representatives. The company seemed to have all the necessary strengths to share fully in the 6%–7% annual sales growth forecast for the industry.

The Raid by H.K. Porter Company

Cooper was not alone in its interest in Nicholson. H.K. Porter Company, a conglomerate with wide-ranging interests in electrical equipment, tools, nonferrous metals, and rubber products, had acquired 44,000 shares of Nicholson stock in 1967 and had been an attentive stockholder ever since. On March 3, 1972, Porter informed Nicholson management of its plan to tender immediately for 437,000 of Nicholson's 584,000 outstanding shares at $42 per share in cash. The offer would terminate on April 4, unless extended by Porter, and the company was unwilling to acquire fewer shares than would constitute a majority.

Nicholson management was alarmed by both the proposal and the proposer. The company would contribute less than one-sixth of the combined sales and would clearly be just another operating division of Porter. It was feared that Porter's quest for higher profits might lead to aggressive cost cutting and the elimination of marginal product lines. Nicholson's Atkins Saw Division seemed especially vulnerable in view of its low profitability.

Loss of control seemed both painful and likely. The $42 cash offer represented a $12 premium over the most recent price of the stock and threatened to create considerable stockholder interest. The disappointing performance of the stock in recent years would undoubtedly increase the attractiveness of the $42 offer to Nicholson's 4,200 stockholders. And the Nicholson family and management owned only 20% of the outstanding shares—too few to ensure continued control.

Immediately after learning of the Porter tender offer, Mr. Cizik and Mr. Rector approached the Nicholson management with an offer of help. It was clear that Nicholson had to move immediately and forcefully; the first 10 days of a tender offer are critical. Messrs. Cizik and Rector stressed that Nicholson had to find a better offer and find it fast. Indeed, Cooper was willing to make such an offer if Nicholson's management and directors would commit themselves to it—now.

But Nicholson was not ready for such decisive action and three days passed without any decision. With each day the odds of a successful counteroffer diminished. Finally, the Cooper officers decided the risks were too great and that Porter would learn of Cooper's offer of help and might retaliate. Cooper's stock was depressed, and it was possible that an angry Porter management might strike for control of Cooper. The offer was withdrawn.

By late March the situation was increasing in seriousness. Nicholson's management moved to block the raid. It talked with the large shareholders personally and made a strong public statement recommending against the offer. But announcements by Porter indicated that a substantial number of Nicholson shares were being tendered. It was no longer a matter of whether to be acquired; the issue was, by whom!

Management sought to find an alternative merger that would ensure continuity of Nicholson management and operating independence. Several companies had communicated with Nicholson in the wake of the Porter announcement, but no one other than Cooper had made a specific proposal. This was largely due to their reluctance to compete at the price levels being discussed or to enter into a fight with Porter. Finally, on April 3, agreement was reached with VLN Corporation on the terms of a merger with it. VLN was a broadly diversified company with major interests in publishing and original and replacement automotive equipment. Under the VLN merger terms, one share of new VLN cumulative convertible preferred stock would be exchanged for each share of Nicholson common stock. The VLN preferred stock would pay an annual dividend of $1.60 and would be convertible into five shares of VLN common stock during the first year after the merger, scaling down to four shares after the fourth year. The preferred stock would be callable at $50 a share after the fifth year and would have liquidating rights of $50 per share. (See **Exhibit 6** for a financial summary of VLN.)

Assured of continued operating independence, Nicholson management supported the VLN offer. In a letter to the stockholders Paul Nicholson pointed out that (1) the exchange would be a tax-free transaction, (2) the $1.60 preferred dividend equaled the current rate on the Nicholson common stock, and (3) a preferred share was worth a minimum of $53.10 (VLN common stock had closed at $10.62 on the day before the offer). He felt confident that the necessary majority of the outstanding common stock would be voted in favor of the proposed merger when it was brought to a vote in the fall. (Under Rhode Island law, a simple majority was sufficient to authorize the merger.)

Porter quickly counterattacked by pointing out to Nicholson stockholders that VLN common stock had recently sold for as low as $4⅝, which would put a value in the first year of only $23.12 on the VLN preferred stock. Furthermore, anyone who converted into VLN common stock would suffer a sharp income loss, since VLN had paid no common dividends since 1970.

Nicholson's stockholders were thus presented with two very contradictory appraisals of the VLN offer. Each company based its argument on some stock price, either the highest or the lowest, which would make the converted preferred stock compare favorably or not with the $42 cash offer.

Opportunity for Cooper?

Mr. Cizik and his staff were still attracted by the potential profits to be realized from Nicholson. It was felt that Nicholson's efforts to sell to every market segment resulted in an excessive number of products, which held down manufacturing efficiency and ballooned inventories. Cooper estimated that Nicholson's cost of goods sold could be reduced from 69% of sales to 65%.

The other major area of cost reduction was Nicholson's selling expenses. There was a substantial overlap of Nicholson's sales force and that established by Cooper for its Lufkin-Weller-Crescent hand tool lines. Elimination of the sales and advertising duplications would lower selling, general, and administrative expenses from 22% of sales to 19%.

There were other possible sources of earnings, but they were more difficult to quantify. For instance, 75% of Nicholson's sales were to the industrial market and only 25% to the consumer market. In contrast, sales by Cooper's hand tool group were distributed between the two markets in virtually the exact opposite proportions. Thus, sales increases could be expected from Nicholson's "pulling" more Cooper products into the industrial markets and vice versa for the consumer market. Also, Cooper was eager to use Nicholson's strong European distribution system to sell its other hand tool lines.

The battle between Porter and VLN seemed to provide Cooper with an unexpected, second opportunity to gain control of Nicholson. Porter had ended up with just 133,000 shares tendered in response to its offer—far short of the 249,000 shares needed to give it majority control.[1] Its slate of

[1]Porter needed 292,584 shares to hold 50.1% majority control. It already owned 43,806 shares and needed, therefore, an additional 248,778 shares.

directors had been defeated by Nicholson management at the Nicholson annual meeting on April 21. T.M. Evans, president of Porter, now feared that Nicholson might consummate the merger with VLN and that Porter would be faced with the unhappy prospect of receiving VLN preferred stock for its 177,000 shares of Nicholson stock. Mr. Evans knew that the VLN stock had been a lackluster performer and might not show any significant growth in the near term. Furthermore, the $1.60 dividend rate seemed low in relation to current market yields on straight preferred stocks of 7%. Finally, he feared it would be difficult to sell a large holding of VLN stock, which traded in small volume on the American Stock Exchange.

On the other hand, a merger of Cooper and Nicholson would allow Mr. Evans to convert his Nicholson shares into either common stock or convertible preferred stock of Cooper. This was a much more attractive alternative, assuming that an acceptable exchange rate could be set. Mr. Evans anticipated that earnings should rebound sharply from the cyclical downturn in 1971, and he felt that Cooper stock would show significant price appreciation. Furthermore, Cooper stock was traded on the New York Exchange, which provided substantial liquidity. At a private meeting in late April, Evans tentatively agreed to support a Cooper-Nicholson merger on the condition that he receive Cooper common or convertible securities in a tax-free exchange worth at least $50 for each Nicholson share he held.

Mr. Cizik was now faced with the critical decision of whether to move for control. Cooper had acquired 29,000 shares of Nicholson stock during the preceding month in the open market—in part to build some bargaining power but largely to keep the loose shares out of the hands of Porter. Still uncommitted, however, were an estimated 50,000-100,000 shares that had been bought by speculators in the hope of an escalation of acquisition offers. Another 150,000-200,000 shares were unaccounted for, although Mr. Cizik suspected that a considerable number would go with the recommendation of Nicholson management. (**Exhibit 7** shows Mr. Cizik's best estimate of the distribution of Nicholson stock in early May.) His hopes for gaining 50.1% of the Nicholson shares outstanding[2] depended upon his gaining support of at least 86,000 of the shares still either uncommitted or unaccounted for.

If he decided to seek control, it would be necessary to establish both the price and the form of the offer. Clearly, the terms would have to be sufficiently attractive to secure the shares needed to gain majority control.

Mr. Cizik also felt that the terms should be acceptable to Nicholson management. Once the merger was complete, Cooper would need to work with the Nicholson family and management. He did not want them to feel that they and other Nicholson stockholders were cheated by the merger. As a matter of policy Cooper had never made an "unfriendly" acquisition, and this one was to be no exception. The offer should be one that would be supported by the great majority of the stockholders.

However, the price and the form of the payment had to be consistent with Cooper's concern that the acquisition earn a satisfactory long-term return and improve the trend of Cooper's earnings per share over the next five years. (A forecast of Cooper's earnings per share is shown in **Exhibit 8**.) The company anticipated making additional acquisitions, possibly in an exchange of stock, so maintenance of a strong earnings pattern and stock price was important. On May 3 the common stock of Cooper and Nicholson closed at $24 and $44, respectively.

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[2]Nicholson File was incorporated in Rhode Island. Under Rhode Island corporation law, a merger can be voted by shareholders holding a majority of the common stock outstanding. For reasons specific both to the laws of Rhode Island and to the Nicholson situation, dissenting stockholders of Nicholson would not be entitled to exercise the rights of dissent and would be forced to accept the exchange offer.

Exhibit 1 Condensed Operating and Stockholder Information, Cooper Industries, Inc., (millions of dollars except per-share data)

	1967	1968	1969	1970	1971
Operations					
Net sales	$198	$206	$212	$226	$208
Cost of goods sold	141	145	154	165	161
Depreciation	4	5	4	4	4
Selling and administrative expense	23	25	29	29	29
Interest expense	1	2	3	4	3
Income before taxes and extraordinary items	29	29	22	24	11
Income taxes	14	15	11	12	5
Income before extraordinary items	15.2	13.9	10.6	12.4	5.6
Preferred dividend	1.0	.9	.9	.9	.9
Net income applicable to common stock	$14.2	$13.0	$9.7	$11.5	$4.7
Common Stock					
Earnings per share before extraordinary items	$3.34	$3.07	$2.33	$2.75	$1.12
Dividends per share	1.20	1.25	1.40	1.40	1.40
Book value per share	16.43	17.26	18.28	19.68	18.72
Market price	23–59	36–57	22–50	22–35	18–38
Price/earnings ratio	7–18	12–19	9–22	8–13	16–34

Exhibit 2 Balance Sheet at December 31, 1971, Cooper Industries, Inc. (millions of dollars)

Assets	
Cash	$ 9
Accounts receivable	49
Inventories	57
Other	2
Current assets	117
Net plant and equipment	47
Other	8
Total assets	$172
Liabilities and Net Worth	
Accounts payable	$ 30
Accrued taxes	3
Long-term debt due	5
Current liabilities	38
Long-term debt[a]	34
Deferred taxes	4
Preferred stock	11
Common equity (4,218,691 shares outstanding)	85
Total liabilities and net worth	$172

[a]Maturities of long-term debt were $5.5 million, $6 million, $4 million, $2 million, and $2 million in the years 1972 through 1976, respectively.

Exhibit 3 Summary of Cooper Industries' Recent Acquisitions (millions of dollars)

	Year Preceding Acquisition by Cooper				
	Sales	Net Income	Book Value	Acquisition Price Paid	Form of Transaction
Lufkin Rule Company	$22	$1.4	$15	$20.6	Convertible preferred
Crescent Niagara Corporation	16	(.04)	4.9	12.5	Cash
Weller Electric Corporation	10	.9	4.4	14.6	Common stock

Exhibit 4 Condensed Operating and Stockholder Information, Nicholson File Company, 1967–1971 (millions of dollars except per-share data)

	1967	1968	1969	1970	1971
Operations					
Net sales	$48.5	$49.1	$53.7	$54.8	$55.3
Cost of goods sold	32.6	33.1	35.9	37.2	37.9
Selling, general, and administrative expenses	10.7	11.1	11.5	11.9	12.3
Depreciation expense	2.0	2.3	2.4	2.3	2.1
Interest expense	.4	.7	.8	.8	.8
Other deductions	.3	.1	.2	.2	.2
Income before taxes	2.53	1.85	2.97	2.42	2.02
Taxes[a]	.60	.84	1.31	.88	.67
Net income	$1.93	$1.01	$1.66	$1.54	$1.35
Percentage of Sales					
Cost of goods sold	67%	67%	67%	68%	69%
Selling, general, and administrative expenses	22	23	21	22	22
Income before taxes	5.2	3.8	5.5	4.4	3.7
Stockholder Information					
Earnings per share	$3.19	$1.65	$2.88	$2.64	$2.32
Dividends per share	1.60	1.60	1.60	1.60	1.60
Book value per share	45.66	48.03	49.31	50.20	51.25
Market price	33–46	35–48	29–41	25–33	23–32
Price/earnings ratio	10–14	21–30	10–14	9–13	10–14

[a]The ratio of income taxes to income before taxes had been reduced primarily by the investment tax credit and by the inclusion in income of equity in net income of partially owned foreign companies, the taxes which are provided for in the accounts of such companies and not in the tax provision of Nicholson. It was estimated that the average tax rate would be 40% in future years.

Exhibit 5 Balance Sheet at December 31, 1971, Nicholson File Company (millions of dollars)

Assets	
Cash	$ 1
Accounts receivable	8
Inventories[a]	18
Other	1
Current assets	28
Investment in subsidiaries	3
Net plant and equipment	16
Total assets	$47
Liabilities and Net Worth	
Accounts payable	$ 2
Other	2
Current liabilities	4
Long-term debt	12
Common stock	31
Total liabilities and net worth	$47

[a]Inventories in the amount of $11.8 million were priced at cost on the last-in, first-out method. The estimated replacement cost exceeds the carrying amounts by $9.2 million. The remaining inventories are priced at the lower of cost on the first-in, first-out method or market.

Exhibit 6 Condensed Operating and Stockholder Information, VLN Corporation, 1967–1971 (millions of dollars except per-share data)

	1967	1968	1969	1970	1971
Operations					
Net sales	$45	$97	$99	$98	$100
Net income	1.97	3.20	3.20	1.13	2.98
Financial Position					
Current assets	$25	$46	$49	$41	$46
Current liabilities	6	11	15	10	13
Net working capital	19	35	34	31	33
Long-term debt	10	18	16	15	17
Shareholders' equity	21	36	40	39	41
Stockholder Information					
Earnings per share	$ .78	$ .61	$ .53	$ .27	$ .54
Dividends per share	--	--	--	.20	--
Shareholders' equity per share	8.23	9.64	10.00	9.24	9.69
Market price range	6–17	10–18	7–18	4–10	5–8
Price/earnings ratio	8–22	16–30	13–34	15–37	9–15

Exhibit 7 Estimated Distribution of Nicholson File Company Stock

Shares Supporting Cooper	
H.K. Porter	177,000
Cooper Industries	29,000
	206,000
Shares Supporting VLN	
Nicholson family and management	117,000
Owned by VLN	14,000
	131,000
Shares owned by speculators	50–100,000
Shares unaccounted for	197–147,000
Total Nicholson shares outstanding	584,000

Exhibit 8 Five-Year Forecast of Cooper Industries' Earnings, Excluding Nicholson File Company, 1972–1976

	1972	1973	1974	1975	1976
Net income available to common stockholders ($ millions)	$11.0	$11.9	$12.8	$13.8	$15.0
Number of shares outstanding (millions)	4.21	4.21	4.21	4.21	4.21
Primary earnings per share	$2.61	$2.83	$3.04	$3.27	$3.56

Note: Forecasts are casewriter's estimates.