FAMILY BUSINESS

"The alchemy was in leverage."

William Stokely III controlled about 20 percent of Stokely–Van Camp. His great-grandmother and her sons founded the business in 1898. Subsequently his father and then his cousin headed it. The business was started in eastern Tennessee, to grow and can local produce for sale, mainly in the Southeast. In 1933 the company moved its headquarters to Indianapolis after the acquisition of Van Camp's and added the Van Camp name to reflect the business combination. The company, however, remained the Stokely family business. In 1981, at the age of forty-one, Bill Stokely III became the chairman and chief executive officer. The company's products represented three generational innovations: canned foods, frozen foods, and Gatorade. And there was a young William Stokely IV, which told volumes about the family pride and character and its hope for further business development.

I always thought of the company in terms of shades of green, which suggested renewal. From the drab olive of the boiled beans

to the electric, almost Day-Glo virescence of Gatorade, the character of the green intensified in each new product. And like the depth of the green, the family commitment to the business also seemed to have strengthened as the stewardship was handed down. Few families in America pass anything along to third and fourth generations and have it respected enough to be preserved and treated like a trust.

Bill Stokely III was short and compact, built to last. Without pretense, he maintained the company's headquarters in an old Indianapolis warehouse building, close to operations, watching costs. Running the company wasn't all duty or bean counting. There was a twinkle in Bill, who had found life-enhancing opportunities in the business. Gatorade required resourceful marketing, which one year justified the company's supporting a car in the Indianapolis 500, the most important sporting event in the city. Thereafter Stokely sponsored a car on the Nascar circuit to increase Gatorade's exposure. Making the company marketing-oriented, Bill also became knowledgeable about dieting and exercise trends, necessary information for him to capture market share for Gatorade. Being sensitive to youthful aspirations, he shared them, which dispelled the stodginess that often seems to come with middle age and running a large business.

In starting the company, the great-grandmother and her sons had controlled it. Over time the company sold stock to finance its growth. In 1935 the company began to trade publicly, and thereafter public ownership became broad enough to list and trade the company's stock on the New York Stock Exchange, evidencing the firm's success. That attainment bore with it a disturbing vulnerability. Bill Stokely's ownership, while substantial, wasn't enough to preclude anybody from buying a controlling stock interest in the open market or making a bid to acquire the whole company.

The company was the last independent, publicly traded canning and food-processing company in the United States. All the others had been folded into larger companies, objects of the conglomeration and consolidation of American industry. Inevitably, Stokely would be acquired. The signs were already there: City Investing, a huge conglomerate, had acquired over 5 percent of the common stock and had publicly filed documents indicating that it might be

interested in acquiring control. The company had fought off those advances, paying greenmail, by repurchasing City Investing interest in its stock at a premium price. Another company, called Minas Basin, a private company located in Nova Scotia, had crossed the 5 percent stock-ownership threshold and continued to buy stock with the hope of forcing the company to swap canning assets held in Canada for the recently purchased common stock.

The holders of large blocks of stock were outside agitators for sale of the company. Whether Minas Basin or another would move to acquire the company was unknown, but each incursion put up a "For Sale" sign for the company without its permission. Every time the trading volume in the company's stock rose, new questions stirred as to its fate. It was an uncomfortable position for the management and more so for Bill Stokely. Running the business was part of his birthright, and the thought of losing it was devastating. As a reflective man, there was no limit to the amount of time that he could spend contemplating the possible loss of the company. As a practical man, he sought a sensible answer.

It was the public ownership of about 80 percent of the company stock that took away his ability to control his destiny. The solution to his difficulties had to lie in repurchasing the public stock, but the amount required was well beyond his individual capacity. The money would have to come from the company itself, which meant a leveraged buyout. Once he fixed on the idea, and worked it through, it was captivating. The more he talked about buying the company, the more real it became.

In November 1982, Bill Stokely engaged Goldman Sachs and Wachtell Lipton to consider the possible buyout. We flew out to Indianapolis on a Sunday morning to meet with him in a hotel room so that our activities wouldn't alarm the employees or cause a leak. Most of the morning was productive and we worked through lunch, eating sandwiches in the room. In the afternoon, he turned on the football games to get the scores, and as the camera panned to the benches, he proudly pointed out the Gatorade containers prominently available to all the players.

"The boys have been doing their job," he said, referring to his marketing staff. "We supply it free. Seeing the players drink it is

the best advertising." Once the games were on, it was impossible to resume the meeting.

What emerged from the meeting was the idea that in a leveraged buyout Bill Stokely could wind up controlling 50 percent of the company and still realize in cash more than the full current market value of his stock interest. To recite the conclusion was not fully to appreciate it. The result sounded specious, like having your cake and eating it too. To think about it in concrete terms and prove the result, you had to do some simple arithmetic. Bill controlled about 565,000 shares out of the 2.7 million outstanding. The current market price of the stock was $40. If he sold all the shares, he'd realize $22.6 million. That was a lot of money, but selling everything was contrary to his dynastic intentions. He sought to end up in the same position as his great-grandmother and then his grandfather, controlling the company. How, then, could he get more than $22.6 million and own 50 percent when he'd started out by owning only 20 percent?

The alchemy was in leverage. In a leveraged buyout, about 90 percent of the money used to buy the company is borrowed money, and the remaining 10 percent is equity. If Bill Stokely already controlled 20 percent of the company, then he held a sufficient number of shares to supply twice the equity needed. One-quarter of his shares, representing 5 percent of the current ownership of the outstanding shares, would supply half of the equity needed in a leveraged buyout. Accordingly, the other three-quarters, or the 15 percent interest, would be available to be cashed out along with the public shares.

These percentages translated into dollars in the following way: In his contemplated transaction he assumed that he would initially offer $50 a share and be prepared to pay up to $55 a share, for an aggregate cost of about $155 million for all shares, including expenses and the repayment of certain indebtedness of the company. About $15 million would be needed for the equity. At $55, Bill Stokely's 565,000 shares were worth over $31 million, and if he deposited $7.5 million in shares (for half the $15 million equity), he would have more than $23 million in cash remaining. If the banks were prepared to lend $125 million and the insurance com-

panies provided $15 million as subordinated lenders, the deal would work without a hitch, and he would have cash amounting to more than the current market value of his holdings and still own half the company.

Indeed, the arithmetic showed that no matter how much Bill paid for the company, he was always in a position where one-quarter of his stock would purchase 50 percent of the equity and the other three-quarters would be cashed out. The limit on him and the management was in their ability to pay back the debt from the earnings of the business measured against the risk of bankruptcy. The banks and the insurance companies would carefully review the assessment, of course, and set limits on what could be borrowed.

At the end of our meeting that Sunday, we asked if the company plane was available, hoping to avoid the inconvenient commercial flight schedule, and Bill Stokely offered us the use of the aircraft. It was a propeller plane, which made it economical, he told us, and it was very airworthy. Then, as he adjusted his glasses, he informed us that a month earlier the pilot had forgotten to put the wheels down at the point of landing and had ripped off a piece from the bottom of the plane before he realized the error, but the pilot was still able to pull the plane up and get the landing gear down. This incident was supposed to illustrate the plane's safety. Rather than inconvenience the pilots on a Sunday, we chose to go home commercially. On the ride back, we all acknowledged that Bill was gracious and the story about the pilot's blunder well timed.

Single-mindedly, Bill pursued the buyout. The purchase price for the company had to be high enough to discourage others but not so high that it left the company unable to grow. Estimates of debt costs at varying interest rates were made and then matched against projections of income over five- and ten-year periods. From those calculations, all the judgments would be made. The question that had to be addressed in estimating future income was how much could you reduce overhead, if you were a private company rather than a public company. Although Bill Stokely was careful about costs, there was always more that could be done. Was he prepared to run the operations on a leaner basis and cut down on capital costs for a few years? Was he prepared to close down some marginally performing businesses and dispense with all the perquisites

that usually come with managing (rather than owning) a public company? In that regard, was he prepared, for example, to eliminate the corporate aircraft? To answer those questions required a hard look at the way the company was being operated.

The analysis sounds dryly mathematical, a variant of cost accounting, but it isn't. A new psychology is required, free from the hindrances of emotional predilections. If competition developed for the purchase of the company, the buyers would be prepared to make radical cuts in direct and indirect overhead. It's difficult to assume the point of view of outsiders, for they are relentless and indifferent to the pain inflicted. Even so, it was possible intellectually for Bill to make the assessment, although he may not have been prepared emotionally to implement all conceivable cuts in expenses. On the emotional side, there's always the desire to leave some cushion so that the stresses of leverage can be absorbed.

Before undertaking the buyout, Bill Stokely had to be reasonably sure that he could win. Looking at various models for purchasing the company, it was fair to conclude that he had an edge over anyone trying to buy the company on the basis of the company's own earnings and assets. His advantage was that he owned a significant amount of stock and could afford to pay more than a full price because he didn't need a high return on his investment. Financial buyers like KKR and others aggressively doing leveraged buyouts in the last few years would recognize his advantage. Reasonably, then, he needn't expect competition from them.

What about corporate conglomerates interested in a new business opportunity? Could he compete against them? The simple answer was that no one had approached him or any of his board members about buying the company. That said a lot, but not everything. If Bill Stokely offered to buy the company, and the price he offered was deemed to be fair, then the company was for sale at any higher price. There were probably some companies that would like to buy the company but weren't prepared to make an offer unless invited. If the company was for sale, those buyers might step forward. There was no way of knowing the extent of the interest, and the risk was significant. Could a corporate buyer pay more? Of course. The corporate buyer could borrow against its own assets as well as those of the company to support a higher price. But the answer wasn't

conclusive. Another question had to be asked. If the buyer significantly leveraged to effect the sale, what would it earn? The $55 price would require all the cash flow of the company, more than the current earnings, to service the debt and would be detrimental to the earnings of the corporate buyer, unless the buyer was very large. Most corporations, committed to reporting consistently higher earnings each quarter, would find the acquisition cost unattractive.

That analysis was comforting, but again it wasn't the final answer for Bill. There was a class of corporate buyer that might be interested anyway, despite the lack of earnings necessary to support the high price that the company would command—namely, strategic buyers, companies that needed or wanted the assets of Stokely–Van Camp because they would extend their product base, or companies currently not in the business but who regarded it as related or as a good business into which to expand. Were there any? Probably, but not many. Would any come forward? That was the most difficult question and everything hinged on it. The answer was that it was possible, but not likely, because there was a potent deterrent on Bill Stokely's side: his name was on the door. It wasn't as if he were buying it as a stranger, some Johnny-come-lately who could see that there was a profit to be made here. There had to be enough honor left in the business community to respect the legitimacy of family business interests, to treat the business as if it weren't for sale to the highest bidder. I believed that sentiment in favor of family businesses existed—especially in the Midwest, where the most likely bidders would be based. The Stokely family name and continuing management should dissuade people from raiding the company. That was a warm feeling. Those kinds of impressions, however, never fully dissipate the chill of risk.

Fifty dollars a share was chosen as the starting price, leaving the ability to raise by $5.00. The trading room was to put Bill Stokely in a position to satisfy any demands of the independent directors for more money. It was inevitable that they would seek a price higher than the one first offered in order to fulfill their role of representing the interests of the public shareholders. That kind of accommodation had to be taken into account in the initial pricing, and there was room to go to $55. To initiate the process, Bill

Stokely announced the buyout at the end of November 1982. The work of the committee of independent directors assessing the fairness of the offer would span about three weeks, and it was anticipated that after three or four weeks the committee would report to the board that the price wasn't satisfactory and the negotiation would begin. The committee hired its own independent investment banker, Dillon, Read & Co., and regular company counsel, Lord, Day & Lord, acted as the counsel for the independent directors.

To our surprise, before the committee rendered its report, Central Soya (a midwestern food-processing company) called Bill Stokely and told him that they were interested in acquiring the company at $55 a share. That was the first indication that outside third parties would step into the process. From the way Central Soya's proposal was voiced, however, it aimed to do a friendly transaction: it wouldn't publicly state its interest if the bid was opposed by the management. Since Bill Stokely was prepared to offer $55, Central Soya's bid would be matched, and it wasn't considered a contender. After the initial surprise, Central Soya's approach was a comfort. It confirmed that the pricing was reasonable and that there was a reluctance on the part of third parties to try to break up the family-sponsored buyout.

Bill Stokely raised the offering price to $55, and at the end of January 1983 the committee of independent directors, acting on the advice of its adviser, endorsed it as fair. Then Goldman Sachs began its work of putting together the financing for the transaction, which would take between thirty and sixty days. Thereafter, the buyout would be presented to the stockholders for their approval, which required an additional thirty days. During that period, the company was in its most vulnerable position. Any new proposal from any source at a higher price couldn't be ignored. The only way to counter a higher price was to find more money to top it. While Bill Stokely could possibly stretch to $60, anything more put the company at great financial risk in the event of a downturn in the economy.

The first indication that Central Soya wasn't the only interested party came from increased activity in the Stokely stock at the end of February and the beginning of March 1983, while financing was being arranged. The rising trading volume meant that somebody

was accumulating stock, buying on rising prices to induce more sellers into the marketplace. It was like hearing the pounding of hooves without being able to see the horse or rider. Finally, Esmark, a Chicago-based conglomerate, filed a schedule with the SEC publicly stating that it owned over 6 percent of the shares of Stokely (168,000 shares purchased at prices ranging from $53 to $55) and that it was considering acquiring Stokely. Goldman Sachs then got a call from Esmark Corporation—from the chairman himself, Don Kelly.

Kelly wanted to talk, and we met with him and his chief financial officer in Chicago, knowing that it wasn't going to be a pleasant session. It was an afternoon meeting, but Bill Stokely looked like it was well past midnight. He'd had a sleepless night and was tense. Kelly tried to treat the meeting as a routine event, but he didn't relax any more than Stokely. Kelly was a rotund, fastidious man who had alert eyes and looked like he spent most of his time searching for deals. Bill Stokely's tenseness made Kelly guarded, and he seemed to choose his words carefully. He took some time to put on a show about having the economic muscle to buy the company, which meant that something else was on his mind. Fairly soon, however, he got to the point. Nothing about Stokely fit into the immediate thrust of Esmark's businesses, but Kelly saw that there was growth potential in the marketing of Gatorade. He liked the company, he said, and he didn't want to lose his investment to the management when they bought the company. With those words he introduced the idea of his becoming a partner.

Kelly was an able businessman who saw an opportunity that he felt entitled to explore. After a tense start, his performance had been adept and efficient, although as the meeting wore on, he again appeared to become unsettled. Insinuating oneself into the middle of a transaction wasn't novel, but it was something tried only in the last few years. Kelly's midwestern sensibility hadn't deterred him, but it may have contributed to his discomfort. His proposal was met with a frigid stare from Bill Stokely. In response, Kelly drummed his fingers on the conference-room table and said, "We can play hardball or softball. It's up to you." His face flushed with anger as his fingers continued to beat on the table, filling the silence.

"We've heard the hardball," Bill finally said. "What's the softball?"

"No, no," Kelly responded. "That's the softball. The hardball is I buy the company or I sell my position to somebody else who will buy it." His fingers relaxed now that he'd fully articulated his position. "We'd like to be friends," he said. "We want to be co-investors. That's the softball."

None of the choices was pleasant. No one had thought of Kelly as a partner, particularly in this case where all the partners had been hand-selected. The limited few that were to participate were Bill Stokely himself, the operating management, and certain financial institutions. But Bill Stokely was defenseless, and there was no choice except to negotiate. At that moment Bill was put in the position of trading an interest in his heritage, something few of us have experienced. To remain in the room took a strong stomach and a sure sense of what's important.

"What percentage are you looking for?" Bill asked.

Kelly didn't hesitate: "Twenty-five percent."

That was a large interest: it would force a significant reallocation, even cause some participants to be dropped, since Bill Stokely wanted to hold control, more so now, if Kelly's company, Esmark, would be participating.

"Something less would be easier to deal with," Bill said. Now that he was fully involved, the strain seemed to have eased.

"I'm firm," Kelly responded.

"I can see that," Bill said without humor. He paused, and before committing himself, said, "I'd like you to invest $15 million in subordinated debt of the company." It was a bold move on Bill's part. Subordinated debt, the financing junior to the bank loans (later known as junk bonds), usually came from insurance companies at that time. If Kelly furnished the money, Stokely could get it on better terms than customary since Kelly wasn't a pure lender and would take into account his equity return in determining the rate on the debt.

"You're increasing my commitment," Kelly said.

"That helps get the deal done," Bill said. Kelly nodded, indicating he would furnish the additional funds. They then talked

about the terms of the subordinated debt and reached an agreement satisfactory to Bill. Before everything was settled, Bill said, "I assume you'll agree not to buy any more shares. And not sell your shares to anyone else."

Kelly said, "I can't agree to all of that. I won't buy, but I have to be free to sell my shares if someone makes a tender offer."

"Then you have an option," Bill said, disturbed. Kelly was positioned to take the benefit of the deal if he wanted it or sell out at a higher price to someone else if a hostile bid was made.

"That's what I want," Kelly said flatly. He knew the power of his position, and exercised it. "There probably won't be another bid," Kelly added.

"What do we get?" Bill asked, more for the sake of embarrassing Kelly than as an inquiry.

"You get . . ." Kelly began, and then stopped, his eyes hardening. He pursed his lips, choosing his words carefully. "You probably get us as a partner."

Kelly wouldn't budge, and Bill agreed to the terms. When the meeting was over, Bill shook hands with his new partner, giving no hint of distress. Like all good businessmen, he curbed his personal feelings.

Once the deal was cut with Don Kelly, we all thought we saw the finish line. We prepared definitive financing arrangements, including those required with Kelly. Just about the time we cleared our disclosure material with the SEC and were about to sign with the banks, Don Kelly balked at requirements set by the banks that Esmark not sell its shares in Stokely until the bank debt was more than half paid down. Kelly wanted Esmark to have complete control over its investment. Neither the banks nor Kelly would change their position. Kelly had Esmark withdraw as an investor in the buyout. The withdrawal occurred at the beginning of May, two months after the original handshake with Bill Stokely. While Kelly stated publicly that he would support the buyout, he qualified his support by adding: as long as it continued to be the highest-priced alternative. The failure to bring Kelly along cost a month, the time it took to find substitute financing with an insurance company. Finally, at the beginning of June, a shareholder meeting was set

for July: the buyout would get done about nine months after it had first started.

Again the finish line was in sight. But in the third week of June, Pillsbury contacted Stokely about making an offer to acquire the company. Bill met with William Spoor, Pillsbury's chief executive officer. Spoor indicated that Pillsbury was prepared to pay $62 a share. Nothing Bill Stokely said could dissuade him. That meeting wasn't the last word. Bill Stokely's arguments were taken up at the Pillsbury board meeting by John Whitehead, then co-chief executive officer (along with John Weinberg) of Goldman Sachs. He was on the board of directors of Pillsbury and came to a regular meeting to find on the agenda the proposed takeover of Stokely–Van Camp. Before that meeting they had never hinted to him of the contemplated takeover.

Because of his firm's involvement in the buyout of Stokely, Whitehead was told that he wouldn't be permitted to participate in the Pillsbury board's consideration of the proposed tender offer. He objected, and the board gave him an opportunity to be heard at the outset of the meeting. An articulate and polished speaker, Whitehead told the board that even if his firm wasn't representing Stokely, he'd have objected to this takeover. As a matter of principle, he was opposed to hostile takeovers. In this case, the Stokely family involvement in the business counseled against any hostile interference with a reasonable transaction. The Pillsbury board, largely Midwesterners, listened politely, asked no questions, and dismissed him when he was finished. Then they met without him.

In the Pillsbury board's view, Stokely had been put up for sale and was underpriced. Gatorade was the attraction for Pillsbury, a high-profit-margin product that could benefit from its marketing expertise and access to shelf space in the supermarkets. Why shouldn't Pillsbury bid and give the Stokely shareholders a reasonable alternative? Considered from a market perspective, it would be wrong for them not to bid and take the opportunity for Pillsbury's shareholders. In their view the offer wasn't hostile or even uninvited, since the company was for sale. And so, if there had ever been an exception for family transactions, it was overridden. A free market admits to no impediments.

Immediately after the board meeting the tender offer was announced, assuring speed and surprise. The swift action freed John Whitehead from the totally uncomfortable position of knowing about an imminent takeover affecting a client that, as a matter of law, he couldn't talk about. In the disclosure of the tender, Pillsbury was careful to state that Esmark, formerly part of the Stokely buyout group, had sold out to Pillsbury for $62.

No one on Bill Stokely's team had ever contemplated paying $62 per share. The question for Bill Stokely was whether he could compete with Pillsbury's price. What number would best Pillsbury? Obviously, Pillsbury had more in its pocket. Pillsbury probably could bid as much as $65 or even $68. The next plateau was $70. Could the company pay $70 for itself? The decision wasn't Bill Stokely's alone. The banks would have to go along with him and so would the insurance companies. He'd have to show unequivocally that the company could service the additional debt, which, for a $15 per share increase, amounted to a raise of approximately $45 million, of which $40 million would be additional debt. The management recomputed the financial information assuming various purchase-price levels. Everyone was eager to find a clear path to competing. What they found was that the company couldn't bear as much as $60 from its own resources. The lenders wouldn't lend more and the management didn't feel comfortable taking on the risks. Bill Stokely had to acknowledge that he'd been outbid.

We had a short meeting at our offices to consider alternatives. There was no basis for attempting to remain independent, because the Stokely board of directors had already concluded that the company should be sold and that $55 was a fair price. All the board could do was seek a higher price. Bill Stokely understood the position of the board. No one said anything to him about having to sell, however, leaving him to utter the words. He was entitled to speak first. His compact shoulders heaved as he bore the weight of the decision and its consequences. "Okay, let's sell it," he said. "That's the only alternative." With that, he turned to Goldman Sachs and told them to see if they could find a higher bid. The best buyer was now someone that, like Pillsbury, was looking for a chance to extend its product base. Such a company would have its own management and wouldn't retain Bill Stokely.

Goldman Sachs and Bill Stokely held an auction, and Quaker Oats was the high bidder at $77. Ira Harris, the Chicago-based deal maker for Salomon Brothers, had done most of the preparatory work of convincing Quaker to step in after the announcement of the Pillsbury tender. When Goldman Sachs called, Quaker was ready to discuss price, prepared by Ira Harris to make a preemptive bid that would discourage all other players. Once Pillsbury made a hostile tender, Harris knew that Stokely would seek the highest price. On Quaker's announcement of $77, Pillsbury withdrew its bid, acknowledging defeat.

The $77 price, startling when compared with the $55 price originally found fair, engendered public criticism of the Stokely insiders. They were charged in national business and legal publications with trying to take the company from the public shareholders at a low price. The charge was made without understanding that the company wasn't being purchased by Bill Stokely and the management to be resold for a profit and without appreciating that bootstrap acquisition prices are limited. Nevertheless, the sale of Stokely came to be accepted into common wisdom as showing that management buyouts take advantage of inside information and that enormous profits are made by the groups that buy out companies. At the same time Stokely proved the contrary: that it isn't possible to buy a company at a bargain price, since someone will always take it away from the bargain hunter. It took another three years to find a structure that resolved the contradictions. But after Stokely, no one could have any illusions about the values of the marketplace.