Kerkorian vs: Chrysler: How Much Cash is Too Much?*

"This is not just a rainy day fund. When you live in a monsoon climate like the auto industry, you don't put away cash on the chance that someday it might rain. It will rain. You plan for it."

-Chrysler Chairman Robert J. Eaton

Background

On April 1, 1995, Kirk Kerkorian made an unsolicited $20 billion bid to take-over the Chrysler Corporation. One of the key factors in this effort was the extraordinary $7.5 billion cash reserve Chrysler had built up during the economic expansion of the early 1990s. Chrysler management had taken the position that it needed this reserve to weather the next recession; Kerkorian (the single biggest holder of Chrysler stock at around 10 percent) argued that this cash should be returned to the shareholders.

The mid-1990s saw a number of companies, especially those in cyclical industries, such as autos, paper, chemicals, airlines, banks, and securities, build up large cash reserves. Table 1 shows the position of nine large firms each holding multi-billion dollar reserves, representing in some cases 30 to 50 percent of the entire market value of the company. These cash reserves naturally generated a great deal of concern on the part of shareholders, who increasingly argued that the cash should be returned to them in some fashion rather than simply sit idle earning low rates of return. Michael Price, for one example, threatened to use his 6 percent share in Chase Manhattan Corp. to break it up unless its executives used its huge cash reserves more effectively.

Companies lucky or successful enough to generate significant cash holdings have essentially three options. One is to return the cash to the shareholders, either by increasing dividends or by buying back stock. Another option is to invest in productive assets, either within existing product lines or by diversifying. Finally, the company can simply hold the cash (typically at rates of return around 3 percent) as a hedge against future events. In Chrysler's case the future event of note was a recession expected in several years.

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* This case was developed for classroom use by Steven Pinado and Kevin Thatcher of Salomon Brothers, Inc. and Professor Stephen G. Powell of the Amos Tuck School of Business Administration, Dartmouth College.

The conflict between Kerkorian and Chrysler management centered on the question of what the company should do with its growing cash holdings. Chrysler took the position that the purpose of the reserve was to provide cash during the coming recession, so the firm would not have to sell assets or slow R&D spending during the downturn. Kerkorian argued that $7.5 billion was far too much for this purpose, and that the company could always borrow what it needed during a recession. The conflict thus became focused on the question: how much cash is enough for Chrysler to hold for the next recession?

Chrysler's Position

In 1995, the Chrysler Corporation was riding the crest of a wave of unprecedented success. It was widely acknowledged to be the most efficient of the Big Three auto makers, with an operating profit per vehicle of $2,100, nearly three times that of Ford and GM. It had the shortest product development cycle in the domestic industry; it had an innovative cab-forward design; it had a small car (the Neon) to rival the Japanese; it invented the minivan phenomenon; its Jeeps had created the sport-utility market. The only weak point in the company's current position was a low quality rating by current owners. Turning that problem around would take lots of capital investment. Chrysler would have to find that capital at the same time it needed to continue investing billions in new product development. Further complicating its planning, the current economic expansion had already run for five years, and a recession was widely expected within a year or two.

Chrysler's experience during the last recession, in 1990-1991, gave it cause for extreme caution. In just one year's time the company consumed nearly $5 billion to weather that downturn (see Table 2 for details), and its then-chairman, Lee Iacocca, was reported to be desperately attempting to convince the Italian auto maker Fiat to buy the company. Fortunately he failed, and Chrysler rebounded dramatically starting in 1992. (A ten-year summary of Chrysler's financial history is attached.)

Kerkorian's Position

Kirk Kerkorian was born in 1918 in Fresno, California to an Armenian immigrant father. He got his start in business after World War II, flying gamblers to Las Vegas. Now 77, he is the owner of the MGM Grand Hotel Casino and Theme Park in Las Vegas and a major investor.

Kerkorian's business career suggests that he is more a dealer than a manager. He sold his Las Vegas airline (Trans-International) once, bought it back a year later, took it public and sold it again. Next came an unfriendly tender offer for Western Airlines, then the purchase of the Flamingo Hotel in Las Vegas. He built the International Hotel in Las Vegas, then made a tender offer for Metro-Golden-Mayer, Inc. Eventually he would dismantle MGM, selling it to Ted Turner for $1.5 billion, then repurchasing United Artists for $800 million. Four years later he sold UA for $1.3 billion. In recent years, his attention has turned from Hollywood to Las Vegas.

Kerkorian's interest in Chrysler began in 1990, when he started to invest in the company during some of its darkest days. He paid $272 million for 22 million shares (roughly 9 percent of the company's shares) or around $12 a share. In 1994, the stock reached a peak of $60 per share.

The idea of a Chrysler buyout seems to have originated with Gary Wilson, co-chairman of Northwest Airlines. Observing that the stock was down and the company had cash reserves of nearly $7 billion, he proposed in October 1994 that Chrysler management take the company private. In November, he asked Lee Iaccoca and Kerkorian to put their shares behind the plan. In December 1994, Chrysler responded to Kerkorian's urgings by increasing its dividend 60 percent and initiating a $1 billion stock buyback. These actions seem to have dampened enthusiasm for the takeover plan. During the first quarter of 1995, with cash continuing to build and the stock still depressed, Kerkorian held a series of meetings with Chrysler management. Then on April 11 he unexpectedly announced a $20.5 billion bid for the company, in the form of an offer to pay $55 per share. He did not have the necessary financing lined up but planned to use $5.5 billion of Chrysler's own cash, $3 billion of his own money, and $12 billion from investors to be named later.

In the ensuing days, the Chrysler directors met in emergency session to deal with the crisis. On April 24, they categorically rejected Kerkorian's bid. This came shortly after Bear Sterns, Kerkorian's investment banker, decided not to participate in the deal. Since that time the offer has lain dormant, with Kerkorian unable to raise the financing but not formally withdrawing the hostile offer. Kerkorian has continued his activist shareholder ways, pushing for increased dividends and share repurchases.

As always during merger and acquisition frenzies, debate has raged over whether such hostile actions are in the interests of the companies involved or their shareholders. One theory was advanced by Alan Schwartz, a Yale Law and Management School professor. His position, which is a version of the free cash-flow theory, is that leveraged buyouts make investors and companies better off without injuring line workers. This theory rests on several observations: first, that many companies should have more debt than they do because interest on debt is tax deductible; second, substantial debt also ensures that managers will work hard to pay off the debt and hold onto their jobs, while large cash reserves tempt them to invest in bad projects; third, while increased debt does increase the risk of financial distress, this is an unlikely problem for Chrysler with its $7.5 billion in cash; and finally, large cash reserves allow inept managers to protect their jobs during a downturn, rather than find more efficient ways to run the company.

Assignment

In the midst of this hostile takeover attempt on Kerkorian's part, Chrysler turned to Salomon Brothers, Inc. to help determine the amount of cash balance it should hold in the current circumstances. The principals involved were Kevin Thatcher (Director, Financial Strategy Group, Domestic Corporate Finance) and Steven Pinado (Associate, Domestic Corporate Finance; Tuck '94). Kevin and Steve built a model that was ultimately adopted by Chrysler. They have since used the same type of model to help several other companies determine a defensible level of cash to hold for economic downturns. Your task is to address the same question Kevin and Steve faced: how much cash is sufficient for Chrysler to hold for the next recession? In carrying out this assignment you should put yourself in the position of

Kevin and Steve in the spring of 1995 and only use information that they could have had at that time.

Table 1
Companies with Large Cash Reserves

Company	Cash after Debt ($ Billions)	Cash as % Market Value
Ford	6.2	22%
Chrysler	5.0	30
Intel	3.5	9
United Healthcare	2.3	33
Mellon Bank	1.5	25
Apple Computer	1.1	25
General Dynamics	1.0	35
Paccar	0.54	34
Destec Energy	0.35	59

Source: *Wall Street Journal*, April 20, 1995

Table 2
Chrysler's Actions During 1990-1991 Recession

Cash and securities on hand June 30, 1989	$3.4 Billion
Stock offerings	+1.2
Auburn Hills debt offering	+1.1
Sale of Gulfstream Aerospace	+0.8
Sale of shares of Mitsubishi	+0.8
Cash and securities on hand March 31, 1992	+2.6
Net cash consumed during recession	-4.7

Note: Normal working capital requirements determine a minimum desired cash balance at any time of $2.0 Billion.

Source: *New York Times*, April 20, 1995

	Ten-Year Summary (Unaudited)						
In millions of dollars							
except per-share data in dollars							
		1993	1992	1991	1990	1989*	1988*
Operating Data:							
Motor vehicles sold (in thousands)		2,476	2,175	1,866	1,984	2,382	2,567
Sales of manufactured products	$	41,247	33,409	26,707	26,965	31,039	30,790
Interest expense	$	369	437	481	449	400	414
Maintenance and repairs	$	851	693	540	545	635	593
Other taxes	$	714	634	495	489	547	552
Research and development	$	1,230	1,053	955	908	958	866
Depreciation	$	853	802	667	644	628	581
Amortization of special tools	$	671	641	644	617	620	540
Provision (credit) for income taxes	$	1,423	429	(272)	79	242	612
Earnings (loss) from continuing operations before							
cumulative effect of changes in accounting principles	$	2,415	505	(538)	68	323	1,009
Per Primary common share	$	6.77	1.47	(2.22)	0.30	1.39	4.48
Net earnings (loss)	$	(2,551)	723	(795)	68	359	1,050
Per primary common share	$	(7.62)	2.21	(3.28)	0.30	1.55	4.66
Average shares outstanding (in thousands)		345,097	295,900	242,561	223,657	232,335	225,112
Common stock dividends declared	$	228	176	145	269	277	224
Per share	$	0.65	0.60	0.60	1.20	1.20	1.00
Net earnings (loss) as a percent of sales		(6.2)%	2.2%	(3.0)%	0.3%	1.2%	3.4%
Expenditures for facilities other than special tools	$	1,738	1,374	1,482	1,034	937	1,079
Expenditures for special tools	$	1,234	872	708	663	651	557
Financial Position-Year End:							
Current assets	$	8,485	6,777	5,763	6,685	6,963	7,103
Current liabilities	$	10,995	8,948	8,694	7,283	7,096	7,485
Working capital	$	(2,510)	(2,171)	(2,931)	(598)	(133)	(382)
Current ration		0.77	0.76	0.66	0.92	0.98	0.95
Net property, plant, equipment and tooling	$	12,275	10,993	9,924	8,900	8,663	8,569
Total assets	$	34,020	27,644	25,544	24,521	23,631	22,230
Long-term debt	$	2,281	3,643	3,672	3,944	2,965	3,329
Shareholders' equity	$	6,836	7,538	6,109	6,849	7,233	7,582
Shares of common stock outstanding (in thousands)		353,728	295,892	291,957	224,356	222,633	232,735
Number of shareholders		144,883	202,502	213,447	221,442	218,806	205,807
The selected data presented reflect the operations of Chrysler Corporation with its investments in CPC and Car Rental Operations							
on an equity basis and should be read in conjunction with the consolidated financial statements of Chrysler							
*Restated to include the effect of discontinued operations.							

1987*	1986*	1985*	1984
2,260	2,198	2,157	2,034
25,381	21,937	21,025	19,573
325	282	158	132
657	671	538	475
478	441	427	382
775	691	590	452
456	230	261	272
412	307	213	283
862	904	715	44
1,254	1,383	1,620	1,489
5.74	6.22	6.20	5.20
1,290	1,389	1,610	2,373
5.90	6.25	6.16	8.37
218,612	222,324	261,426	278,643
219	176	116	105
1.00	0.80	0.44	0.38
5.1%	6.3%	7.7%	12.1%
1,264	1,305	1,036	800
655	749	492	447
5,702	5,043	4,952	3,980
6,525	5,005	4,496	4,116
(823)	38	456	(136)
0.87	1.01	1.10	0.97
8,202	6,017	4,537	3,713
19,745	14,253	12,154	9,039
3,333	2,334	2,366	760
6,503	5,281	4,166	3,282
220,778	216,043	226,531	273,312
193,054	132,422	131,999	151,298