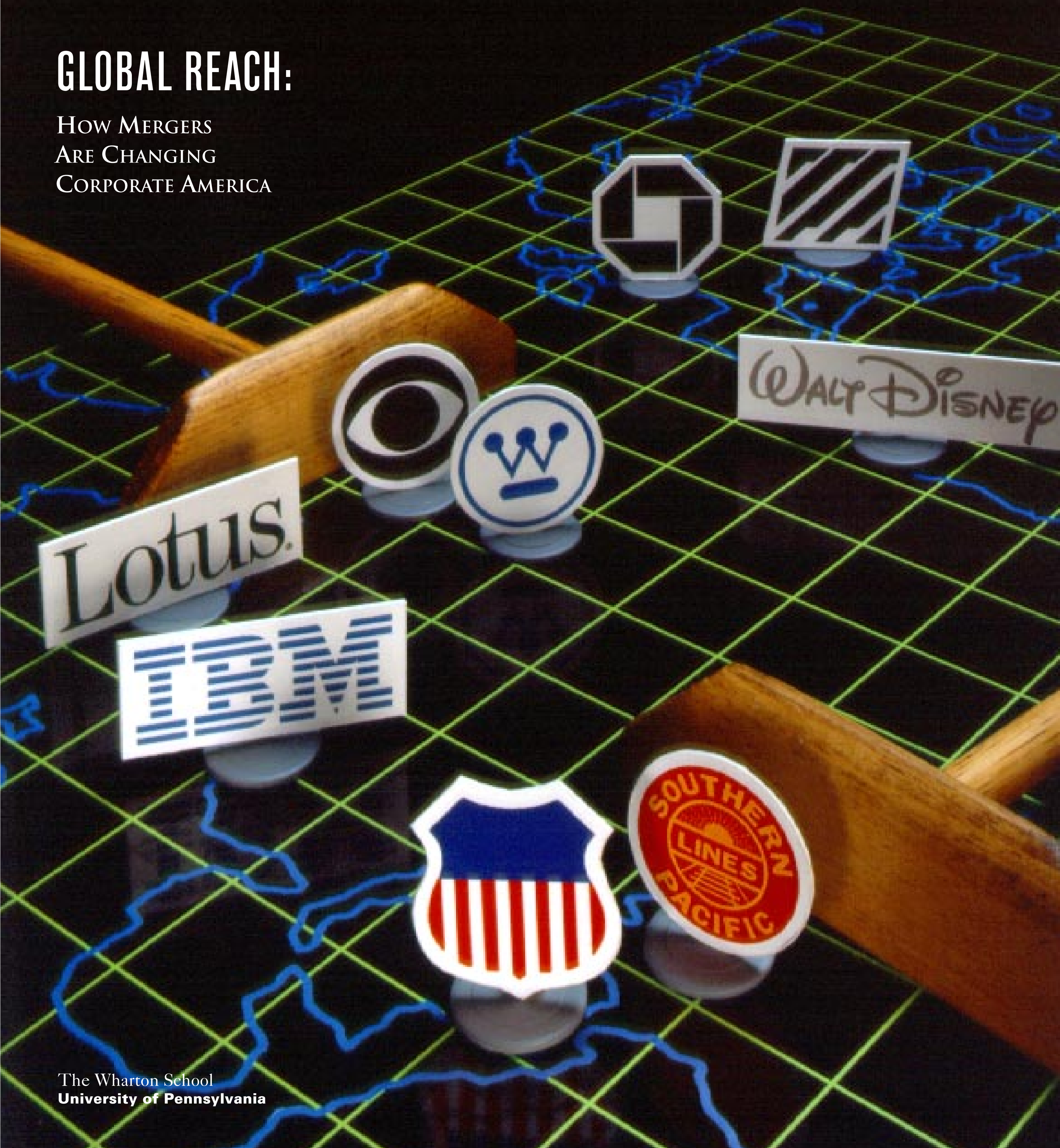
Spring 1996

Wharton

ALUMNI MAGAZINE

GLOBAL REACH:

How Mergers
Are Changing
Corporate America



The Wharton School
University of Pennsylvania

GLOBAL ALUMNI NETWORK

IN

HONG KONG

3rd Asian Regional Alumni Meeting

May 23-26, 1996

Events Include:

- Day-long Symposium on "Business Leadership in Asia — Profit and Responsibilities"
- Luncheon with Keynote Speaker Anson Chan, Chief Secretary of the Hong Kong Government
- Presentation of the Dean's Medal of Honor by Wharton Dean Thomas P. Gerrity

For information and registration, contact Karen Chang in Hong Kong: T: 852-2805-1218 F: 852-2543-3534

Guest Speakers Include:

Alexander Au, Vice Chairman & Chief Executive, Hang Seng Bank

Anthony Neoh, Chairman, Securities & Futures Commission

Hank Townsend, Chief Executive, Airport Authority

Linus Cheung, Chief Executive, Hongkong Telecom

Steve Marcopoto, President, Time Inc., Asia

1996 REUNION WEEKEND SCHEDULE

FRIDAY, MAY 17, 1996

2:00 p.m. to 7:00 p.m. — **Registration**
Under the Hospitality Tent at Mack Plaza and Lehman Brothers Quad, 37th Street between Locust and Spruce Sts.

4:00 p.m. to 5:30 p.m. — **Executive Seminar: Persuasion**
Professor Peter Cappelli
Yasuda Amphitheater, Steinberg Conference Center
38th and Spruce Streets

5:30 p.m. to 7:30 p.m. — **Welcome Cocktail Reception**
Tarnopol Room (MBA Pub), Steinberg Conference Center, 38th and Spruce Streets

7:30 p.m. to 10:30 p.m. — **MBA Reunion Class Parties**
Decade parties will be held at three sites:

Classes of '66, '71, '76 — The Stock Exchange - Steinberg Hall-Dietrich Hall
Classes of '81, '86 — Hoover Lounge and Patio
Class of '91 — MBA Pub

SATURDAY, MAY 18, 1996

8:00 a.m. to 4:00 p.m. — **Registration**
Mack Plaza and Lehman Brothers Quad
A continental breakfast will be served from 8:00 to 10:30am

9:00a.m. to 10:15 a.m. — **Alumni/Faculty Exchange**
Personal Finance: "How to Invest in the Stock Market"
Moderator: Professor Marshall E. Blume

10:30 a.m. to 11:30 a.m. — **Alumni/Faculty Exchange**
Electronic Commerce: "Cybermarkets in our Future?"
Moderator: Professor Eric Johnson

11:45 a.m. to 12:30 p.m. — **"Wharton Town Meeting" with Dean Thomas Gerrity**

12:30 p.m. to 2:00 p.m. — **Picnic Lunch**
Mack Plaza and Lehman Brothers Quad

2:00 p.m. to 3:00 p.m. — **Penn Parade of Classes**

3:00 p.m. to 4:30 p.m. — **Alumni/Faculty Exchange**
The Entrepreneur in Asia
Moderator: Professor Stephen J. Kobrin

3:00 p.m. to 4:30 p.m. — **Alumni/Faculty Exchange**
Financial Services: "The Changing Face of 'Banking'"
Moderator: Professor Anthony M. Santomero

7:00 p.m. to 12:00 a.m. — **MBA Reunion Gala**
Dinner and Dancing

Classes of '66,'71,'76, '81 and '86 — Union League of Philadelphia
Class of '91 — 30th Street Train Station

SUNDAY, MAY 19, 1996

11:00 a.m. to 2:00 p.m. — **Farewell Brunch**
Society Hill Sheraton
2nd and Walnut Streets, Philadelphia

For more information and to register, please call Wharton Alumni Affairs at (215) 898-8478, or e-mail at alumni.affairs@wharton.upenn.edu Individual events require pre-registration.

// Wharton Alumni Magazine

Spring 1996

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Global M&A transactions — valued last year at a record setting $866 billion — have little in common with the deals of the last decade.

Photograph by
Joseph Andris 7

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A New Partnership

Since the creation of Wharton's Latin American Advisory Board three years ago, the U.S. has signed the North American Free Trade Agreement (NAFTA) and joined the World Trade Organization.

In December, Wharton organized a three-day seminar in Miami on leadership training for the successor generation in Latin American family-owned corporations.

And just this month, Wharton's Latin American students held their fifth annual Latin-American Conference titled "Partnership in the 21st Century."

These events illustrate the rapid changes taking place in the global economy and the important leading-edge involvement of Wharton in all regions of the world. Along with our growing activities in Europe and Asia, Latin America offers the School an exceptional opportunity to work within emerging regional economies and move toward global market competition.

Family-owned corporations are the predominant form of business organization throughout the world. In the U.S. alone, at least 75 percent of businesses — including 35 percent of the Fortune 500 — are family-owned or controlled. In Latin America, with the opening up of trade borders, family-owned firms now face significant challenges in areas such as capital acquisition, corporate organization, family member involvement and strategic realignment.

"The opportunity for us at Wharton is to leverage the School's strengths, including its global capabilities and international perspective, into creating new business practice models for family-owned firms."

One of the issues discussed with our Latin American Advisory Board, which met again in Lima last month, was the challenges faced by Latin American family businesses and the educational responses best suited to meet their needs. Additionally, many of the School's 1,100 Latin American alumni either come from, or work for, family-owned businesses, and they too are a tremendous resource in helping to guide our efforts.

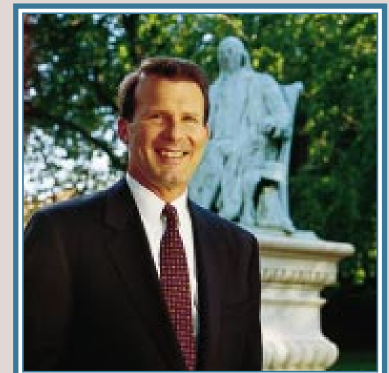
Because family firms are so crucial to Latin America's global adaptation, Wharton's Family Business Program is poised to play a strategic role. While much of the existing research in the U.S. on family-owned firms traditionally has centered around succession and estate planning, and has been largely domestic or regional in scope, our Family Business Program under the direction of Tim Habbershon is working with firms internationally, focusing initially on Latin America to create new practice models for family firm competitiveness as well as to establish an educational network of family-owned corporation stakeholders. This model can then be replicated in other emerging economies around the world.

Latin America is an ideal place for the program's current focus before it expands to Asia and Europe. Because of the region's political and economic history, family-owned businesses have tended to be mini-conglomerates, with their own sourcing, production, distribution channels and even banks. Given the changes in the global marketplace, these firms are already searching for new organizational structures that will help them focus more efficiently on specific competencies and enhance their family's involvement.

The opportunity for us at Wharton is to leverage the School's strengths, including its global capabilities and international perspective, into creating new business practice models for these family-owned firms. If we are going to access and impact Latin America in the coming decades, we have to understand the family corporate structure and work to enhance its competitiveness.

The opportunities are there for sharing information and experience, not just goods and services. It can indeed be a 21st century partnership.

Thomas P. Gerrity



KIM: ASKING THE RIGHT QUESTIONS

WHERE CHILD CARE IS SERIOUS BUSINESS

Stacy Kim's goal, once she earns her doctorate in early childhood education, is to conduct research on child care issues for business leaders and policy makers.

She already has much of the background needed to do that. Kim was one of 17 students who graduated last May from the Early Childhood Education Master's Degree Program, a joint project between the Graduate School of Education (GSE) and Wharton.

"While child care has a lot to do with child development and psychology, it has also become an issue for the business community," says Kim. The growing increase in working women in society corresponds with an increase in businesses willing to support various kinds of child care benefits and programs, she notes.

That means a need for education students who understand the accounting, marketing and management skills required to run a corporate daycare center, for example, or operate a resource and referral service. Although graduate students in the Early Children Education program receive their degree from GSE, they take courses at Wharton in entrepreneurship and organization, human resource management, marketing and finance, among other subjects.

"We want to give our students a background in business administration and policy so they will be equipped to work with companies in designing programs to support their employees, including child care, job-sharing, flextime and maternity leave," says Joan Goodman, professor of education at GSE and director of the early childhood education program. "Ours is a unique approach. No one else is integrating business and early childhood education in the same way."

Graduates of the two-year program also do consulting work with corporations on child care issues and, like Kim, conduct research into policy issues.

Her master's degree has allowed Kim to talk the language of both educational/social service organizations as well as employers. "You have to think like a business person to succeed," she says. "You have to know not only the importance of quality care but how many children you need in your center to stay profitable.

"Since taking these courses, I have come to recognize that work/life, child care and family issues are much more complex and contradictory than I thought," adds Kim, who graduated from Northwestern University in 1990 with a degree in human development and social policy. "There are no easy answers. The program has taught me instead how to ask very good questions."

PHOTOGRAPH / JERRY MILLEVOI

QUICK STUDY: On Jan. 17, 31 members of the South African Tri-partite Alliance — including the African National Congress (ANC), the South African Communist Party and the Congress of South African Trade Unions — came to campus for courses on issues familiar to any student of emerging markets: the role of a central bank, how to attract foreign investment, job development and privatization.

This unique 10-day program, developed by Wharton's Snider Entrepreneurial Center and the Emerging Economies Program, was created to provide South Africa's new leadership with the kind of training it will need to formulate policy and nurture a market economy. Eighteen Wharton professors offered a "global tour" of management, marketing, finance, technology and public policy, among other topics.

Three more sessions — each presented to 30 South African leaders — are scheduled to take place over the next 15 months.

PHOTOGRAPH / ANTHONY WOOD

STANDEN AND SCHULTZ

PHOTOGRAPH / RICHARD BELL

Thouron Scholars Head for U.K.

Two of this year's six Thouron Awards — prestigious fellowships that promote better understanding between the U. S. and U.K. by providing fellowships for students from both countries — went to dual degree students at Wharton.

Joshua Schultz, W'96, C'96, is majoring in international relations and finance. He has applied to an international relations program at Cambridge University, and is considering a career in either investment banking or consulting.

Schultz has studied abroad in Prague and several cities in Israel. At Wharton he was a member of the varsity diving team, the debate team and the Dean's Advisory Board.

Staci Standen, W'96, SEAS'96, will graduate this spring from the five-year Jerome Fisher Program in Management & Technology where she has majored in finance and mechanical engineering. She is applying to programs at Cambridge and Loughborough Universities.

Standen says she wants more practical knowledge in the design side of engineering, and is interested eventually in business management within an engineering design firm. She was on the Penn gymnastics team for four years.

The Thouron fellowship, established in 1960 by Sir John Thouron and the late Lady Thouron, covers tuition, room, board and expenses for travel and cultural enrichment. Thouron Scholars are chosen for academic excellence as well as leadership and global perspective.

Conference Agendas: Business Opportunity In India and Latin America

Two conferences organized this spring by Wharton students offered unique forums to debate the future of rapidly changing global marketplaces.

"India, Opportunity of the 21st Century" was the theme of an inaugural conference March 22 presented by the Wharton-India Economic Forum. Speakers included the chairmen and/or managing directors of Reliance Industries Ltd., Jardine Fleming India, Indian Petrochemicals Corp. Ltd., Emerson Electric Asia Pacific, the Export Import Bank of India, and the Industrial Credit and Investment Corp. of India Ltd., among others. Discussion centered on the major economic and political forces shaping the business environment in India today.

"Partnership in the 21st Century" highlighted the fifth annual Latin American Conference held on April 19. Among the speakers were Jorge Paulo Lehman, chairman, Banco Garantia; Jaime Gilinski, president, Bancol; and Felipe Ortiz de Zevallos, chairman, Grupo Apoyo. Panelists and guests, including business leaders, government officials and students, addressed such topics as the current climate of the financial markets, the fading of international borders in the areas of information and technology, and the convergence of consumer markets.

Chair Honors Whitney M. Young, Jr.

With the establishment of the Whitney M. Young, Jr. Professorship in January, Wharton became the first leading business school to name a faculty position in honor of an African- American. The professorship will be used to help attract outstanding scholars to Wharton who are committed to promoting the extension of educational and economic opportunity for all citizens.

The endowed chair is named in honor of Whitney M. Young, Jr., civil rights leader and executive director of the National Urban League from 1961 until his death in 1971.

A $1.25 million fundraising effort was initiated by a group of alumni and students in 1989. Since that time, African-American students, alumni and friends of the School have raised $650,000 toward the creation of the chair. Proceeds of $200,000 from the annual Whitney M. Young, Jr. Memorial Conference, sponsored by the Wharton African-American Association, have also helped to fund the effort. Other contributions were generated from corporate and foundation grants including those from the Whitney M. Young, Jr. Memorial Foundation, the General Mills Foundation, Ford Motor Company, American Express, Arco Chemical Company, CS First Boston, Merrill Lynch and Salomon Brothers. In all, contributions were received from more than 300 individuals and corporations.

"The chair will have monumental significance in the recruitment and matriculation of students," says Omowale Crenshaw, WG'96. Crenshaw was director of this year's Whitney M. Young, Jr. Conference, whose theme was "Creating Wealth in the African Diaspora Through Education, Entrepreneurship and Community Action."

The 20th Annual Wharton Follies Presents "Mission: Improbable"

Plot summary: The nameless, faceless dean of a competing business school hires Ruth Less and her sidekick Clark — two employees from Robbers & Crooks, LLP — to infiltrate Wharton and sabotage its number one ranking.

The diabolical duo carry out their assignment with well-planned attacks on admissions, the ethics module, resume writing, the computer system, alumni affairs, recruiting and the MBA social scene. With each sinister plot twist comes the trademark "Mission Impossible" music as hapless Wharton students try to understand why no one is e-mailing them, hiring them, or worse — dating them.

Who is the nameless, faceless dean? (We don't know, but we can guess.) Does Robbers & Crooks succeed? (Of course not.) They are foiled by the likes of Slick (a.k.a. the Slick-man, the Slickmeister, the Slick-o-rama, a shameless schmoozer who conned his way into Wharton and majors in golf, undergrads and free recruiting dinners); Sherman Patton Eisenhower MacArthur, III (a.k.a. Ace, a Navy pilot looking to make it big in banking), and Hillary, loving wife and mother, MBA student, member of the Director's List, president of the WGA and PTA and recently elected to City Council.

But enough havoc is wreaked along the way to inspire a medley of songs, dances and irreverent jibes at the Wharton experience.

There are such tunes as "Unrecruitable," (after "Unforgettable," by Natalie and Nat King Cole), "How I Waste My Time," (after "For the Longest Time," by Billy Joel), and "Super-Registration," (after "Super-cali-fragi-listic," from *Mary Poppins*).

There is the medical team sent in to resuscitate a damaged computer; the students who bring a burlap bag to carry away free food samples from a recruiter's table; the ragtag band of abused, confused Wharton students raising the Wharton flag as they battle against unseen destructive forces, and a skit modeled after Pulp Fiction, with two individuals debating the philosophical underpinnings of a "steak with cheese".

What's more, there is both romance and redemption, plus heartwarming reassurance in the end that sabotaging Wharton is, indeed, "Mission Impossible."

PHOTOGRAPHS / JERRY MILLEVOI

Campus NEWS

Vice president Al Gore kicked off Penn's 50th anniversary celebration of the world's first all-electronic computer — ENIAC — during a visit to campus on Feb. 14.

The celebration for ENIAC (Electronic Numerical Integrator and Computer) will span 18 months and bring together computing pioneers, scholars, business leaders, scientists and technology advocates for a series of events focused on the birth of modern computing. The program includes symposia, hands-on demonstrations of new electronic technologies, art exhibits and other events.

ENIAC, the product of Penn inventors John W. Mauchly and J. Presper Eckert, was originally commissioned to calculate ballistics tables during World War II. It weighed 30 tons and occupied a room that measured 30 x 50 feet.

Companies seeking first- or second-year MBA students with specific skills or experiences can take advantage of Wharton's Rapid Resumé Service, offered free by the School's Career Development & Placement Office (CD&P).

CD&P will search for candidates by area of career interest, language proficiency, prior work experience, and/or undergraduate concentration, among other criteria. Searches for summer positions or full-time employment are limited to 30 resumés, and can usually be done in a few days.

Two examples of recent searches: Second-year MBA students who speak Portuguese; and German-speaking first-year MBA students who have health care backgrounds.

For information, call (215) 898-3595, or fax to (215) 898-4449.

Wharton junior Johnathan Seeg and College junior Abby Close received the prestigious 1996 Howard R. Swearer national Student Humanitarian Award in February for creating an environmental education program at Shaw Middle School in West Philadelphia. The two students took three academically-based community services courses last year in order to better their understanding of both technical issues — such as the effect of lead poisoning — and theoretical issues.

The award includes a $1,500 cash prize to supplement the students' educational initiative at Shaw.

$10 Million Donated for Undergraduate Scholarships

A $10 million gift to endow undergraduate scholarships at Wharton was donated this year by William Meiklejohn, W'42, and his wife Louise Meiklejohn, of Laguna Hills, Ca.

It is the largest gift to undergraduate financial aid in Penn's history.

"We are particularly appreciative of the Meiklejohns' generous gift and the opportunity it provides for Wharton to continue to attract the finest undergraduate business students from all around the world," notes Wharton Dean Thomas P. Gerrity.

More than 60 percent of Penn's current freshman class of 2,350 receive some form of financial aid.

Meiklejohn, who retired from the Northrop Corp. as manufacturing control coordinator in 1970, graduated from Wharton with a degree in accounting. Before her retirement, Louise Meiklejohn was employed by the Orange County Superintendent of School's Office. A previous gift from the Meiklejohns to Penn included support for athletics. Meiklejohn, an avid sports fan, was a member of the Penn wrestling team.

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FEATURE

THE URGE *to merge*

STRATEGIC REALIGNMENTS, NEW TECHNOLOGIES AND A RAGING BULL MARKET CAUSED A FRENZY OF M&A ACTIVITY IN 1995. WHAT HAVE WE LEARNED FROM IT, AND WHAT'S AHEAD FOR 1996?

For Brian Finn, W'82, 1995 was a big deal. A big, big deal. As co-head of mergers and acquisitions at CS First Boston, Finn helped lead a department that was involved in the execution of more than 100 deals valued at $165 billion. They included Seagrams' $6.5 billion acquisition of MCA, Union Pacific Corp.'s pending $5 billion acquisition of Southern Pacific Rail Corp. and IBM's $3.5 billion acquisition of Lotus Development Corp. In all, CS First Boston handled a firm-record 35 transactions in excess of $1 billion each in 1995.

While these and other megadeals — such as The Walt Disney Co.'s $19 billion purchase of Capital Cities/ABC, Inc., Chemical Banking Corp.'s $10 billion acquisition of The Chase Manhattan Corp. and Westinghouse Electric Corp.'s $5.4 billion purchase of CBS Inc. — dominated the news, consolidations were taking place in dizzying numbers among companies large and small.

According to the research firm Securities Data Co., global transactions in 1995 came in at a record $866 billion, an increase of 51 percent over 1994's $572 billion. The United States saw more than 9,000 mergers worth almost $460 billion. That performance smashed 1994's record year of 7,568 deals valued at $347.5 billion. Even such traditionally low-profile industries as utilities, health care services, and defense were playing "Let's Make a Deal" at a breakneck pace.

What fueled this merger frenzy? Will 1996 be a repeat? Is there an M&A "Best Practices Guide" to help the more inexperienced players? To find some answers, the Wharton Alumni Magazine *recently interviewed several alumni and faculty members who have been involved in various aspects of M & A activity, including investment banking, management consulting, corporate management and academic research.*

PHOTOGRAPH / JOSEPH ANDRIS

"Many, many companies find themselves in a position where their business or industry is going global and the competitive dynamics are changing," says Finn. "And many people have found that another way to increase their growth is through merger and acquisition activity. It's the old question of buy versus build, and buy has proven to be more appropriate in many industries."

A good example, says Finn, is Hoechst AG — a major German pharmaceutical company — and its acquisition of Marion Merrell Dow, based in Kansas City, Mo. "If you want to be a worldwide player in the pharmaceutical business," says Finn, "the conventional wisdom is that you need a substantial stake in the U.S." At the same time, he adds, many global manufacturers realize that their opportunities for growth lie outside the U.S. As a result, Americans have been buying overseas more than ever.

Even as global competition heats up, many industries — especially commercial banking — are suffering from overcapacity, due in part to technological advances. "Companies are driven to merge principally as a way to cut costs," says Finn.

Chemical and Chase, for example, can now spend "approximately the same amount as one of them would have spent on new technology investment, but spread it over twice the customer base. That creates enormous economies of scale."

This same phenomenon has occurred in the media and entertainment industry as well, adds Finn, pointing to the economies of scale in content and programming assets created by the merger between Disney and Capital Cities/ABC and the pending Turner/Time-Warner merger.

Nearly as active as the banking and entertainment industries has been health care services. Burdened by cost pressures and overcapacity in many areas, health care was one of the 10 busiest M&A sectors in 1995 (see sidebar). Anheuser-Busch Term Assistant Professor of Management Geoffrey Brooks, who is conducting research on hospital mergers in the San Francisco Bay area, believes that the high volume of M&A activity has its roots in the early '80s with the advent of Medicare's prospective payment system. Under this approach, says Brooks, medical procedures ranging from appendectomies to heart surgery are reimbursed at a standard rate rather than on an individual cost-plus basis.

"It turned around the hospitals' incentive system," says Brooks. "Before, the incentives were to build in as much cost as possible, because hospitals were getting profit off the top of whatever they charged. Now, they're getting a fixed amount. As a consequence, increased cost pressures are necessitating a reduction in lengths of stay as a means of efficiency." Shorter hospital stays plus an increase in procedures being done on an outpatient basis are resulting in "huge overcapacity in the hospital industry," he adds.

M&A mania has also been fueled by a raging bull market and favorable interest rates. The Dow, which soared to record levels in 1995, made it easier for companies to finance deals.

"Life feels better when the Dow is at 5000 than when it's at 3000," says Finn. "It emboldens people to take risks. Having a highly valued currency, and being able to use equity and do deals in stock," has been the catalyst for a number of transactions.

"If the stock market is valuing your company at 20 times earnings you can buy a lot more for that stock than when it's valued at 10 times earnings," notes Ray Minella, WG'76, managing general partner at Berenson Minella & Co., a private investment and merchant banking firm.

A healthy stock market "also provides a felicitous climate for initial public offerings," adds Minella, who, prior to co-founding Berenson Minella in October 1990, was a managing director in investment banking at Merrill Lynch and co-head of their merchant banking group.

"The financial entrepreneurs and LBO firms that did leveraged buyouts in the latter part of the '80s, who in 1990 were wondering whether they would end up as chumps or heroes, have been able to realize value not by selling the company to somebody else, but by taking it public," Minella says. The "IPO market of the early '90s helped make a lot of firms' returns look great, enabling them to raise a whole new round of funds." As a result, he adds, there is about five times more equity capital in leveraged buyout funds now than there was 10 years ago.

THE '80s vs. THE '90s

While the '80s have been described, in so many words, as a hotbed of hostile takeover activity led by a cadre of corporate raiders armed with sophisticated financing techniques, the more

An Electric Year for the Utilities Industry

Although not as glamorous as telecommunications and entertainment, the utilities industry was among the busiest in terms of mergers in '95 with 72 deals valued at $15 billion, according to Securities Data Co. That performance also placed utilities as the sixth most active sector in '95, a major leap from a 17th place rank in '94 with total deals valued at just under $7 billion.

A catalyst for these mergers, says Stephen R. Goldfield, WEMBA'96, vice president and corporate director at Metzler & Associates, a management consulting firm based in Deerfield, Ill., was the passage of the Energy Policy Act in 1992 which "created a competitive wholesale power market." In addition, Goldfield says that in 1994, California started a regulatory proceeding aimed at evaluating the opportunities for having open retail competition within the state. This action would allow industrial and commercial customers to actually choose their energy suppliers, similar to how customers can now choose their long distance carriers.

"Just the mere investigation of that possibility caught the interest of many other states and started a groundswell feeling in the industry that companies — sooner or later — were going to have to compete," says Goldfield.

As a result, utility companies have been seeking ways to cut costs and increase their competitive position. A natural reaction, says Goldfield, "is to grow bigger to achieve some economies, eliminate some redundant operations, and merge." At the same time, he adds, there has been some loosening of other regulations, including a public utilities holding company act that prohibited electric utilities that also owned a gas utility franchise from ever buying another utility out of state. This type of restriction is now being relaxed.

The increased competition will also create the need for beefed up marketing efforts, says Goldfield. A number of people from outside the industry have moved into leadership positions at major utilities, he adds, especially executive-level marketing posts which are being increasingly filled

recent mergers are perceived as more strategic and better geared to long-term success.

The '80s were more exciting than the '90s because there were financial players as well as corporate players, says Peter Linneman, Albert Sussman Professor of Real Estate, professor of finance and real estate, and director of the Wharton Real Estate Center. "Largely what you have now is a disproportionate number of corporate players. It's less exploratory and more professional. And it's more acceptable because the people making the big offers tend to be the elite of corporate America."

"When companies announce transactions today, investors look at them nine times out of ten and say, 'That's a smart deal,'" comments Finn. "In the '80s, buyers were mostly perceived as damaging shareholder value. In fact, most stocks traded down when a company made an acquisition. Not today."

Another characteristic of the '80s, according to Minella, was the ability to achieve great financial returns from an acquisition even when overpaying. Between 1982 and 1987, he says, "interest rates were falling, so the cost of money was always less than was forecast at the time the deal was structured. Also, equity values were rising fast, so that if you bought control of a company and sold off constituent parts, you almost always sold them for more than you thought they were worth when the company was bought. It was not unlike buying wholesale, and selling retail, while the underlying price of assets continued to increase in value. That was the strategy that Kohlberg Kravitz & Roberts (KKR) executed with great success in the Beatrice Foods transaction." In 1988, Minella adds, "the music finally stopped and those who had come to depend on a rising equity market and lower interest rates were caught short."

The ease of securing capital in the '80s may also have led to misguided merger strategies. "In well-developed markets, people will pursue vertical integration mergers believing that there are great gains," says Linneman. "In the '80s, for example, shopping center owners bought department stores and specialty stores with the rationale that shopping centers need stores, and stores need shopping centers. The shopping center owners thought it was going to be a great strategy and it turned out to be a disaster."

QUALITY, NOT QUANTITY

Given the mixed record of mergers and acquisitions in the 1980s, some people believe that companies now sense a need to focus on quality more than quantity. "We're in a period where people realize that they can't do everything," says Lawrence Zicklin, WG'59, managing partner and CEO of Neuberger & Berman, an investment banking and securities brokerage company.

"Companies have certain expertise and certain assets. Now they're trying to rationalize and find out what they can do well and do it, and also determine what they can't do well and avoid it." Eastman Kodak Co. and Xerox Corp., for example, recently sold or spun off pieces of their business that simply "didn't fit," Zicklin notes.

Harbir Singh, associate professor of management and a leading researcher on mergers and acquisitions, agrees that it is crucial for firms to figure out what types of acquisitions are successful and which aren't. One way to determine this, he says, is to look at a company's past track record.

"Study your failed acquisitions and see what you can learn from them," says Singh. "People very often attribute their failures to poor performance of the acquired firms. But the failure may actually be a firm's poor judgment in choosing their acqui-

by individuals from consumer products companies.

"There will be a few more dynamics in the industry from a financial performance perspective, but I don't think it has the growth prospects that will make it a darling industry of Wall Street. You'll see the betas of stocks going up, the investor return requirements increasing over time, the probability of more bankruptcies and greater earnings fluctuations. But electric energy growth has really flattened out in this country and it's not likely to increase."

In the traditionally conservative utilities industry, Goldfield cites one company that has been successful by taking an aggressive merger approach. Entergy, an electric utility based in New Orleans, acquired operations that gave them a strong presence in Louisiana, Arkansas, Mississippi and parts of Texas.

"Entergy invested heavily in integration of those companies and in the pulling together of the overall operations," says Goldfield. "At the same time, Entergy distinguished itself by also investing heavily in nonregulated business activities as a diversification strategy that centered on different business lines. For example, they are heavily invested in energy management services across the U.S. So while they cannot sell electricity outside their franchise service territory, they can sell services."

Eager to compete in a deregulated environment, U.S. utilities have been among the more active players in seeking overseas partners. The U.K. has opened up its electric utility system to competition, and many of the distribution companies have actually been acquired by U.S. electric utilities in the past 12 months, says Goldfield.

The U.S. industry is looking to the British model to see if it's working. U.S. utilities are also snapping up many Australian distribution companies. Because these overseas electric companies are subject to competition, U.S. utilities, Goldfield adds, are hoping to learn how to operate more competitively in the deregulated environment of the future.

sitions to begin with. Or, it might be incompatibility. Companies should find out whether the key success factors in their current business are applicable to the target firms' business."

"We sometimes forget that mergers can be very costly mistakes," adds Gerald Faulhaber, professor of public policy and management. One particularly spectacular failure was AT&T's hostile takeover of NCR. At the time of the purchase, Faulhaber says, AT&T had already spent 10 years unsuccessfully attempting to enter the computer business. "So the question is, why would you take a company that's been a failure in this business and put it together with a company which has been, at best, a modest success?" Faulhaber asks. "All AT&T could do was drag NCR down, which is effectively what they did."

The fate of AT&T is not that uncommon, according to Daniel Lovallo, assistant professor of management. "When people plan a merger, they tend to take an 'inside view' of the problem, which suggests that they will focus on scenarios and develop a 'future history' of what will occur. Our research has shown that when you do that, the overwhelming tendency is for people to be overly optimistic."

Overoptimism may help explain the findings in Singh's recent study of acquisitions by defense firms. "Most defense firms have been trying to convert their assets and get into new areas," he notes. "But according to our research, most acquisition cash flows were not impressive. It seems like the defense firms are actually better-off if they stay with their core businesses — even when the business is struggling. The argument is that there are probably profit opportunities within that business itself."

ADVICE FROM THE FRONT

Michael Bregman, W'75, has been directly involved in a number of transactions, first as chairman and CEO of MMMuffins, Ltd., and currently as chairman and CEO of The Second Cup Ltd., Canada's leading specialty coffee retailer with more than 500 stores throughout North America and annualized sales exceeding $200 million.

Although MMMUffins' acquisition of The Second Cup in 1992 was financially successful, the transition phase created some unforeseen difficulties.

For example, as the two companies merged, "what we frequently heard from The Second Cup operators was, 'We've been doing it this way for four years without a problem, so why change now? Why should we throw away coffee after 30 minutes? Why should we throw away the coffee beans after two weeks? Why should we use thermometers to check the temperatures of our lattés — rather than use our hands to feel the outside?' It was very, very difficult to get some people to buy into the need for an uncompromising approach to quality."

Pricing and marketing strategies were often contentious, Bregman adds. "If we suggested a certain marketing program, some franchisees would automatically assume that we wanted to build sales so that we could earn more royalties at the expense of their profitability rather than our real goal, which was to *help* their profitability."

"We did a lot of things to assist with the transition. For example, we changed the way we bought coffee and certain other supplies and gave the franchisees much more access to purchasing information." As a result, from the outset, each store saved about $14,000 a year. "And for the first time we allowed the franchise representatives to have a hand in all major decisions that might affect their stores."

Despite this strategy, he notes, "It took a long time — in some cases three to four years — before franchisees were willing to let down their guard and trust us."

For those agonizing over the pros and cons of a merger, Bregman says that it is critical to maintain a sense of objectivity and rationality. "People can get emotional and undisciplined in the valuation process. You should never be afraid to say no, or to back away from a deal, no matter how sexy or strategic it looks on the surface. Many times the values are generated by financial engineers who tend to be full of positives and often overlook the unexpected negatives."

Minella agrees that a lot of "wishful thinking" goes into the M&A process. Completing a deal "is one of the most important things executives are going to do in their corporate life, and it's much better to make decisions based on realistic expectations than to allow yourself to be sweet-talked and misled."

Today, Finn says, people are doing smarter deals by pricing and structuring more carefully. And, he adds, "they're walking away if the deal doesn't make sense. Mostly, people are buying what they know as opposed to diversifying and creating conglomerates."

Steve Kaye, WG'90, CEO of GTCO Corp., a privately-owned $10 million manufacturer of digitizers and other computer peripherals based in Columbia, Md., concurs with the "buy what you know strategy." GTCO, which sells in 45 countries and employs 75 people, recently acquired $2 million Science Accessories Corp., a competing manufacturer of digitizers based in Stratford, Conn.

After reinvigorating GTCO's operations back in the early '90s, Kaye and his management team set their sights on consolidation which they believed would shape their maturing industry in the coming years. Their acquisition of Science Accessories "wasn't a financial play like the '80s where if you could finance it you would do it, even if it didn't make strategic sense," Kaye says. "Here, it was two companies in the same business and we could essentially operate both companies off of a single cost structure ... Our interest was to drive the industry consolidation and benefit from it as opposed to being subject to it."

CREATING A COMMON VISION

Once a deal is consummated, the degree to which it is a success or failure depends on how much attention the companies put into cultural integration, says Stephen R. Goldfield, WEMBA'96, vice president and corporate director at Metzler & Associates, a management consulting firm based in Deerfield, Ill.

"With electric utilities, the major functions that the companies perform — such as electricity production, facilities construction, transmission and distribution, and billing systems

— are very similar across the industry. So there are not many technical difficulties involved. But the cultures are very different. The companies that do the best job of bringing the merger to a successful completion spend a lot of time pulling the two cultures together."

In a merger of two midwestern utilities, Goldfield's consulting firm helped establish transition teams to "create a common vision of what the company wanted to accomplish through its merged operations," says Goldfield, who specializes in electric utilities. "We had senior management participation from both companies and then created eight to ten task teams to address various issues and functions. It was important that the task teams be well represented by both groups.

"The most critical piece is to merge operations as quickly as possible," Goldfield adds. "We believe that the uncertainty and the trauma involved for the employees is so great that if you don't clearly articulate where you're going, what your vision is, and what your goals are, you will fail. Your people will never recover."

Bregman concurs on the importance of maintaining open communications with merged workforces. "Often — and I've been guilty of this — you spend so much time consummating a transaction, dealing with things like legal and tax issues, that you don't do justice in spending enough time with the new company," Bregman says.

He suggests that the process of acquiring another company should include identifying all of the opportunities in which each company would benefit from working together. But "this doesn't happen by itself. You have to orchestrate an event where the people involved from both organizations can meet face-to-face to jointly solve a problem."

For example, during The Second Cup's recent acquisition of U.S.-based Gloria Jeans Gourmet Coffee, The Second Cup was interested in selling one of Gloria Jean's most popular products — "minicans" of coffee. "On the surface everyone felt that this would be a terrific win-win," says Bregman. "Our franchisees in Canada were happy to have a new product that would help their Christmas volume, and Gloria Jeans had a new customer."

Despite the apparent upside, however, Gloria Jeans management viewed their minicans as proprietary and didn't like the idea that they might be sold in The Second Cup franchises. Bregman's response was, "If it's proprietary, isn't that what we bought? We don't compete with one another. There are no Second Cup stores where there are Gloria Jeans stores."The issue was quickly resolved, Bregman adds, but it shows how solid business decisions can be undermined by misunderstandings and lack of communication at the senior management level.

"The way to address these issues is to establish reasons to get together," he says. "For example, set up a buying committee where representatives from both companies meet to identify areas where they can buy together or buy from one another in a way that helps both organizations ... The more at ease employees are with the transition, the more productive they will be."

Which is not to say that layoffs aren't a big reality for many employees of merged firms. While numerous managers and investors have reaped huge profits from the M&A wave, thousands of workers have found themselves out of a job. In 1995, layoffs related to corporate marriages accounted for 16.4 percent of the nation's total job cuts, according to the outplacement firm Challenger, Gray and Christmas.

"I see a lot of this with spin-offs and liquidations," says Zicklin. "Companies may do this because it is the only way to stay competitive, but I wonder if it's really good for the country. If shareholders are going to benefit from all of this activity, then what are the employees entitled to? The country is experiencing a reasonable economy and still a lot of people are losing their jobs. If all of these people are truly unnecessary, why did management hire them in the first place? And why isn't the burden of management error shared more equally?"

Also troubling, says Singh, is the potential to make the wrong cuts. "If you're going to downsize after the fact, then often the question is, 'Are you making the right choices?' You may end up losing the better employees."

1995 Merger and Acquisition Top 10 Ranking by Target Industry Sectors

Target Industry	Value ($mils)	# of Deals
1. Commercial Banks, Bank Holding Companies	65,943.7	661
2. Radio and Television Broadcasting Stations	52,345.9	330
3. Business Services	38,838.7	990
4. Insurance	21,946.0	245
5. Telecommunications	19,704.9	241
6. Electric, Gas and Water Distribution	14,985.0	72
7. Paper and Allied Products	14,804.7	70
8. Health Services	13,917.3	463
9. Real Estate, Mortgage Bankers and Brokers	12,607.1	274
10. Printing, Publishing and Allied Services	11,364.0	238

Source: Securities Data Company

Merger-related downsizing has hit the electric utility industry especially hard, with, on average, about 50 percent of proposed savings coming from the elimination of jobs, says Goldfield.

"If you look at the average personnel reduction as a percent of total employees, companies that merge project somewhere around five to six percent total employment reduction," he notes. "That's where the majority of the savings are coming from." Goldfield says that a recently announced merger between Interstate Power, IES Industries, and Wisconsin Power & Light proclaimed $700 million in costs savings over 10 years, much of that the result of personnel reductions.

THE VALUE OF LEADERSHIP

Transactions are "very much about people," says Finn. "The interpersonal relationships between and among parties get deals done and kill deals all the time. We can run numbers until we're blue in the face, and we can conclude that businesses A and B are a compelling combination. But, if the people representing companies A and B don't want to combine for personal reasons, they won't be combined."

Finn says that has led to an acceptance of hostile corporate takeover activity. He points to IBM's acquisition of Lotus and Wells Fargo's takeover of First Interstate as examples of strong leadership by Louis Gerstner, chairman and CEO of IBM, and Paul Hazen, chairman and CEO of Wells Fargo. "These were hostile takeovers where the acquiring executive said, 'I know you don't want to do a deal, but it's in my shareholders' interest, so I'm going to force the issue.'

"The single most important event in recent times," Finn adds, "was when IBM went after Lotus so quickly and so successfully. It gave a lot of people the backbone to try it as well. It's not that people wanted to do hostile deals, but that they were willing to go hostile if necessary to accomplish their objectives. ... We're finding that more and more CEOs have the guts to look the public in the eye and say, 'This is the right thing to do and I'm not going to let one person stand in the way of it.'"

With hostile takeovers completed by companies like General Electric Co., American Home Products Corp., and Johnson & Johnson, "the stigma associated with corporate hostility is gone," Finn adds.

Goldfield has a slightly different twist on the "people" issue. "The greatest obstacle against a merger taking place in the utilities industry is the management succession issue," he notes. "It's widely known in both the investment banking and consulting industry that the best way to identify a merger opportunity isn't to look at the company's strengths, weaknesses, overlapping needs or cultures, but to look at the ages of the chief executive officers."

To effectuate a merger, says Goldfield, "you need one CEO who is close to retirement age so that you have a natural stepdown, and another CEO ready to come in and take over. Lack of management succession planning is the primary reason why negotiations break down."

LOOKING AHEAD

What lies ahead in the area of mergers and acquisitions clearly differs for different industries. Goldfield, for example, predicts significant change for the traditionally stable electric utilities field. "Historically there has been absolutely no incentive to merge or consolidate," says Goldfield. "But given certain federal and state regulatory proposals (see sidebar), it is self-evident that competition will be here at some point in time, depending upon whom you talk to and what state they operate in. It's either two years from now, five years from now, or 10 years from now. It will be here in some form."

If recent research into San Francisco Bay Area hospitals by Geoffrey Brooks is any indication, the health care services industry should also see increased activity. "In San Francisco, there is an amazing amount of consolidation," he says. "It's as if all of the key hospitals in the area are starting to link up. Major hospitals on the West Bay Side are merging with hospitals all the way to Sacramento. It may be in their interest to do this now, but it's not clear that in the long run the coordination cost is going to be warranted."

In the health care marketplace of the future — largely driven by managed care — integrated delivery systems will emerge as the winners, adds Kate Flynn, WG'80, vice president of VHA East, a member of a national alliance of not-for-profit hospitals and health care systems. Those winners, says Flynn, will be systems that "can effectively speak for the whole continuum of care, rather than the balkanized, cottage industry we've had in the past. The managed care insurers, and now Medicare and Medicaid, are very much driving toward a managed care environment. They will want to deal with large systems that can speak with one voice, that integrate everything: outpatient, doctor's office, lab, x-ray, hospital, home care, long-term care. That's what's leading the drive towards all of this integration."

Although the conditions that have driven M&A activity over the last two years generally continue to exist, says Finn, "I think 1996 will be a down year from 1995 because 1995 was a hysterical peak. We're not going to see much activity in the TV network business in 1996, because once ABC, CBS and Turner Broadcasting are gone, how many network TV transactions can there be? Many industries are done. They've evolved. The hospital industry had a huge wave of activity a year and a half ago and that's probably pretty much over. The railroad industry has had a wave of activity but I'm not so sure it's over. The banking industry has had a wave of activity that is definitely not over. So each of these industries has its own cycle going on."

Finn cautions, however, that a stock market crash could slow down activity substantially, as could the inability of the government to nail down a budget agreement. Other potential barriers: a material economic shift in Europe or Asia or an interest rate spike. These factors make M&A activity "vulnerable to change in a negative direction," says Finn. "But from where we sit today, I would forecast that '96 will be a very active year. Perhaps the second most active year in history." ▼

— Michael Baltes

FEATURE

ALIVE AND WELL AND WORKING IN ... LONDON

OUR SERIES ON ALUMNI IN DIFFERENT CITIES LANDS IN LONDON, DESCRIBED BY ONE OF THE APPROXIMATELY 600 WHARTON GRADUATES THERE AS THE "MOST CIVILIZED CITY IN THE WORLD." IT'S PROSPEROUS AS WELL, AS BOTH CITY AND COUNTRY BOUNCE BACK FROM A RECESSION IN THE EARLY 1990S TO BECOME ONE OF THE STRONGEST ECONOMIES IN EUROPE. ON MARCH 28-29, LONDON HOSTED THE WHARTON EUROPEAN FORUM CENTERED AROUND THE THEME: "EUROPEAN COMPETITIVENESS: DYNAMO OR DINOSAUR?" SPEAKERS INCLUDED PETER D. SUTHERLAND, CHAIRMAN OF GOLDMAN SACHS INTERNATIONAL AND FORMER DIRECTOR GENERAL OF GATT AND WTO, AND THE HON. RAYMOND G. H. SEITZ, MANAGING DIRECTOR, LEHMAN BROTHERS INTERNATIONAL, AND FORMER U.S. AMBASSADOR TO THE U.K. ◆ VISITORS TO LONDON FOR BUSINESS OR SIGHTSEEING CAN DINE AT A RESTAURANT OWNED BY AN ALUMNUS, STAY AT A HOTEL OWNED BY AN ALUMNUS, OR BUY A PAIR OF SHOES DESIGNED BY AN ALUMNA. READ ON FOR DETAILS.

ILLUSTRATION / PIERRE-PAUL PARISEAU

Sir Paul Judge, WG'73
Ministerial Adviser to the Chancellor of the Duchy of Lancaster

Along with his other accomplishments, activities and honors, Paul Judge can now add a knighthood.

On February 20, Judge was knighted by Queen Elizabeth during a ceremony that recognized him "for public and political services." Chief among those was his three-year position as director general of the Conservative Party from 1992 to 1995, a job which entailed looking after the Party organization, including campaigning, finances, research and communications.

Since November 1995, he has been a ministerial adviser in the Cabinet Office responsible for maintaining England's competitive position vis-a-vis world markets. Specifically, Judge advises the government on such issues as deregulation, information technology, and ensuring that Britain remains attractive to British and foreign investors. "Since the 1980s Britain has undergone a transformation in terms of its competitiveness," says Judge, whose office is in Whitehall. "Already more than one-third of all investment into the European Union comes into the UK. It's a matter of maintaining and enhancing that record.

Judge is officially a "Knight Bachelor," now known as Sir Paul Judge, and his wife, Anne Judge, WG'75, is officially "Lady Judge." They have two sons, ages 10 and 11, and live in London and in a village near Worcester.

Born and raised in London, Judge attended St. Dunstan's College and Trinity College, Cambridge, before coming to Wharton as a Thouron Scholar. In 1973 he joined Cadbury Schweppes as a financial analyst. He was promoted to deputy finance director in 1977 and to group planning director and member of the Group Executive Committee in 1984. In 1985 he initiated the management buy-out of the UK, French and Irish food interests of Cadbury Schweppes to form Premier Brands, of which he became chairman. At $150 million, it was the largest buy-out in the UK in 1986 and is still the largest ever in the UK food manufacturing industry.

The company was sold to Hillsdown Holdings in 1989 for $500 million, at which point Judge stepped down as chairman.

In addition to serving on the boards of numerous companies, foundations and schools, Judge is an entrepreneur. He is chairman and major shareholder of Isoworth Ltd., which has a patent on a device that easily carbonates water and can therefore be incorporated into machines dispensing high quality soda and beer from syrup. "It's more economical because you can use the water that is already in your house or office, and it's environmentally better because you save more than 80 percent of the packaging as you do not have to ship all that water in bottles or cans from a central factory," says Judge. His other major investment is in Belgo, a Belgian-style restaurant that was just named "Restaurant of the Year" by *Time Out*, London's main weekly listings magazine.

As someone who is an active participant in both the government of Britain and its economy, Judge sees a prosperous 1996 ahead for consumers. "We had the highest growth rate of all the major European countries in 1993, 1994 and 1995, with especially strong manufacturing and export sectors. But because of tax increases in 1992 and 1993, not all of that prosperity has shown up yet in consumers' pockets. This year economic growth is continuing and we've reduced taxes, which should mean significant increases in the standard of living."

Alain Levy, WG'72
President and CEO, Polygram NV

Two months ago, *Mr. Holland's Opus* was the number one movie in America. Although the film was produced by Interscope Communications, which is owned by Polygram NV, Alain Levy wasn't entirely satisfied. "Movies are only 13 to 14 percent of our sales," says Polygram's president and CEO. "They should be 25 percent. But we have a strategy to achieve that without necessarily going for a major studio."

On the movie side, "we are operating a bit like we operate in the record business, which is to have separate labels," says Levy, who heads one of the fastest-growing entertainment companies in the world. "You never see Polygram on a recording. You see Motown or A&M Records or Deutsche Grammophon. Polygram is a distributor for all these creative units. We are doing the same thing in movies. Rather than have a studio chief who has all the production coming to him, we have independent labels who have their own creative units and who develop movies. The distribution system is the same for all the labels. A small budget movie, like *Dead Man Walking* for example, will be distributed by Gramercy, which we just bought back from Universal. For bigger movies we still are in a rent studio system where the studio distributes the film to hundreds of cinemas and gets a fee in return."

Whatever its strategy, Polygram NV, which is 75 percent owned by Philips Electronics NV, is a huge success story. The company recently posted its eighth year of uninterrupted sales and profits, in spite of a slow second half in 1995. Sales were up 11.2 percent, from $4.9 billion in 1994 to $5.5 billion in 1995, while net income grew by 9.2 percent, from $424 million to $463 million.

On the movie side, Polygram has already spent approximately $400 million to acquire its small production companies, whose hits have ranged from *Four Weddings and a Funeral* and *Usual Suspects* to *French Kiss* and *Priscilla, Queen of the Desert*. The company recently

renewed its agreement with Jodie Foster's Egg pictures for three more years.

On the music side, Polygram currently has a 14.4 percent share of the American music market — second only to Time Warner's music division — and an enviable marketing and distribution network in Europe and Asia. In September, Polygram formed a 50/50 joint venture with the estate of Leonard Bernstein to publish his works.

Levy himself is highly regarded for his ability to recognize and attract both new and old talent, including The Cranberries, Sting, Elton John, Boyz II Men, Janet Jackson, Adagio Karajan and Luciano Pavarotti.

These days, however, Levy spends "more time with financial analysts than artists. The real issue is making sure you find the best people. These are my heads of labels who have the same philosophy I do and who are very good at discovering and nurturing talent. My role now is more one of a coach and a finder of executives than doing actual grass roots work."

Levy, who is French and graduated from the École Des Mines in Nancy, has three sons from previous marriages and is currently married to a lawyer who also works at Polygram. He became chief executive of Polygram's United States operations in January 1990 and head of the whole company in 1991. Before joining Polygram in 1984, Levy worked for CBS Records in the U.S. and Europe.

"If we manage our growth into the movie business and continue to increase our TV production as well," says Levy, "we should have a sizable part of the content needed to be an entertainment package."

Henry A. Sweetbaum, W'59
Chairman and CEO of Wickes plc

In an article published last summer in the magazine *Directors & Boards*, Henry Sweetbaum argues that "burdening the [corporate governance] system with excessive and possibly ineffective controls" is counterproductive, and worse, damaging to the whole concept of free enterprise. Instead, he says, offer incentive packages that allow CEOs to attract high-quality outside directors who will act in the best interests of the company and its stakeholders.

During a recent interview, Sweetbaum identified three distinct kinds of companies. "First, there are well-managed companies with strong boards and excellent corporate governance. These companies clearly do not benefit from additional regulations. Second, there are small- to medium-sized companies led by well-intentioned but perhaps inexperienced management, often unable to attract highly qualified non-executive directors. To ensure a high standard of corporate governance, these companies require education, training and the means to attract quality directors, not additional regulation. Third, there are companies led by 'rogue managers' who are not prepared 'to do the right thing.' History tells us that these people ignore the rules in any event.

"What concerns me," says Sweetbaum, "is that we are reaching a point — often discussed in America and increasingly heard in Europe — where there is litte joy in running a public company, given all the criticism, liability risks and press attention that surround it. That doesn't seem right."

Sweetbaum is quick to say that his own board is excellent and has served the company well. Wickes plc, one of Europe's leading home improvement retailers, has 150 stores throughout the world, revenues in 1994 of $1.1 billion and pre-tax profits of $45 million. In 1995, in addition to selling off its troubled timber interests, Wickes opened 16 stores in the UK, three stores on the continent and its first two stores in South Africa (as part of a joint venture with Barlow Limited, one of South Africa's largest industrial companies.) In 1996, 20 more stores are opening in the UK, five on the continent and six in South Africa. "With the emerging South African consumer and the enormous need for housing, the opportunity for businesses like Wickes are enormous," says Sweetbaum, whose move represents one of the first ventures by a British retailer into the South African market.

Sweetbaum, who is married and has four children, has been chairman and CEO of Wickes since 1982. Prior to that, he assisted with a number of technology-based corporate rescues and equity transactions in both the U.S. and Europe. He participated in the rescue of Wickes Companies Inc. in 1982, serving as chairman and CEO of Wickes International Corp. until 1987 when he led the management buyout of its successor, Wickes plc.

He is bullish about Britain, which he feels is "in the best shape in Europe from a cost and productivity perspective." Germany, he says, has made great improvements in this area over the past two years while France "still needs to undergo the process of change ... Given the strains of the past few months, there is no sign this will happen peacefully."

Mary Minowada, WG'91
Designer, Joan & David

Between the time she graduated from Wellelsey College and the time she attended Wharton, Mary Minowada worked in sales and trading at Morgan Stanley in New York.

Today, she designs footwear, accessories and leather goods for Joan & David, a $115 million upscale shoe and clothing company with headquarters in New York and more than 43 boutiques around the world including flagship stores in Paris, London and Hong Kong.

Quite a career change, Minowada acknowledges, although not as dramatic as it might seem. As a graduate of the Joseph H. Lauder Institute of Management and International Studies, Minowada was determined to use not just her management

skills but also her languages (she speaks several) and cultural training.

In 1991 she was hired by the French designer Christian LaCroix in the area of retail and wholesale management. "It was a very entrepreneurial office — only three of us in New York," says Minowada, who managed two retail stores in the New York area and worked with buyers at the New York and Paris fashion shows. "We were overworked and underpaid, but it was fun."

After one year, she was lured away by Joan Halpern, chief executive and chief designer at Joan & David, to be "her right arm." Although Minowada expected a management role, she ended up spending a lot of time in Italy watching her boss design. "One day, I said to her, 'Do you want me to help out with the drawing?' Her response was, 'Oh, do you know how to draw? Great, and if you have any ideas, sketch them up.'" That was three years ago and today, Minowada is one of the company's three designers.

She loves her job, but was prepared to leave Joan & David and move to England where her fiance, Renaud Jezequel, WG'91, works for GE Capital. Instead, the company agreed to transfer her to London, location of three Joan & David stores. Even so, she is only home four to five months a year, dividing the rest of her time between Italy, where all the company's designs are manufactured in preparation for four annual collections, and headquarters in New York.

The "unorthodox" approach of the company appeals to her, "in the way that we work and in the fact that we don't make 10,000 pairs of one model," says Minowada. "Instead of mass production, it is almost one-of-a-kind manufacturing."

L. John Clark, W'63, WG'68
Chief Executive Officer, BET plc

In 1991, BET plc was a "1980s conglomerate that had bought 170 companies in five years and was severely challenged by debt," among other problems, notes John Clark.

Within four years, Clark had sold off or merged all but 55 of the companies, reduced the staff from 184,000 to below 100,000 (it is now about 130,000), paid off all debt and restructured the remaining businesses. Today, BET is a solidly profitable $3.6 billion company that provides specialized support services to business customers. These services range from electronic security, cleaning, plant hire, distribution, catering, personnel and temporary staffing to resort management, conference centers and facilities management in Europe and the U.S. Sales grew 10 percent last year and earnings were up 22 percent.

Turning around a multibillion dollar or pound company usually takes three steps, says Clark, who has done this before. First is reorganization and restructuring (downsizing); second is a strong productivity phase, and third is customer focus.

Outsourcing expertise and experience play a large role in company strategy. BET's innovative vision of outsourcing can mean, for example, "entering into a joint venture to run 50 percent of a retailer's stores; building and running conference management centers for a multinational corporation over a 10-year period; or buying and operating the truck fleet of a major petrochemical company," says Clark.

Meanwhile, he adds, "we have gone through the turnaround/restructuring/focus phase. Now is the enjoyable part — growing the business."

BET is the third successful turnaround Clark has engineered over the past 15 years. After getting his MBA at Wharton, he joined the Singer Company. In 1981 he was appointed president and CEO of Singer's Europe, African and Middle East operation. Within three years he had turned a $33 million net loss into net income of $60 million.

After two years as executive vice president at the VF Corp. where he repositioned product lines for the Lee, Vanity Fair and Wrangler brands, among others, he was appointed president, CEO and later chairman of Core-Mark International, Inc., a $2.4 billion consumer products marketing and distribution company which at the time had logged three consecutive years of losses. Clark restructured the business, increased its profitability and value and then sold it.

Clark was born in Eustis, Fla. He and his wife, Judith Dooley Clark, a 1963 Penn graduate, have two children.

He describes the UK as a "very advantageous place for low-cost export manufacturing in Europe, with a strong currency and low inflation." On the other hand, he worries that "there is still too much capacity for the amount of demand. It means you have to be very competitive to exist here."

Michael von Grey, W'83
Owner, Sandringham Hotel

It was the combination of unfilled need coupled with very depressed property values that got Michael von Grey into the hotel business back in 1992.

When von Grey and his wife first moved to Hampstead, an upscale neighborhood about 15 minutes from downtown London, they were surprised to find that the area lacked a first-class hotel — so surprised that they bought a derelict Victorian building and within 18 months had it up and operating as a 17-room bed & breakfast. Sandringham Hotel was listed this year in the *Michelin* guide, plus two prestigious British publications called the *Good Hotel Guide* and *Which?* In addition, they were voted the only 5-star bed and breakfast establishment in London by the AA (the equivalent of the AAA in the U.S.)

Von Grey and his wife, who was working at the time as a management consultant with KPMG Peat Marwick but also

has a fair amount of interior design experience, "actually lived on the property amidst all the rubble for nearly two years. Then last July we hired a professional management team and in September, moved into our own space," says Von Grey. He and his wife, both of whom come from Pittsburgh, have one daughter and another child on the way.

The hotel is not von Grey's first entrepreneurial undertaking. After graduating from Wharton, he spent four years in the U.S. Army, earned his MBA at Harvard, and then moved to London to start a computer software company focusing on automating the activities of hospital nursing departments." He sold it in 1992 to a Houston firm called CHC.

Now, von Grey adds, his "entrepreneurial antennae are up again. I'm looking at Internet-based software opportunities, things like bartering over the Internet and electronic data exchange. But right now I'm still in the search mode."

Bilge Ogut, W'94
Financial Analyst, Goldman Sachs International

While studying finance and taking courses in operations and information management at Wharton, Bilge Ogut became fascinated by technology. She has translated that interest into a job as financial analyst in Goldman Sachs' London office where she does corporate finance and M&A work for communications, media and technology companies.

Her work takes her mainly to western Europe but also to eastern Europe where, for example, she advises mobile communication networks that are in their start-up phases on ways to finance their operations. She also works on privatizations for state-owned telecommunications companies. "By 1998, because of regulatory changes in Europe, all these companies will be privatized," says Ogut. "At the same time, they are trying to defend their home market from other people interested in getting into the business. It's a very competitive industry and it is changing extremely rapidly."

Ogut, who was born in Turkey and grew up in Istanbul, speaks German, Turkish and English and has a reading knowledge of French. She was a Benjamin Franklin Scholar at Wharton, graduated Phi Beta Kappa and earned a dual degree in German literature.

She wanted to work abroad because "Europe is so interactive. You travel two hours and you are in a totally different environment. Going from the Netherlands to Belgium is easier than going from New York City to Boston." London, she says, "is a very early city. It starts early and ends early. In the States, everything is accessible all the time. Here you have to plan ahead, so in that sense life is a little inconvenient.

"Otherwise, London is a very culturally rich, very international city. You take the tube, for example, and everyone is reading Balzac and Victor Hugo. It's very different from the New York subway system."

Roger Low, WG'71
Associate Director, Bear, Stearns International Ltd.

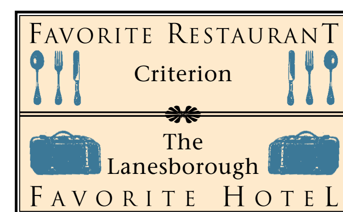
Of all the major cities in the world, says Roger Low, "London is the most civilized. In addition to having a vibrant business community, it's a very international society that is always open to new ideas."

Low should know. He has lived there since 1972 and worked in the area of institutional equity sales for four different employers. In 1971 he had joined Burnham & Co. in New York City with the goal of being transferred overseas as soon as possible. An opening in the London office came up in 1972. Low stayed there until 1975, moving on to Salomon Brothers for seven years, and then Dean Witter for two years. He has been with Bear Stearns since 1984.

The current year is a tricky one for investors, says Low, who provides advice on U.S. equities to UK clients, including pension funds, hedge funds and insurance companies, among others. "People's expectations have risen after a year in which they saw returns of close to 37 percent. It's difficult if people think they can earn that again this year. The average for decades has been about 10 percent annually. For 1996 it is likely to be on the low side of that."

Low thinks that stock selection will be more important in '96 than in '95 and that opportunities exist in small- and mid-cap stocks rather than large-cap stocks.

His clients have a certain percentage of their funds invested in U.S. equity markets at all times. He works with these clients to maximize the percentage. "On an asset allocation basis, they have been underweight in U.S. equities, which means they have missed the main run in the U.S. equity market," he notes.



"The interesting thing about the securities business is that every day is different," says Low, who works long hours because of the need to bridge the U.S. and UK equity markets. "All news has some impact on financial markets, so you can never be too well informed."

Low notes that some of the competitors in his field are "top notch, including several Wharton graduates." His clients include alumni as well: Among them are Peter de Putron, WG'92, Paul Midgley, WG'72, and Wesley Wadman, WG'60.

Low, who was born in Anniston, Ala., and graduated from Columbia College, is married and has two children, a son who graduated from Oxford and is now a radio journalist, and a daughter at Bristol University. *R.W.S.*

FEATURE

ACCOUNTING PRINCIPLES, *According to Knutson*

Professor Peter Knutson Wraps Up 31 Years Instructing Students How to Look Behind the Numbers, Or, As He Puts It, "How to Distinguish Reality from Accounting and GAAP from Claptrap"

Since 1965, the year he came to Wharton, Peter H. Knutson has taught accounting to more than 6,000 graduate and undergraduate students and hundreds of executives. He has won six teaching awards, five of them since 1990, and a course he created in 1970, "Problems in Financial Reporting," has been one of the most popular elective courses ever taught in the MBA program.

Knutson, who is retiring this year, has also been witness to, and a participant in, profound changes within the accounting profession. In 1966, for example, Arthur Andersen & Co. hired its first woman from the MBA program. Today, Knutson estimates, more than half the people entering public accounting are women.

The profession in general has undergone an evolution that Knutson feels has been both positive and negative. In the 1960s and 70s, "accounting was like a gentleman's club where boorish behavior resulted in expulsion," he says. "Standards were very high. There were rules against aggressive competition. Firms didn't advertise and they didn't directly solicit clients."

Public accounting today is a business, partly the result of the application of U.S. antitrust laws that forced the American Institute of CPAs in the early 1980s to remove restrictions against direct competition for clients. That opened up the field to advertising, client solicitation and "certain practices which I feel are questionable, like 'opinion shopping,' where companies may switch from one auditor to another in order to get a report that will be 'acceptable' to the SEC," says Knutson. "It's like when my doctor tells me to lose weight. I would like to find another doctor who will tell me to grow taller instead ... About the only thing that the FTC kept was a prohibition against contingency fees.

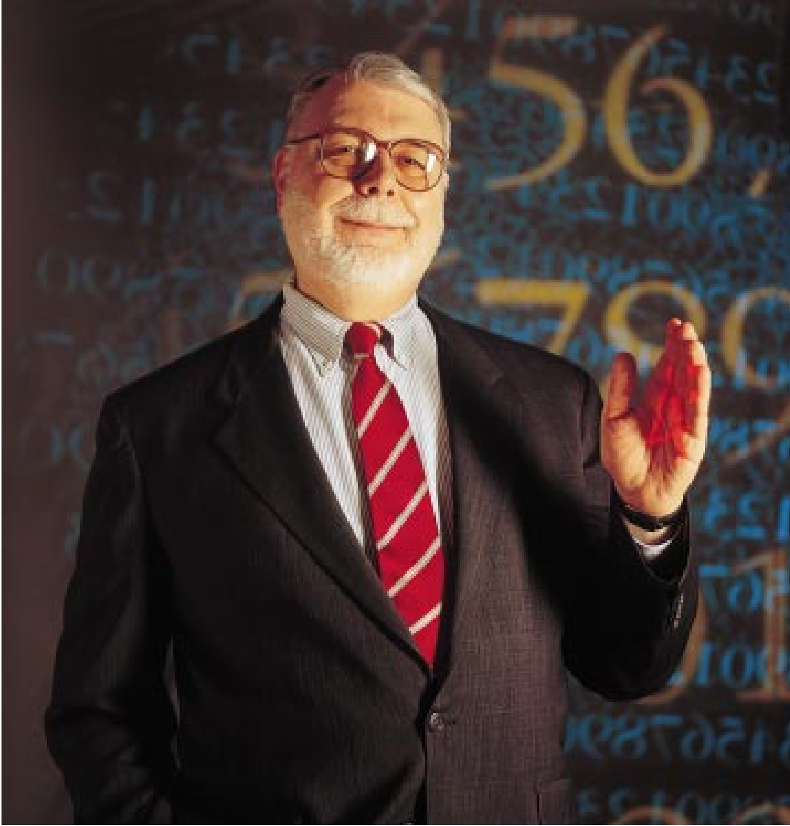
"I'm a believer in free markets but I think this trend has been very destructive to accounting, whose whole purpose has always been to act independently and objectively. The lawyer is expected to be an advocate and the physician is expected to defend the patient's interest, but the auditor is expected to serve the general public and attest to the fact that financial statement information is presented fairly and honestly."

Despite his criticisms, Knutson is quick to speak highly of accountants. "In my work with financial analysts, I am reminded that they place a very high value, and have a tremendous reliance, on the work of auditors. Sometimes those of us close to the profession tend to concentrate on its failures and forget that the vast majority of work is well done under what are becoming more and more difficult circumstances. Even opinion shopping is rare, mainly because the accounting profession has done a very good job combatting it."

If Knutson sounds a bit like a crusader, it's because he has spent his career teaching others how to best navigate through a field that has engaged him for more than four decades. He earned his BBA and MBA from the University of Wisconsin-Madison and his PhD from the University of Michigan. He worked as a staff accountant for Robert E. Wegner and Associates and for Arthur Andersen & Co. during the late 1950s and early 1960s. From 1976 to 1993, he consulted for CoreStates Financial Corp., and continues to consult for The Robert Morris Associates and the Arab National Bank in Saudi Arabia, among other clients.

He clearly views retirement as an opportunity to continue, if not increase, his professional activities. He is chair of the Financial Accounting Policy Committee of the Association for Investment Management and Research (AIMR), an organization of investment professionals, including financial analysts and portfolio managers. He is also a member of the steering committee on Earnings Per Share for the International Accounting Standards Committee (IASC). His professional responsibilities have taken him in the last few years to Australia, South Africa, Geneva, Great Britain, Tokyo and Saudi Arabia. This year, at least as of now, his itinerary will include Barcelona, London and Saudi Arabia.

In some ways, Knutson sees himself as the keeper of the flame — a strong believer in the role of his profession as the key repository of dependable, equal access information and a crucial part of the effort to provide a common international language of business. Below, he talks about recent developments in both the teaching and the practice of accounting.



> *"The only way markets can operate efficiently is with a surplus of information which all participants are equally able to obtain and use."*

On Changes in Accounting Models ...

"The accounting model used today was developed to fit primarily manufacturing or merchandising companies. If I sell a building I know when it has been sold and at what price. But today, much of the value added by business enterprises in the economies of the U.S., Canada and other developed nations comes from services: business services, personal services and financial services where physical assets, plants, inventories and the like have little importance. This means that traditional accounting-based performance measures have suffered severely reduced usefulness. For example, return on invested capital is not a very meaningful measure in a law firm or accounting firm, or even an investment advisory firm because so much of the capital is formed from human resources, inherently unmeasurable under current accounting precepts ...

The problems in accounting for service-type firms are epitomized by the methods of accounting that apply to computer software firms. The Financial Accounting Standards Board, which is charged with developing and maintaining generally accepted accounting principles (GAAP) in the U.S., sets standards for reporting the cost of computer software to be sold, leased or otherwise marketed. Its reasoning is in accord with traditional accounting thought, but its result is to place on the balance sheet as an asset an amount that depicts neither the value of the software nor the total cost of developing it. It applies accounting for assets more or less successfully to computer software development, but it gives unsatisfactory answers to the unique problem of a software vendor's continuing obligations to customers after installation ...

Meanwhile, analysts are increasingly confounded by the proliferation of new and exotic financial instruments, many of which do not now appear on balance sheets, or if they do, understate the potential for loss that they engender. For example, how can risks be assessed intelligently for a financial institution that is extensively arbitraged through contractual arrangements with multiple other financial institutions world - wide? Those risks are at least required to be disclosed but the disclosures are scattered through the financial statement notes and are completely understood only by relatively sophisticated and tenacious financial statement readers.

Or say I have a release from the SEC on disclosures about derivative financial instruments. How do we disclose that information to investors? Even quarterly reports fail because my risk position changes hourly or even minute by minute. How do we report sensibly so investors understand the type of risk their investment is taking?"

On Economic Value Added ...

"One of the big concepts today is economic value-added, which is a way of evaluating performance that says economic value is the present value of future cash flows. It asks to what extent we have created additional value by creating additional future cash flows.

An example of this would be a pharmaceutical company that undertakes research on drugs to combat a particular disease. The researchers are creating economic value as long as their discoveries are on the mark. Let's say they get a patentable drug. They have created future cash flows, but this doesn't show up on the financial statements; only the costs do.

Traditional accounting measures are not necessarily a good way to measure performance because much of what people have created doesn't hit the books until it actually results in cash inflows. Yet you want to reward people for creating value that is going to be realized in the future. If you don't, then managers won't feel encouraged to make long-term decisions.

I tell my MBA students that they will never earn more than while they are at Wharton because of the value being created during their two years in terms of future cash flows. It makes the distinction between income and cash flow: Their cash flow is clearly negative, but their income is very high because they are creating value by being here. Otherwise, why would they do it?"

PHOTOGRAPH / PETER OLSON

On Mandated Quarterly Reporting ...

"I'm very much in favor of quarterly reports, in part because the issue speaks to one of the reasons I teach accounting.

I am a firm believer that the only way markets can operate efficiently is with a surplus of information which all participants are equally able to obtain and use.

It's true that accounting measurements lose precision as the period covered becomes shorter. Quarterly seems to be about as quick as we can get financial statements together and still have them be sensible.

As for those who say quarterly reporting leads to 'short-termism' and puts the U.S. into an uncompetitive position vis-a-vis the rest of the world (where most reports are issued only semi-annually), some of that criticism is self-inflicted and has the same appeal as the child who kills his parents and then asks the court for mercy because he is an orphan. Much of the short-termism is actually generated by the reporting companies themselves, who put pressure on their pension managers for quarterly results.

A number of firms have in fact stopped sending quarterly reports to their shareholders. One such company recently told me that I could write them for a copy of Form 10-Q (the quarterly financial report required of all public companies by the SEC). I asked them to put me on a mailing list for it; they said they don't maintain a mailing list. So now I have to write a new letter every quarter and ask for a copy of this report. It's onerous."

On Teaching Accounting ...

While most of my emphasis in the classroom when I first came to Wharton was teaching students how to be accountants, today, at least on the MBA level, we are teaching people how to use financial statements. It's because our graduates expect to be decision makers, to take leadership roles, to make deals, and so forth. Financial statements are obviously a primary source of information for those activities.

On the undergraduate level, there have not been as many changes. To some extent we are constricted by the laws of the individual states which regulate accounting. In a move that could have a serious impact on our undergraduate program, many states are adopting laws requiring 150 hours of education beyond high school in order to become a CPA. That means at least five years of education, not four.

Beginning in 1965 and continuing into the 1970s, we did put in a fifth year program, a master's in accounting, designed to prepare students to be partners in public accounting firms. It couldn't compete because people didn't want to spend the extra time and money for that degree. But it was a wonderful program. In recent years, three and possibly four of the Big Six firms have been or are still managed worldwide by alumni of Wharton's undergraduate or five-year accounting program."

On International Accounting Standards ...

"U.S. companies report under U.S. standards and conform their foreign subsidiaries to U.S. standards as well. But if a U.S. investor or company buys an interest in a German or an Asian company, it first must learn that country's accounting system. It's sort of like me going to places where English isn't spoken. In many countries, you will find signs in the native language and in English. A lot of financial statements are done that way because companies whose securities are registered to trade on the exchanges in this country must reconcile their financial statements to U.S. GAAP.

But let's say I want to buy a private company in another country. I am probably going to make use of my investment bankers and accounting firms, who have people well qualified to advise me on the accounting standards in those countries. So there are networks set up. But think of all the work that takes. Now suppose we had one accounting language worldwide. All the translators would be out of business. That's really what it is, a translation problem. I've got to translate not only the language but accounting standards, and today it's done imperfectly.

> *"Analysts are increasingly confounded by the proliferation of new and exotic financial instruments, many of which do not now appear on balance sheets, or if they do, understate the potential for loss that they engender."*

The whole point is that accounting methods vary around the world. For example, Germany follows the principle of prudence, which in effect means that companies are allowed to manage their earnings. This is, they can use some surplus from the good times to offset the results of the bad. Companies will tell you they are doing worse than they are, so that later they can tell you they are doing better. German companies treat profits like squirrels treat acorns: They save them up for a cold winter.

But in the U.S. that isn't allowed. The standards are stricter. Good or bad, it's supposed to be reported when it happens.

What this means, for example, is that one year Daimler Benz will report a profit in the U.S. under U.S. standards, while it reports a loss in Germany. But even more importantly, in another year it will report a huge loss in the U.S. while reporting a profit in Germany, just because of the so-called secret reserves, or, as the former finance director of Daimler Benz called them, "the silent reserves."

Why is this a problem? Because the heart of analysis is comparison. If capital is going to move worldwide, I want to compare Daimler Benz to GM to Toyota. I also want to

be able to look across industries. If one company is depreciating over 10 years, and another over 20 and a third over 40, I don't have comparable information and I have to make adjustments.

The international Accounting Standards Committee (IASC), based in London, sets international standards which some countries choose to adopt because they don't have their own standard-setting body. However, no country is required to follow these standards. The U.S., for example, doesn't follow them because in some areas they don't meet minimum U.S. requirements. But U.S. standard setting is being coordinated with the IASC. For example, both bodies worked together closely on the earnings per share project in which I am involved.

The International Organization of Securities Commissioners (IOSCO) has told the IASC what it must do to have its standards accepted by the securities regulators. That includes revising and upgrading certain standards, eliminating some alternatives, setting up a benchmark in each area, and so forth. A key part of this initiative is establishing standards in areas where they have never before existed. One of these areas is earnings per share (EPS). It has been quite a challenge to produce a single standard out of diverse practices around the world. The exposure draft of the proposed IASC standard on EPS was released for comment in January 1996.

The IASC is in the process now of setting acceptable international standards. It's an excruciatingly slow process and probably won't be completed until the year 2000 or later. After all, you're covering the whole world."

On Information ...

"Markets operate on information. It's their life blood, and nobody should have information that others don't have. In the AIMR report, "Financial Reporting in the 1990s and Beyond," of which I am the principal author, we make it clear that we think all market participants should have the same information, and that as much information as possible should be broadly disseminated and made easily available to everyone.

An example is pension accounting. It is dependent on a variety of actuarial assumptions. The question is, should these be revealed or not? Some people say there is no reason to reveal them because the information is available directly from the company if needed, or it can be figured out.

Others, including myself, say, 'Tell the assumptions on which the information is based.' The idea is to make accounting 'transparent' so that you can see through the accounting into the underlying economics.

We had a recent case in a Financial Accounting Standards Board (FASB) proposal on accounting for stock compensation, where the idea was to put on the financial statements the cost to the company of employee stock options. Options of course are not without cost because if they have value to the executive and are used to compensate the managers, then logically they must have a cost to the firm.

The FASB proposed putting these costs on the financial statements, a move which industry — especially high-tech growth companies — bitterly contested. Bills were introduced in Congress both in support of the proposal and against it and even President Clinton got involved (and came out against the proposal). The FASB finally backed down but did require the information to be included in the notes section of the financial statement rather than on its bottom line.

That was all right to opponents of the FASB proposal because there is a belief among many that only one number on a financial statement counts, and that number is earnings per share. This is something I have spent my career teaching people is wrong. You have to look at and behind all the numbers and assess their validity and so forth. I compare people who look at only earnings per share to those young men who sit outside their fraternity house and yell numbers at women walking up Locust Walk. It's the same kind of ignorant behavior that mistakenly assumes that one number alone can capture an incredibly rich universe of information."

On Computing Power and Telecommunications ...

"Right now I can turn on my computer in the morning and see all the documents filed at the SEC. And because of advances in telecommunications, I can be in every world market in real time. Our financial markets are global, and our accounting standards are panting at full speed trying hard to catch up. They never will catch up because markets are always ahead of accounting standards.

Interestingly, computing power and telecommunications are taking us much more towards demand-driven rather than supply-driven markets of information. It used to be that if I watched TV, I had my choice of the three networks and public television. Then we started getting UHF stations and now cable. I have 53 channels at home to choose from. So if I don't like the networks I have other alternatives. Notice, however, that I am starting to pay for those alternatives.

I think we will go the same way with information. I can get stock quotes through any of the on-line services. I pay a monthly fee, but it's small. On the other hand, the figures are delayed 15 minutes. If I want real-time quotes, I have to pay a much higher fee. It may come to the point where users end up paying an increasing price for the information they get. At some point, it may no longer be the companies who pay, but the users who will pay for the level of assurance they are looking for. The problem is, who selects the assurers (auditors)? If the companies do, we will still have some of the same problems with independence we have today. But if the users start selecting the assurers, then independence becomes less of a problem. The assurers will become advocates of the users, which is the way it should be." *R.W.S.*

TAKING THE PLUNGE

MEET THREE COMPANIES STARTED WITHIN THE LAST THREE YEARS, LED BY WHARTON ALUMNI FROM THE LAST FOUR CLASSES

LEFT TO RIGHT: RAY MOSELEY, JAY COEN GILBERT, TOM AUSTIN, A CARDBOARD LARRY JOHNSON, BART HOULAHAN, GUY HARKLESS AND SETH BERGER (HOLDING THE BALL)

PHOTOGRAPH / JERRY MILLEVOI

AND 1 SCORES BIG:

SETH BERGER, WG'93; RAY MOSELEY, WG'92 ; TOM AUSTIN, W'93

"One reason our product sells so successfully is because we are not only *close* to our customers, we *are* our customers," says Seth Berger, WG'93, who is one of those entrepreneurs fortunate enough to be able to combine his passion with his business.

The passion is basketball, which he played at Penn as an undergraduate and still plays three days a week and on Saturdays. The business is AND 1, a basketball apparel company that racked up sales of $6 million in 1995 and projects $10 million in 1996.

The company's "trash" line of clothing — tee shirts, sweatshirts, shorts and hats, as well as off-the-court casual wear — is adorned with a company logo known as "The Player." Explains Berger: "He's the raceless, faceless embodiment of every basketball player. He's big, strong, fast, and has a mouth to go along with his game."

AND 1's products are in national retail outlets across the country, including Foot Locker, Champs and Foot Action, as well as regional outlets and small independents. Penn's basketball team converted to AND 1 in February. And Berger expects that within a year or two the company will be marketing "The Player" in video games, comic books, cartoons and toys.

The idea for AND 1 — a name that refers to a player who has made a basket and also gets one free throw because he has been fouled — came from Berger, childhood friend Jay Gilbert and Tom Austin, W'93, whom Berger met on the basketball court at Penn. The group spent an initial $30,000 to support themselves while they researched the market and then raised an additional $50,000 from friends and family to finance inventory.

"The most exciting part about our company is that we are learning as we go along," says Berger. "When we started, none of us had any retail or business experience. We have grown the company by bringing in very bright people who have backgrounds that are in some way applicable to what we are doing. But we haven't brought in anyone from industry."

It's an interesting strategy that seems to be working. AND 1, based in Wynnewood, Pa., has 12 full-time people and 30 sales reps around the country. Pro basketball players have worn AND 1 apparel on national TV, and the company has signed Larry Johnson of the Charlotte Hornets, to an endorsement contract. AND 1 ads have appeared in national magazines like *Sports Illustrated*, *Slam* and *The Source*, and on cable T.V.

"We have invested a lot in advertising and promotion and we hired six new people in the last six months," says Berger. "My feeling is the brands that survive are the ones that emphasize marketing." The company also has donated a minimum of five percent of its profits every year to educational and sports organizations.

Berger grew up in New York City and spent two years between college and graduate school in Washington D.C. as a legislative director for Harold Ford, Democrat from Tennessee. Moseley worked in investment banking at Smith Barney in California for three years

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PIX LINKS BROKERS TO BUYERS:

PHILIP WHARTON, WG'91, FRED ROSSI, WG'90

PHOTOGRAPH / ANTHONY WOOD

The inspiration for starting Property Information Exchange (PIX), Inc., says founder Philip Wharton, "was seeing the inefficiency in the investment property market. I was working at the time for The Yarmouth Group, which invests pension funds in real estate. Here was one example of a firm that had been out of the market, raised some new capital and wanted to change its investment strategy. It seemed that it should be easier and more efficient for someone with capital to find properties. I couldn't figure out why that service didn't exist."

WHARTON (LEFT) AND ROSSI

Now it does. Wharton, along with a former colleague at Yarmouth, started Property Information Exchange, Inc. (PIX) in February 1994. The company tracks the investment interests of hundreds of buyers nationally and internationally and connects them with investment properties listed for sale that match their criteria. PIX helps listing brokers present properties to buyers in the market and helps to screen properties for those buyers.

In lay terms, says Fred Rossi, one of the regional partners in PIX, "we are a dating service for investment grade properties. We match the property with the buyers and we charge a fee for the service as opposed to a commission, as a broker would. In addition, our investor clients pay an annual fee to access our information."

It works this way: "A Boston investor who is already on our system and who had received our monthly summary report of assets for sale called me recently and said he had just gotten a $60 million equity allocation for buying triple-net leased properties with a tenant credit rating of triple B or less," says Rossi. "Traditionally he has been a multifamily investor. So we changed his criteria and he can now access a different part of our database. A lot of brokers know about this investor but don't know he has these new funds to invest."

PIX has doubled in size during the last year, with more than 500 investor

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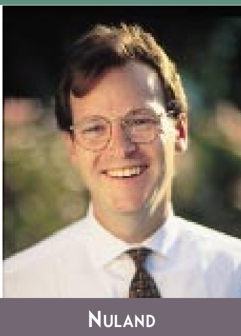

NULAND

IT'S PRIME TIME FOR AGC CHINA:

DREW NULAND, WG'92

After he graduated from Yale in 1986, Drew Nuland taught English to medical students in China's Hunan Province. At Wharton's Joseph H. Lauder Institute of Management and International Studies, he specialized in East Asian studies and Chinese. From 1992 to 1994, he was manager of new product development for the Shanghai office of Bristol-Myers Squibb.

Today he and a partner are starting up a broad-based entertainment initiative in Beijing that will focus on national syndication of TV shows, artist management, musical recordings and media brokerage.

The new business is called Avant-Garde Communications China, (AGC China) and it will include, in addition to the entertainment company in Beijing, a production company in Shanghai. It will be structured as a subsidiary of the family-owned Avant-Garde Communications Group (AGCG) in Los Angeles, whose chairman is Nuland's partner in AGC China.

AGCG already has a joint venture in Shanghai called SOSA TV, which currently offers a top-rated prime time weekly variety show called "Pacific Abroad" and a daily music magazine program on cable television in Shanghai.

Nuland's new venture will use the SOSA TV production team to start producing its own shows in Mandarin, to be aired towards the end of this year.

The idea of an entertainment company in China may sound risky to some, but Nuland, who grew up in Hamden, Conn., is optimistic. "We have learned over the past year how to be very careful," he says. "We stay away from subjects we know the government does not want broadcast, like any discussion of government relations, politics, military issues or conflicts between China and other countries. That is why we have developed entertainment-oriented shows."

Even that area isn't completely predictable, Nuland acknowledges. "China recently restricted the right to show two American singers - Madonna and Michael Jackson - on Chinese TV. Before we heard about the restriction, we included a Madonna video in one of our music magazine episodes. Within four minutes of its airing, we got calls from the government, the television station and some of our Chinese partners."

Those partners, he adds, are crucial to doing business in China. "You need very strong, very reliable long-term insiders who work with you," says Nuland, who speaks Mandarin and understands Shanghainese. "I couldn't do this on my own

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Managing Risk

In the past, when companies were burned by risky financial bets, many responded by taking the loss and perhaps making a few policy changes. Few companies, however, put formal policies in place to protect themselves from future downturns.

Learning from their past, and from the recent derivatives fiascoes, companies are now beginning to realize that hedging risk is possible — and perhaps vital — for surviving the increasingly complex 1990s.

Wharton faculty examine how companies are going about managing risk.

Are U.S. Companies Using Derivatives Responsibly?

A number of high-profile cases over the past year has shown companies getting burned by using derivatives for speculative purposes. But are most firms using these investments to make a killing in the market, or are they using them to hedge risk?

Researchers at Wharton's Weiss Center for International Financial Research, together with Chase Manhattan Bank, recently surveyed 530 firms to create a profile of the corporate derivative investor.

They found that over a third of the companies surveyed reported they use derivatives primarily to manage risk. More than 75 percent said they use them to hedge commitments, the majority doing so frequently. Only 40 percent use them to hedge the balance sheet. Of the 31 percent who use derivatives to hedge across markets, only a minority do so frequently. Of the 40 percent of the companies who use derivatives to "take a view" on the market (speculating on the direction of interest rates or foreign exchange movements), only 8.2 percent do so frequently.

Swaps are the derivatives used most often for interest-rate risk management (63 percent). Foreign exchange rate risks are most often managed with OTC forwards (49 percent), although swaps (22 percent) and OTC options (25 percent) are used frequently.

Almost a third of the large firms in the survey (market value more than $530 million) use derivatives, compared with 13 percent of small firms (market value less than $50 million). Commodity-based industries such as agriculture, refining, and mining are the highest users (50 percent), followed by manufacturing (40 percent), and public utilities (30 percent). Derivative use is least common in service industries (23 percent).

The researchers also asked the firms how concerned they were over several issues related to using derivatives. Accounting risk was the issue that received the most concern, with 26 percent expressing high concern and 37 percent expressing moderate concern. The firms were least concerned with the cost of derivatives or the transaction costs incurred when buying them.

Richard Marston and Gary Gorton, "Wharton Chase Survey of Derivative Usage Among U.S. Non-Financial Firms: Executive Summary," February 1995.

ILLUSTRATION / RANDY LYHUS

Characteristics of Firms Hedging with Derivatives

Many corporate decision-makers have realized that derivatives can serve a number of purposes — to hedge risks, lower borrowing costs, or engage in speculative trading for profit. But what types of firms are most likely to use derivatives?

Catherine Schrand, assistant professor of accounting, Christopher Geczy of the University of Chicago, and Bernadette Minton of Ohio State University examined the use of derivatives by Fortune 500 firms. They tested theories of optimal risk management to determine which types of these firms are more likely to use derivatives and why.

The researchers found that firm characteristics affect not only the company's decision to use derivatives, but also which types of derivatives it uses.

Firms with a combination of high-growth opportunities but limited access to external financing are most likely to use derivatives. Such a firm might not have the cash on-hand to jump into new investment opportunities and may be forced to borrow from banks, which is potentially more expensive. Maintaining an adequate stock of internal buffer funds for investment projects, then, is useful. Derivatives can be used to lower this cash-flow variation, increasing the chances that the firm will have money to invest in new projects. Firms with heavy research and development expenditures or companies with low liquidity are more likely to use derivatives for this purpose.

Firm characteristics affect managements' decisions as to which type of instrument they use. Highly-leveraged firms and those with tighter financial constraints are more likely to use interest rate derivative instruments, while those with high foreign income and lower debt-to-equity ratios are more likely to use currency derivatives.

Christopher Geczy, Bernadette Minton, and Catherine Schrand, "Why Firms Use Derivatives: Distinguishing Among Existing Theories," June 1995.

Coordinating Risk to Maximize Profits

Current models of risk management are generally concerned with explanations for the reduction of optimal total risk. Yet many firms may actually want to reduce some risks through active portfolio management while remaining exposed or seeking exposure to others, according to Catherine Schrand, assistant professor of accounting, and Haluk Unal, visiting professor of finance. By using derivatives or other investment and financing decisions, risk management activities can not only alter the level, but also the optimal allocation, of risk exposure within a firm's portfolio.

For instance, when a savings and loan (S&L) issues loans, it is simultaneously taking on some credit risk and some interest rate risk. These firms don't really know what's going to happen with interest rate risks and therefore use derivatives to reduce these risks. But S&Ls do have control over credit risk, because they can issue mortgages to those with better credit. By reducing that non-controllable interest rate risk to an optimal level, the S&Ls can increase their exposure to credit risk, the area in which they have greater expertise.

To identify "coordinated risk management within firms," Schrand and Unal examined 81 savings and loans which converted from a mutual form of ownership to a stock ownership structure during the period between 1984 and 1988. They found that the managers of the newly-converted S&Ls increased exposure to credit risk by taking on additional risky real estate projects. At the same time, they reduced interest rate risk by using both on-balance sheet techniques and derivative instruments. Together, these results support the notion of coordinated risk management.

Agency theory proposes that firms which are going public will maximize shareholder wealth by increasing total firm risk. Using their coordinated risk management model, the researchers found S&Ls followed this theory, but increased their risk by using the coordinated risk management approach.

Schrand and Unal concluded that institutions which anticipated greater growth capacity at the time of conversion not only better managed their on-balance sheet interest rate risk, but also used higher levels of derivatives. Managers of those institutions with greater interest-rate risk purchased fewer shares, on average, at conversion and continued to mismanage their interest-rate risk for a number of years

Continued on next page

The insurance industry's catastrophic losses from 1989 to 1992 were over $34 billion, more than the total previous 21 years. As a result, insurers and reinsurers are increasingly concerned about the impact of catastrophic losses from earthquakes, hurricanes, and windstorms on their surplus and ability to offer coverage in the future.

To examine this problem, the Wharton Risk Management and Decision Processes Center recently was awarded a two-year research grant to explore, in greater depth than any previous studies, the role of insurance and regulations in dealing with natural hazards. The study, funded by the National Science Foundation, will model behavior of firms to determine their probable future actions. Empirical studies will be undertaken through case studies, surveys, and interviews with key decision makers in insurance and reinsurance firms.

MANAGING RISK *Continued from page 25*

after conversion.

Catherine Schrand and Haluk Unal, "Hedging and Coordinated Risk Management: Evidence from Thrift Mutual-to-Stock Conversions," May 1995.

PRICING INSURANCE DERIVATIVES

In response to recent natural disasters, the Chicago Board of Trade introduced insurance futures to provide a hedge against catastrophic property insurance loss. The CBOT has created a loss-ratio index of a number of insurers, and divides those losses by the premiums collected over the same time period. Insurance firms can then buy catastrophe insurance futures to hedge their underwriting risks.

For example, an insurer could buy an option that the loss ratio will fall within the 40 percent to 60 percent spread. If losses fall within this spread, the insurer would exercise the option and then sell the contract at a profit, which would compensate the insurer for its underlying losses. If the ratio does not fall within this spread, the option is worthless.

The price of the futures contract at any given time reflects the market's expectation of the quarter's catastrophic loss in relation to the earned premiums for that quarter. The insurer gains from a long position if the settlement price is greater than the price at the inception date of the contract.

J. David Cummins, Harry J. Loman Professor of Insurance and Risk Management at Wharton, and Helyette Geman, a professor at ESSEC in France, examined the current models used to price CBOT's catastrophic insurance futures and created a new model which incorporates the unique features of these derivatives.

Since the CBOT's insurance futures are an accumulation of indices over a three month period, conventional option pricing models aren't completely applicable because they're meant for options that settle on the value of an index at a specific point in time. Cummins' model uses an Asian approach, where an option is exercised based on its average price over a specific period.

The researchers' model is also the first to incorporate jumps or catastrophes with an Asian approach to pricing. Instead of viewing these events as anomalies, or unaccountable events, their model incorporates small and large jumps in industry losses as a standard feature.

Cummins and Geman believe that these futures represent an attractive alternative to reinsurance. If their use grows, these derivatives may become a vital tool for insurers to manage catastrophic risk.

"The CBOT insurance futures and call spreads offer an important new example of risk securitization," the researchers said. "Maintenance of viable insurance markets for high-exposure losses such as property catastrophes and commercial liability is likely to become increasingly dependent on insurance derivatives."

J. David Cummins and Helyette Geman, "Pricing Catastrophe Insurance Futures and Call Spreads: An Arbitrage Approach," The Journal of Fixed Income, March 1995. ▼

AND 1 *Continued from page 22*

before joining AND 1 a year ago.

Right now, "the hardest part about running AND 1 is managing its growth," says Berger, who is getting married in June to Christelle Williams, W'89, a Reebok marketing rep. "We have to keep bringing smart people into the company, but also making sure that as a unit we work together. Finance has to know what marketing is doing and what sales is doing. There are a lot of days when you turn your head and say, 'Wait a minute. When did that happen?'"

Does he worry that AND 1 apparel will eventually lose its appeal in today's fickle marketplace? "Companies are hot and then they're not. I know that," Berger says. "So you've got to make sure that you are set up to survive those tough times because they do occur. We are a basketball company and basketball is the most popular sport in the country. As long as we understand our consumer, we'll be successful." ▼

PIX *Continued from page 23*

clients (20 percent of those international), listings for approximately 350 properties worth more than $2 billion, and hundreds of brokers who use PIX listings (for which they pay a marketing fee) to supplement their own information. Headquarters is in Manhattan, with regional offices in Boston, Miami (covering Latin America), Dallas, Chicago, Portland (Oregon) and London, and a joint venture in Buenos Aires. Mary Bechler, WG'89, works for the company as a marketing consultant.

Buyers are required to have a minimum of $10 million of capital available for real estate, or have closed a $1 million property. Most of the properties listed are in the range of $5 to $50 million.

The company is expanding on several fronts and recently initiated discussions with potential investors to help fund that growth. "We have become a distribution network for the investment business," says Wharton. "That means that clients are asking us to add on different products and services, including mortgages notes, corporate leaseback properties and so forth. Our challenge now is to prioritize these opportunities and not dilute our efforts."

PIX also has a website on the Internet. "We are encouraging investors, who generally aren't computer oriented, to access our information there," says Wharton. "The whole Internet phenomenon has been very good for small independent firms like us. It gives us a presence inexpensively and it's a way to send information around the world."

Starting PIX, he adds, "has been a roller coaster. You either like that or you don't. For the past two years I have been using every resource, trying to tap into every skill I've ever learned, calling everybody I've ever met. We're firing on all fronts." ▼

Research Wire

Below is a summary of several research projects recently completed by Wharton faculty.

Computers Pay Off for Workers Who Use Them

Computers and other technology have been blamed for the decline in human jobs and earnings, but a Wharton study has found that computers have a positive effect on salaries.

The study — by Peter Cappelli, professor of management and co-director of the Center for Human Resources, and Kermit Daniel, assistant professor of public policy and management — found that the more computer technology in an organization, the higher the human earnings. Further, even the use of computers by non-managers raises the earnings of supervisors, managers and technicians in the organization. Only part of these effects can be attributed to the higher skill levels needed to operate the equipment.

"Our results suggest that computer technology is not 'deskilling' production jobs, but rather 'upskilling' them," the authors write.

Peter Cappelli and Kermit Daniel: "Technology, Work Organization and the Structure of Wages"

Quality-Oriented Competitive Strategy

U.S. firms have long been criticized for relying exclusively on financial control systems that place too much emphasis on budgets and short-term profits. In contrast, others often argue that Japanese control systems are more closely aligned with long-term goals and strategies, thereby contributing to Japan's competitive success.

Using data from the automobile and computer industries in Canada, Germany, Japan and the U.S., Accounting Professors Christopher Ittner and David Larcker examined organizations that follow a quality-oriented competitive strategy to see whether quality action plans were being implemented as intended and whether long-term strategic quality goals were being achieved. Their study found that American and German organizations emphasizing quality in their strategic plans do tend to implement quality-oriented strategic control systems. However, Japanese manufacturers make greater use of these strategic control practices regardless of their strategic emphasis.

The authors also found that some practices, such as greater management involvement in selecting specific strategic action plans, are associated with higher performance in both industries. Other practices, such as providing overly-detailed long-term action plans in computer firms, can actually hinder performance.

Christopher D. Ittner and David F. Larcker: "Quality Strategy, Strategic Control Systems and Organizational Performance"

Labor Lessons and the Auto Industry

Management comes up with another great scheme to reorganize factory work, but how does it look to the rank-and-file?

Wharton researchers polled Chrysler workers at six plants that had moved to a Modern Operating Agreement (MOA) — a union-management system based on fewer job classifications, shop floor work teams, pay-for-skills compensation and extensive training. The survey of nearly 800 workers, carried out within three to five years of implementation, found that initial resistance and skepticism among workers had changed into a clear preference for certain aspects of the new work system. Work teams were supported more strongly by workers than the new pay plan or reduced job classifications. Younger, better-educated male workers were most likely to be positive about the new system.

The researchers also found that workers were more positive the more they had experienced the system's impact on their daily work activities.

John Paul MacDuffie, Larry Hunter and Lorna Doucet: "What Does Transformation Mean to Workers? The Effects of the 'New Industrial Relations' on Union Employees' Attitudes"

Pension Systems for Developing Countries

Worldwide population aging, combined with serious financial instability in national social security systems, make pension reform and redesign an urgent necessity, say researchers from Wharton's Pension Research Council.

In a recent paper, the researchers outlined the fundamental role that a well-designed pension system can play for developing countries. Such a system would be mandatory, maintain a tight link between benefits and contributions both at the individual and generational levels, invest contributions in a "sensibly internationally-diversified" portfolio, be fully funded, pay benefits only to the old, and pay out pensions as annuities rather than as lump sums.

The researchers suggest alternative forms that benefits should take, depending on a country's income, its tax and benefit system and its political/economic stability.

Olivia S. Mitchell and Gary S. Fields: "Designing Pension Systems for Developing Countries"

For copies of studies, contact Wharton's Office of Public Affairs at (215) 898-4853.