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HARMAN INTERNATIONAL AND KKR (B)

On September 21, 2007, it turned bitterly cold by the afternoon. Sidney Harman, his top executives, and Harman International's legal counsel huddled in an offices at Bear Stearns, the company's financial advisor, awaiting word from Kohlberg Kravis Roberts & Co. L.P. (KKR) about the status of the proposed $8 billion private equity transaction between the two companies. The phone finally rang. KKR's lawyers conveyed to the Harman International team that the private equity firm was terminating the deal. KKR indicated that it believed a material adverse change (MAC) had occurred in Harman International's business, thereby negating the private equity firm's obligation to pay a $225 million termination fee. Harman International responded in a press release later that day, stating that it "disagrees that a material adverse change has occurred or that it has breached the merger agreement."[1] The damage, however, was done. Harman International shares plunged 24%, closing at $85, and a full 29% below the deal's $120 per share purchase price (**Exhibit 1**).

MAC Provision

A *material adverse change* provision was often included in merger agreements to give the acquirer an opportunity to withdrawal from a deal if the targeted company experiences a specific adverse event. In general, MACs were difficult to prove in court. For example, in a case involving the agricultural firms IBP and Tyson, the conclusion reached by the court was that a firm had to "prove there has been an endemic and sustained decline in the business. Short-term blips don't do it."[2]

The agreement between KKR and Harman International stated that KKR could not terminate the deal for events "generally affecting the consumer, or professional audio, automotive audio, information, entertainment or infotainment industries, or the economy or the

[1] Harman International (NYSE: HAR) press release, September 21, 2007.
[2] Dennis K. Berman and Dana Cimilluca, "KKR, Goldman Cancel $8 Billion Harman Deal," *Wall Street Journal*, September 22–23, 2007.

This case was prepared by Daren Dickerson (MBA '09) and Associate Professor of Business Administration and Associate Dean, MBA for Executives Paul Simko. It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation. Copyright © 2010 by the University of Virginia Darden School Foundation, Charlottesville, VA. All rights reserved. *To order copies, send an e-mail to* sales@dardenbusinesspublishing.com. *No part of this publication may be reproduced, stored in a retrieval system, used in a spreadsheet, or transmitted in any form or by any means—electronic, mechanical, photocopying, recording, or otherwise—without the permission of the Darden School Foundation.* ◊

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financial, credit or securities market."[3] This effectively ruled out the deteriorating credit market during 2007 as a reason to kill the deal; however, various news outlets reported that Harman International's worsening financial performance and, in particular, its capital spending beyond the limits stated in the merger agreement were at the root of the MAC assertion.

The capital spending at Harman International eventually became an intriguing case of semantics. Fearful of new private equity owners, a Harman International business unit based in Germany spent approximately $60 million during the last month of fiscal year 2007 (ended June 30). These payments contributed to Harman International's full year capital spending overrun of $25 million—$175 million actual results versus a forecast of $150 million made just three months earlier. According to KKR, this plan overrun was in violation of the merger agreement. Harman International countered that the word *plan* did not appear in the merger agreement; rather, the operative word in the agreement's covenants was *budget*. Harman International's board of directors had approved a $175 million capital expenditure budget at the beginning of the fiscal year.

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Revised Forecast

While the company was contemplating legal action against KKR, Harman International and Dinesh Paliwal, Harman International's new high-energy CEO, resumed running the public company. A week after the merger termination was announced to the public, on September 24, 2007, Harman International issued a second press release providing financial guidance for fiscal 2008.[4] The press release forcefully stated that "Harman International is a sound company with exceptional market position and strong future prospects. It is important for investors and our other constituents to be reminded of this, particularly in light of last Friday's decision by our former merger partners."[5]

The financial guidance contained in the press release disappointed analysts—the estimated operating income for fiscal 2008 was well below the forecasts provided to KKR during the merger negotiations. Although the company cited increases in research and development costs to support several new infotainment platforms and associated launch costs as primary drivers of the lower forecast, this did little to mitigate ongoing concerns.

Termination Fee

On the surface, it appeared that KKR and its financial partners had little leverage regarding the $225 million termination fee, a substantial sum even for Wall Street titans. For its part, Harman International had to assess the financial costs, negative publicity, and management

[3] David Cho, "$8 Billion Buyout of D.C. Firm Collapses," *Washington Post*, September 24, 2007.
[4] Carol J. Loomis, "An Old Hand in a Strange New World," *Fortune*, January 23, 2008.
[5] Harman International (NYSE: HAR) press release, September 24, 2007.

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distraction of a potentially lengthy court battle over the termination fee. Some estimates were in the range of $50 million to $70 million for legal and investment banking fees during such litigation.

On October 22, 2007, the legal drama abruptly ended when KKR and its partners agreed to invest in Harman International in lieu of litigation and payment of the fee. The investment was $400 million in the form of 1.25% senior notes, convertible into Harman International common stock at $104 per share. The proceeds were used by Harman International to repurchase common stock through the company's accelerated share repurchase (ASR) program.[6]

Harman International also announced in its press release that a managing member of KKR would join Harman International's board of directors. Henry Kravis, co-founding member of KKR, maintained that the investment and representation on the board was "an outstanding way to support Harman and its management team in the future."[7]

The New Harman International

Harman International's future success was largely dependent on a new management team inheriting a business with declining profit margins. Not surprisingly, in February 2008 the company announced disappointing second-quarter earnings. Contributing to these results were major retail price pressure in the market for portable navigation devices (PNDs), an unfavorable product mix, and higher engineering and material costs during a period of critical product launches for automotive customers. Paliwal conceded that the company "grossly underestimated" the resources needed for 13 new automotive infotainment launches in 2008 and 2009, compared to only 4 during the 2005 through 2007 period.[8]

In response to mounting pressure to improve financial results while executing its new product commitments, the management team commenced a restructuring program to optimize Harman International's manufacturing, engineering, and sourcing. Essentially, it was time to migrate much of the company's cost structure from high-cost countries such as Germany and the United States to low-cost countries such as China and India. The restructuring program was led by Paliwal and a redesigned management team in close consultation with the company's board.

Corporate governance, too, had undergone major changes. The board expanded to nine members in an effort to bring new expertise and global expertise to the company. Five board members arrived after July 2007 (**Exhibit 2**). Notably the board still included a member of KKR, keeping a watchful eye on the private equity firm's investment. There were also noticeable

[6] An ASR was a means for a public company to repurchase their shares from an investment bank utilizing a forward contract. This allowed the company to reduce its shares outstanding upon entering the forward contract, which has the effect of increasing shareholder value.

[7] Harman International (NYSE: HAR) press release, October 22, 2007.

[8] Harman International (NYSE: HAR) press release, February 5, 2008.

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