COOPER INDUSTRIES, INC

Nicholson File

Early in 1972 Nicholson File had to stave off a take over attempt by H.K. Porter Company Inc. which controlled 30.5% of the company's stock. Porter made a cash tender offer to stockholders. However, Porter did not get enough stock to take over Nicholson. In trying to fight the takeover Nicholson File made several merge overtures to other companies like VLN Corp. A few years back, it had rejected an offer from Cooper Industries.

Cooper Industries interest in Nicholson

Cooper was interested in Nicholson because of its competitive strength in the hand tools industry. Nicholson had a 50% share for files and wraps with a very strong brand name and high quality line. It also had a 9% share of the 200 million hand saws and saw blades market with excellent brand & quality. It had a very effective and large distribution system across US, Canada and overseas. Cooper industries believed that Nicholson can achieve 6% annual sales growth as also bring down the cost of goods sold from 69% to 65% and selling and administrative expenses from 22% to 19% , thereby increasing its profitability. Cooper would be able to use Nicholson’s distribution system to cross sell Cooper’s hand tool lines in the industrial and consumer markets.

Cooper anticipated that the Nicholson acquisition would lessen its earnings volatility and currently Nicholson is in the merger market to stave off the raid by H K Porter Company.

Valuation of Nicholson File (without merger)

Please see **Exhibit -1 and Exhibit -3** for details and assumptions

Assuming that Cooper will continue to have sales growth equal to 2 % with cost of goods sold at 69% of the net sales, its market price will stay in the ($19 to $27 range in 1972) and ($22 to $31 in 1976) because of the operating in-efficiencies and lower profit margins (3% to 4 %) as also the un-certain ownership situation. Its share price is therefore lower then its book-value.

Its EPS will range from $2 to $2.25 over the next five years. Nicholson File is getting a tax-rate of about 40%, lower than the 50% industry tax-rate because of investment tax credit and net income from partially owned foreign companies, especially in Europe.

Its stand-alone valuation as of 1972 will be $30.1 million and in 1976 will be $31.4 million on a book-value basis.

Valuation of Nicholson File as part of Cooper Industries

Please see **Exhibit – 2** for details and assumptions

Cooper Industries estimates that if Nicholson mergers with it, it will be able to move the EPS up to the $14 to $17 range, by bringing down the cost of goods sold to 65% from 69% of the net sales and selling expenses to 19% from 22%. This will increase the profit margin of Nicholson from 3% range to 10%.

Also, the Nicholson sales growth will increase form 2% to 6% because of synergies between the two companies and Nicholson will have access to both the industrial and consumer segment.

Its valuation will increase to $32 million in 1972 going up to $42 million in 1976.

Its share price under Cooper assumptions, on a stand-lone basis will go up to the ($73 to $89 in 1972) and ($96 to $117 in 1976). Its EPS under Cooper assumptions will be in the range of $5.27 to $6.88 from 1972 to 1976.

The synergies for a Nicholson and Cooper merger will increase the earnings for shareholders of both the companies, as they can cross-sell their products across a wider market at a higher margin, with reduced expenses.

Valuation of Cooper Industries (without merger)

Please see **Exhibit – 4, Exhibit – 6 and Exhibit - 7** for details and assumptions

Cooper industries is valued at $84 million in 1972, with sales growth of 6% and a tax-rate of 50%. Its profit margin is around 10% and the EPS will be from $2.61 to $3.56 in 1972 to 1976.

Its PE ratio is very volatile $9 to $18 in 1972 and because of the cyclical nature of some of its earnings component, its share price ($23 to $47 in 1972) and EPS fluctuates a lot. In 1971, the EPS came down to $1.11 because of a cyclical down-turn, from $2.73 in 1970. Exhibit – 7 shows the EPS trend for Cooper industries from 1967 to 1971.

Valuation of Cooper Industries after merger with Cooper Industries

Please see **Exhibit – 5, Exhibit - 6 and Exhibit – 7** for details and assumptions

Cooper is looking to assemble a strong presence in the non-powered hand tool industry to reduce this fluctuation in its earnings. Cooper sees Nicholson File as a good fit to its product line offerings and believes that it can leverage the international distribution of Nicholson to cross-sell the combined product offerings. Its previous mergers in the last three years have been successful and it has been able to keep the management of the merged entities on-board. Cooper believes it will be able to bring operating efficiencies to Nicholson and grow its sales by 6% from the current 2%.

Per exhibit 5, Valuation of Cooper after merger shows that the EPS will rise from $2.61 in 1972 to $3.52 in 1976. The PE will stabilize in the range of $14 to $17 from current $9 to $18. The share price in 1972 will be in the range of $37 to $44 and in 1976 from $59 to $60.
Its book value in 1972 will rise to $108.1 million. Its Net Income will rise to $14.1 million in 1972 after merger, in comparison to $11 million without merger.

Competing offers for Nicholson File

Nicholson File had received competing offer from VLN and the Nicholson management supported the VLN offer as it promised continued operating independence. VLN offered one VLN preferred stock for one Nicholson share with an annual dividend of $1.60. But H.K. Porter Company with about 30% Nicholson stock strongly opposed the VLN offer. Porter believed that the VLN stock has been under-performing, having reached as low as $4.625 recently will result in a value of $23 on the offered VLN preferred stock. Also, the $1.60 dividend was low in comparison to the Treasury bonds yield of 6.5%. As per Exhibit – 8 attached, the VLN offer had a support of only 22% of the share holders, in comparison to 35% for the Cooper offer. The VLN stock was not expected to show any significant growth in the near term. Secondly, VLN was a broadly diversified company with interests in publishing and automotive equipment. It does not offer any immediate cost-savings to the hand-tools company Nicholson, in contrast to Cooper. Based on these reasons, Porter supported the merger of Nicholson with Cooper.

Cooper Industries Merger Decision

Based on **Exhibit 5, Exhibit 6 and Exhibit 8** attached, Cooper should be willing to pay $50 per Nicholson's share.

Mr. Cizik should go ahead and acquire Nicholson File at $50 a share, valuing Nicholson File on a standalone basis at about book value of $30 million. He should issue 2.08 Cooper shares for 1 Nicholson File share with the current Cooper share price of $23, thereby issuing about 1.2 million Cooper shares to Nicholson shareholders for a 100% stock for stock exchange. This will make the merger a tax-free event for the shareholders of Nicholson, which was one of the conditions for HK Porter's president Tom Evans, for supporting the merger with Cooper. The addition of Nicholson Files' product lines to Cooper Industries offerings will provide stability to the earnings and enhance the Cooper brand.

As per **Exhibit 7**, Cooper Industries will continue to maintain its current upward earnings per share trend.

Nicholson File's Decision

Nicholson should also decide to go with Cooper Industries as its offer is much better then VLN offer. Cooper already controlled some Nicholson stock (29,000) and had the backing of H.K. Porter which owned 177,000 of Nicholson shares, as per exhibit 7 of the case. The synergies for a Nicholson and Cooper merger will increase the earnings for shareholders of both the companies, as they can cross-sell their products across a wider market at a higher margin, with reduced expenses. In the previous mergers, Cooper has kept the existing management and is planning to keep Nicholson's management on board, after the merger. This will free the Nicholson management to focus on stronger growth of its product lines, with a stronger balance sheet. The Nicholson shareholders, as per Exhibit 2 attached, will get a PE ratio of 14 to 17, from the current 10 to 14 range. The EPS will go up from $2.28 in 1971 to $5.72 in 1973, after the merger. Cooper offers a growth opportunity for Nicholson product lines and its offer at $50/share will attract the unaccounted shares and the shares owned by speculative. Cooper Industries already has the support of 206,000 (35%) shares and needs another 86,000 shares for a 50.1% majority needed as per Rhode Island merger law.

Per Exhibit 8 attached, Cooper will be able to get this 50.1% majority. Also, the Cooper stock trades on the New York Stock Exchange and will provide greater liquidity to the Nicholson shareholders. It will be in the best interests of the Nicholson Management to accept this friendly merger.