

Part II

Background and evidence

3 The merger situation and the companies involved

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Introduction

3.1. This chapter deals with the events surrounding the agreement between Cendant and the company then named RACL for the former to acquire RACMS and describes the parties principally involved, which are Cendant, Green Flag (Cendant's subsidiary providing insured breakdown services in the UK) and RACMS, which provides insured breakdown services in the UK under the RAC brand. The chapter also deals with the financial performance of Green Flag and RACMS, the financial position of Cendant and the financial rationale for the merger.

Events leading up to the referral of the proposed merger

3.2. The following paragraphs deal briefly with the history of The Royal Automobile Club up to the announcement of a proposal to sell RACMS, which was contained in a letter dated 27 March 1998 from the then Chairman of the Club to its life members and full members, and the subsequent events that occurred relating to the agreement with Cendant to buy RACMS and the restructuring of the Club.

The Royal Automobile Club and connected companies up to 27 March 1998

3.3. The Royal Automobile Club was founded in 1897 when a pioneer group of early motor enthusiasts formed 'a society for the protection, encouragement and development of automobilism'. Uniformed patrols were introduced in 1901 and their role developed to one of attending to members who had broken down at the roadside with a view to either repairing the vehicle or towing it to suitable facilities.

3.4. The Club has several classes of members including life members and full members. Only life members and full members can vote at general meetings. Subscribers to the RAC branded motoring services are often referred to as 'members of the RAC' and indeed the Club has given leave for them to be called 'associate members of the RAC'. However, a person who subscribes to these services does not thereby become a member of the Club. In this report we adopt the commonly used terminology by referring to those who subscribe to or benefit from motoring services provided by any breakdown organization as members of that organization, whatever the precise contractual relationship may be.

3.5. In March 1998 the Club was owned and managed by a company then named The Royal Automobile Club Limited (RACL) (a company limited by guarantee). Membership of RACL was restricted by its Articles of Association to life members and full members of the Club. Under the Club rules, the board of directors of RACL formed the Club committee.

3.6. RACL, through its subsidiaries and other affiliated bodies, was involved in various activities for the benefit of members of the Club. These activities fell into four broad categories:

- (a) running the main clubhouse at Pall Mall in London and a golf and country clubhouse at Woodcote Park, near Epsom in Surrey;
- (b) playing a role in the development of public policy on matters related to motoring—for example, road-building projects, the taxation of cars and the impact of cars on the environment;
- (c) having responsibility for the administration of motor sports in the UK. The RAC Motor Sports Association issues competition licences to drivers, organizes events such as car rallies and veteran car runs and awards trophies (for example, for the land speed record); and
- (d) providing insured breakdown and related services. Further details regarding this activity, carried out by RACMS, are given in paragraphs 3.43 to 3.46.

3.7. At the end of 1995, the board of RACL appointed a new Chief Executive of RACMS and gave him the task of improving the performance of RACMS's businesses. RACMS was prevented by its Articles of Association from distributing its profits and was primarily funded by retained surpluses. These were considered unlikely to be adequate in the long term to provide the investment needed to offer a high-quality service aimed at the future needs of motorists. After careful analysis of its core market, insured breakdown services, RACMS developed a five-year strategic plan designed to reverse a decline in financial performance and market share and to focus on mobility and associated technology (see paragraphs 3.49 to 3.53). The strategic plan was kept under regular review.

Subsequent events

3.8. On 27 March 1998, without any prior consultation with or the authorization of the remainder of the board, the Chairman of the Club and of RACL wrote a letter to the life members and full members of the Club proposing that RACMS be sold, the proceeds of sale to be distributed among those members (approximately 12,000 individuals).

3.9. In spite of the precipitate and unorthodox way in which a proposal to sell RACMS was made public, which in fact resulted in the dismissal of the Chairman, the suggestion, once made, clearly had the support of a large number of members of RACL. As a result the remainder of the board decided to hold an auction for the business in April 1998, with a deadline for bids of 5 May 1998.

3.10. The auction process attracted six serious potential acquirers of the business comprising three trade and three financial buyers. It emerged from this process that Cendant, a US company incorporated in Delaware, was prepared to pay the highest price for the business and was the preferred candidate of the board of RACMS. Cendant already owned Green Flag, the third largest provider of insured breakdown services in the UK.

3.11. On 1 May 1998 RACL and Cendant announced that they had entered into exclusive negotiations regarding the sale of RACMS to Cendant at an agreed price of £450 million. Cendant entered into a period of due diligence investigations into the affairs of RACMS. Following the favourable outcome of this process, the executive board of Cendant approved the acquisition at a board meeting on 19 May and the recommended offer of £450 million for RACMS was announced on 21 May.

3.12. In order to be able to dispose of RACMS, RACL had first to address two significant legal issues:

- (a) The first was to clarify precisely who was ultimately entitled to the benefit of the proceeds of the sale. RACL's view (based, *inter alia*, on its Memorandum and Articles of Association) was that the benefit belonged to the members of RACL, namely the life members and full members of the Club, and not, for example, to overseas members, widows of members, former members or members of RACMS (ie those who subscribed to the RAC brand motoring services). This view was subsequently upheld by the High Court. However, RACMS told us that subsequently commenced legal actions were outstanding in California and the UK and further legal action was also being taken in the UK by certain overseas members.
- (b) The second issue was the need to reorganize the structure of the RAC group so as to facilitate the sale of RACMS whilst mitigating the tax effects.

The proposed merger

3.13. On 21 May 1998 RACL, RACMS, RAC Holdings, RAC Acquisitions (an unlimited company) and Cendant reached an agreement for Cendant to acquire control of RACMS. The agreement envisaged the transaction being in two stages:

- (a) First stage: the RAC group would be reorganized so that the ultimate holding company of RACL, and hence of RACMS, would be RAC Holdings, which had been formed for the purpose. The Club subsidiaries, which operated the clubhouses in Pall Mall and Woodcote Park, would become subsidiaries of a new Club holding company.
- (b) Second stage: the shares in RAC Holdings would be sold to Cendant.

3.14. The first stage is complete. RAC Holdings is the ultimate holding company, through an intermediate holding company (RAC Acquisitions, an unlimited company), of RACL which remains the parent company of RACMS. RACL was initially renamed RAC Limited and is now an unlimited company named RAC. The Memorandum and Articles of Association of RACMS have also been amended by the deletion of the former prohibition on distributing its profits. Those individuals who were members of RACL on 8 July 1998 were shortly afterwards issued with two shares each in RAC Holdings and their membership of RACL has ceased. The former Club subsidiaries of RACL have become subsidiaries of a new company now named The Royal Automobile Club Limited. The members of that new company are the current life members and full members of the Club.

3.15. As envisaged by the sale agreement, the members of RAC Holdings on 12 August 1998 passed a special resolution (by an overwhelming majority) approving a proposed scheme of arrangement, under section 425 of the Companies Act 1985, providing for the entire share capital of RAC Holdings to be transferred to Cendant for a consideration of £416.3 million. The shareholders would

have the option of receiving cash or loan notes (either guaranteed or unguaranteed) equivalent to their share of the consideration. The guaranteed loan notes would be guaranteed for at least 364 days. The unguaranteed loan notes would attract a slightly higher rate of interest. The principal object of the loan note options is to mitigate the tax liability of the shareholders.

3.16. The scheme of arrangement is subject to satisfactory clearance by the competition authorities and the final approval of the High Court. If there is satisfactory clearance by the competition authorities (and the other conditions remain satisfied) and it is approved by the High Court, Cendant would be bound by the scheme. The scheme would also be binding on all the shareholders of RAC Holdings. Cendant told us that court approval would not be sought until the outcome of our inquiry was known but was not expected to give rise to any difficulty. There is no provision in the sale agreement for either party to withdraw unless there is a breach of condition.

3.17. Under the terms of the agreement, as well as paying £416 million to acquire RAC Holdings, Cendant would pay £17 million to the new company named The Royal Automobile Club Limited and £13 million to a charity known as The Royal Automobile Club Foundation for Motoring and the Environment Limited. According to a circular sent to the shareholders of RAC Holdings it is expected that the balance of the purchase consideration (around £4 million) would be accounted for by a bonus of around £1,000 per person paid to the staff of RACMS, RAC Motor Sports Association and the Club. Three members of RACMS's senior management would be eligible to receive discretionary bonuses costing around £570,000 in total. Interest accrues to the purchase consideration from 16 September 1998.

3.18. Under the terms of an option agreement dated 21 May 1998, Cendant has the right to acquire RACMS from RACL until 21 April 1999 in certain circumstances, for example if an application for the scheme to be approved is not made to the court by a specified date, the court refuses to approve the scheme or there is a change of control of RACL or RAC Holdings. In the former two cases, before it can exercise its option, Cendant has to make an offer to buy the RAC Holdings shares. The option then becomes exercisable only if the offer does not become unconditional. A sale by RACL to Cendant under the option agreement would deprive the RAC Holdings shareholders of the tax advantages of disposing of RACMS by selling their own shares to Cendant under the main agreement.

3.19. On 24 September 1998 the Secretary of State for Trade and Industry referred the proposed merger to the MMC for investigation under the terms of the Fair Trading Act 1973.

Cendant

3.20. Cendant is a major US company. For the year ended 31 December 1997 it had sales from continuing operations of roughly \$4.2 billion (£2.5 billion) and underlying profits before tax (ie excluding exceptional and extraordinary items and the results of discontinued businesses) of around \$1 billion (£600 million).¹ At the year end it had approximately 34,000 employees. As at 30 November 1998 it had a market capitalization of around \$16 billion.

3.21. Cendant came into being following the merger of two quoted US companies, HFS and CUC, in December 1997. Both HFS and CUC had themselves grown significantly through acquisition. Until 1998 the activities of Cendant were primarily confined to North America. Shortly after the merger, Cendant discovered significant accounting irregularities, which had inflated the apparent profitability of most of the CUC business units. These irregularities and the implications following their discovery are considered in detail in paragraphs 3.85 to 3.121.

¹These sales and profit figures are as restated following the investigation into the accounting irregularities discovered at Cendant: see paragraphs 3.86 to 3.93.

Brand management (the HFS businesses)

3.22. Cendant's businesses derived from HFS are primarily involved in owning and managing a portfolio of consumer brands in the property, travel services and hotel industries and provide additional services relating to those brands (for example, mortgage lending and relocation services). HFS was formed in 1990 by Henry Silverman (Chairman, President and Chief Executive Officer of Cendant) via a leveraged buyout of the Howard Johnson and Ramada hotel franchises in the USA. HFS obtained a listing on the New York Stock Exchange in December 1992.

3.23. Brands owned by Cendant include Century 21, Coldwell Banker and ERA (estate agencies); Avis (car rental); Ramada, Howard Johnson, Wingate Inn, Travelodge, Days Inn, Knights Inn, Super 8 and Villager Lodge (hotels); and Jackson Hewitt (income tax preparation). All of these businesses are operated by franchisees. Cendant's role is to award franchises, support the franchisees and promote and develop the brand.

3.24. Cendant also owns the world's largest provider of timeshare holiday exchanges and time-share services, Resort Condominiums International (RCI), and the world's largest corporate relocation business, and is the ninth largest originator of mortgage loans in the USA (the mortgage loans, once arranged, are generally securitized and/or sold). Through PHH it owns the largest vehicle fleet management companies in the UK, Germany and Canada and the second largest in the USA.

3.25. As HFS diversified beyond its original core base in the hotel industry it was able to cross-sell its services to consumers in a wider range of industries. The increased scope to do this was the principal business logic behind the merger with CUC.

Alliance marketing (the CUC businesses)

3.26. The Cendant business primarily derived from CUC is termed alliance marketing. CUC was formed in 1973 and became a listed company on the New York Stock Exchange in 1983. The alliance marketing operation is organized into three segments—individual, insurance/wholesale and lifestyle.

3.27. The individual membership segment directly markets services and products to more than 33 million members of different programmes. Membership programmes include dining, home shopping, travel and home improvement services. Members are recruited through joint marketing initiatives targeted at credit card customers of major retailers, oil companies and financial institutions. Cendant acts as an intermediary between suppliers and customers (to whom it provides freephone telephone numbers) in a way that enhances the product offering (for example, by providing an extension to a warranty) or provides a discount to the consumer. This division also runs AutoVantage, a motorists' club with over 4 million members.

3.28. The insurance/wholesale segment markets packages of programmes providing benefits to customers of banks and credit companies. These benefits typically include free accidental death insurance, products from the individual membership division and cheque account enhancement facilities (for example, a nationwide cheque encashment service). A monthly fee is charged for the package.

3.29. The lifestyle segment is concerned with providing products that are designed to enhance customer purchasing power. For example, its largest segment, Entertainment Publications, assembles and markets books of discount vouchers (typically offering two for the price of one) which are distributed in specific geographic locations. The vouchers can be redeemed by the purchaser at local outlets such as restaurants, hotels, theatres and sporting events. The books are primarily sold through schools and community groups in fund-raising projects, but are also given away as employee or customer benefits.

3.30. Two key features of the alliance marketing business are, first, the provision by Cendant of an enhanced product offering or discounted price through the co-operation of primary suppliers; and

secondly the ability to use sophisticated computer techniques for analysing and sorting customer databases (sometimes referred to as data mining) in order to sell Cendant's different membership programmes in the most effective manner possible.

Cendant in the UK

3.31. In 1997 HFS acquired PHH, which has vehicle fleet management operations in the UK as described in paragraph 3.24. In January 1998 Cendant acquired Harpur, another of the principal vehicle fleet management companies in the UK, which is also involved in the provision of fuel cards under the Overdrive and Dial-a-Card businesses. Some of Cendant's other brands (such as Century 21 and RCI) are also represented in the UK.

3.32. However, Cendant was looking for a significant acquisition in the UK as part of its plan to enter the European market and apply its core skills in brand management and alliance marketing in a new geographical area. In April 1998 Cendant took that step when it acquired NPC for approximately \$1.6 billion (£1 billion).

3.33. NPC owns National Car Parks, which is the largest private car park operator in the UK with some 500 locations. According to Cendant the attractions of this business to Cendant were the fact that it operated in the travel industry, it had a potentially useful database of customers and it also had a substantial property portfolio, which could be developed or sold over time.

3.34. NPC also owned Green Flag, which it had acquired in 1984. Green Flag was of considerable interest to Cendant, partly because of Cendant's ownership of a similar business, AutoVantage, in the USA (see paragraph 3.27) and partly because of Green Flag's database of members who could be targeted to cross-sell Cendant's other products. Cendant told us that the fact that RACMS came on the market at almost the same time was a coincidence but one which clearly offered the opportunity for combining Green Flag and RACMS and developing the two businesses together.

Green Flag

3.35. The Green Flag business originated in 1971 when four Bradford businessmen set up National Breakdown Recovery Services Limited (trading under the brand name National Breakdown) in order to provide an alternative source of insured breakdown services to the AA and RAC brands. At the beginning Green Flag sought to differentiate itself from the AA and RAC brands by offering a towing service which would deliver its members back to their homes or to a repairing garage in the event of a breakdown. At this time the AA and the RAC group provided only a roadside repair service. Initially Green Flag's membership was primarily confined to motor enthusiasts living in West Yorkshire, but within seven years the company had built up a national network of independent garages acting as contractors in order to service its customers. It was the first company to create such a nationwide network, although the AA and the RAC group had used contractors to supplement the resources of their in-house patrols.

3.36. In 1994 the decision was taken to rebrand National Breakdown as Green Flag. This was prompted by a view that, since the company was expanding into Europe and also widening its range of activities, the original brand name was no longer appropriate. Initially dual branding was adopted until the National Breakdown name was finally abandoned in 1996. This caused considerable confusion. Although Green Flag has attempted to increase consumer awareness of its brand, notably by sponsoring the England football team from 1994 to 1998, it still has a much lower recognition than the AA or RAC brands, and awareness of Green Flag products is even lower.

3.37. Green Flag has about 2.3 million members for its insured breakdown services in a variety of categories. Membership is usually sold on the basis of the vehicle covered although personal membership is also available. Green Flag's head office is in Leeds. As at 30 September 1998 Green Flag had 859 permanent employees (full- and part-time), equivalent to 767 standard units of employment.

3.38. As well as providing insured breakdown services for light vehicles, Green Flag also provides a number of other services. These include breakdown assistance for heavy commercial vehicles, accident recovery services, emergency home assistance, property repair services and international medical assistance.

3.39. From the outset Green Flag sought to achieve a competitive advantage over the AA and the RAC group by responding to calls for assistance more rapidly than those organizations. Green Flag adopted practices, such as giving more accurate information as to the nature and location of a breakdown, a higher payment structure for garage contractors and prompt settlement of their accounts, which were designed to encourage contractors to attend Green Flag call-outs as quickly as possible. Contractors have never been required to work exclusively for Green Flag. Often they are the same contractors that are used in certain circumstances by the AA and RACMS, as well as forming part of the networks of other contractor-based breakdown organizations such as Mondial, Britannia and Europ Assistance. As the level of business grew, Green Flag also had the benefit of the volume of work that it could offer to individual contractors.

3.40. Over time the range of services offered by Green Flag increased to include a roadside repair service and attendance when a vehicle failed to start at a member's home. In the mid-1980s Green Flag introduced freephone numbers for members who broke down and required its services.

3.41. Green Flag pioneered the development of sales through third parties. Its first such scheme was in 1982 with The Caravan Club Limited (Caravan Club) which offered its members a tailor-made recovery scheme branded as Mayday. This service was provided to scheme members by Green Flag under contract with the Caravan Club.

3.42. For the reasons outlined in Appendix 4.1, since the late 1970s Green Flag has been obliged to have the insurance risk associated with providing its services underwritten by an authorized insurance company or by Lloyd's. At first Green Flag had the risk underwritten by an insurance syndicate at Lloyd's but NPC subsequently established an insurance subsidiary, UKI, primarily in order to carry out this function. It took UKI roughly ten years to build up sufficient capital and reserves to be able to underwrite all the business of Green Flag. Once this was achieved, from around 1987 onwards, the group's profits increased substantially.

RAC Motoring Services

3.43. RACMS has roughly 5.5 million members and provides a variety of products and services for motorists. The principal business is the provision of insured breakdown services for light vehicles in the UK. RACMS also owns BSM, acquired in 1997 for £57 million, which is a driving school with some 1,800 instruction cars and around 100 high street centres throughout the UK. Other services provided by RACMS include the following:

- (a) breakdown assistance for heavy vehicles;
- (b) ITS (for example, RAC Traffic Alert 1210);
- (c) motor insurance, through a joint marketing alliance with Guardian Direct;
- (d) used vehicle inspections and warranties;
- (e) legal services;
- (f) road signs for events; and
- (g) hotel inspections and accreditations.

3.44. Direct retail members of RACMS pay an annual subscription that varies depending on the type of breakdown service required (for example, assistance at home and the provision of onward

travel are optional extras). Membership is usually sold on the basis of individual membership, which can be extended to cover other members of the family, although cover on the basis of a specified vehicle is also available. As at 30 September 1998 RACMS employed 3,806 people (including 1,313 patrolmen and 1,020 call-handling staff).

3.45. Breakdowns are usually attended by one of RACMS's liveried patrols and a high priority is given to fixing the vehicle at the roadside. In roughly 20 per cent of cases (including most breakdowns where the vehicle has to be recovered) attendance will be by an independent contractor, which may work for several motoring organizations.

3.46. As explained in Appendix 4.1, the AA and RACMS, on account of the fact that they normally provide breakdown assistance from their own resources (unlike Green Flag), have been treated as exempt from the provisions of the Insurance Companies Act 1982, which requires companies carrying on an insurance business to be authorized under the Act and to maintain a solvency margin.

Operational performance of Green Flag and RAC Motoring Services

3.47. In the following paragraphs we compare and contrast the operational performance of Green Flag and RACMS. First, however, it should be noted that there are three significant differences between the two organizations that may help to explain their different financial achievements. These are their commercial aims, their commercial status and their methods of service delivery.

Commercial aims

3.48. Green Flag has since 1984 been a subsidiary of NPC. Although NPC was a private company it had several institutional shareholders and for a number of years prior to the acquisition of NPC by Cendant its principal shareholders had been considering a sale of the business. It is reasonable to assume that its primary objective was to maximize its profits and value in the best interests of its shareholders.

3.49. RACMS, on the other hand, was a company limited by guarantee and was until July 1998 unable to distribute its profits. Whilst it aimed to make a surplus sufficient for investment, its primary purpose was to provide a service to its members.

3.50. There was an awareness at RACMS from at least 1996 onwards that the business was in some difficulty. It had made a trading loss, having budgeted a profit, in 1995 and had been gradually losing market share. As a result some fundamental changes were needed to bring about a process of recovery, investment and consolidation.

3.51. In the longer term RACMS's intention is to establish a position in the wider mobility market by providing call-centre telematics services dealing with many aspects of journey management and incident avoidance. For instance, in the future ITS providers will be able to help motorists to plan their journeys (both by car and intermodally) much more effectively (for example, to avoid congestion or to book a parking space at their destination). They may even be able to diagnose and fix some faults remotely (for instance, to gain entry to a locked car). ITS and telematics are discussed in more detail in paragraphs 4.119 to 4.122.

3.52. In order to address its problems in the short term and pursue these longer-term goals RACMS identified four intermediate objectives, which form part of its rolling five-year plan. These were:

- (a) to update and reposition its brand and identity in order to maintain and strengthen its customer base (steps towards this were taken in mid-1997);
- (b) to develop ties with motor car manufacturers and to develop joint products which could be provided to an installed base of customers;

- (c) to find partners with access to capital and relevant technology; and
- (d) to invest in ITS. Capital expenditure of some £[§] million in this area has been allowed for by RACMS in its strategic plan over the next five years.

3.53. The somewhat erratic profit performance of RACMS needs to be seen in the context of these objectives and problems.

Commercial status

3.54. As explained in paragraphs 3.42 and 3.46, Green Flag has had the insurance risk associated with providing breakdown services underwritten by an authorized insurance company or Lloyd's, whereas RACMS has not. In practice this has meant that the Green Flag business is now operated through Green Flag and UKI.

3.55. In reality, because the insurance business of Green Flag is now underwritten by a fellow subsidiary of NPC (UKI), there should be little difference resulting from this distinction between the operating performances of Green Flag and UKI taken together and RACMS. RACMS's exemption from the insurance solvency requirements may, however, have allowed it somewhat greater flexibility than Green Flag/UKI in determining its investment policy. Furthermore, Green Flag/UKI has had to meet the costs of regulation associated with UKI's operation as an insurance company.

Methods of service delivery

3.56. Although Green Flag and RACMS both deliver roadside assistance, the chosen methods of service delivery are different. Whereas Green Flag uses the services of independent garage contractors, RACMS predominantly uses its own dedicated patrol force manned by direct employees, which attends around 80 per cent of its members' breakdowns.

3.57. The assets employed by each company and their respective cost structures are therefore somewhat different.

Financial performance of Green Flag

3.58. Profit and loss accounts and balance sheets for the Green Flag business for the three years ended 31 March 1996, 1997 and 1998 and a forecast for the year ending 31 March 1999 are set out in Appendices 3.1 and 3.2. For internal accounting purposes (as opposed to statutory requirements) the profit and loss accounts and balance sheets of Green Flag and UKI are aggregated and inter-company transactions and profits are eliminated so as to show the overall result of the combined businesses. This is the basis on which Appendices 3.1 and 3.2 and the tables derived from those appendices have been prepared.

3.59. Some of the more significant figures derived from Appendices 3.1 and 3.2 are analysed in Table 3.1 and the performance of Green Flag is considered further in the following paragraphs.

TABLE 3.1 **Green Flag: group financial performance, 1995/96 to 1998/99***

	<i>£ million</i>			
	<i>Years ended 31 March</i>			
	<i>Actual 1996</i>	<i>Actual 1997</i>	<i>Actual 1998</i>	<i>Forecast 1999</i>
Turnover	101.8	112.4	120.7	[∞]
Gross profit	<div style="display: flex; align-items: center; justify-content: center;"> { <div style="text-align: center;"> <p><i>Figures omitted. See note on page iv.</i></p> </div> </div>			
Profit before investment and other income				
UK operating profit				
Group operating profit				
Capital employed				
	<i>per cent</i>			
Gross profit margin	<div style="display: flex; align-items: center; justify-content: center;"> { <div style="text-align: center;"> <p><i>Figures omitted. See note on page iv.</i></p> </div> </div>			
Return on sales†				
Return on capital employed†				

Source: Green Flag.

*The profit and loss accounts and balance sheets of Green Flag and UKI have been aggregated in order to compile this table—see paragraph 3.58.

†Based on profit before investment and other income.

3.60. The figures in Table 3.1 include all the operations of Green Flag in the UK (see paragraph 3.38), as well as loss-making operations in the USA and Europe that have now been closed down. However, roughly 80 per cent of turnover and [∞] per cent of the contribution to profits is attributable to breakdown services for light vehicles in the UK and hence Table 3.1 is largely representative of the results of this core business.

3.61. Over the period from 1995/96 to 1997/98 Green Flag's turnover increased by 18 per cent from £101.8 million to £120.7 million. In 1998/99 it is forecast to fall to £[∞] million. This fall is largely attributable to the loss of one contract to provide paging services to British Telecommunications, a separate activity from the provision of insured breakdown services. UK operating profit increased by [∞] per cent from £[∞] million in 1995/96 to £[∞] million in 1997/98. In 1998/99 it is forecast to [∞] £[∞] million. The [∞] in the forecast level of operating profit can be attributed to a [∞] forecast level of investment and other income (£[∞] million in 1998/99 compared with £[∞] million in 1997/98).

3.62. Capital employed (excluding deferred revenue and investments) grew from £[∞] million at March 1996 to £[∞] million at 31 March 1998 but is forecast to fall to £[∞] million at 31 March 1999.

3.63. Green Flag's return on sales (excluding investment income) [∞] from [∞] per cent in 1995/96 to [∞] per cent in 1997/98 but is forecast to [∞] per cent in 1998/99. Return on capital employed (excluding investment income) has fluctuated between a [∞] per cent in 1997/98 and a forecast [∞] per cent in 1998/99. These large figures and variances reflect the fact that there is very little capital employed in Green Flag's businesses.

3.64. Green Flag's insured breakdown services business is primarily divided between direct retail customers, intermediary schemes, motor manufacturer schemes, mandatory schemes and fleet schemes. The following paragraphs consider some of the more important determinants of Green Flag's profit, both overall and in relation to some of these different types of customer or scheme.

Average revenue per vehicle

3.65. For the year ended 31 March 1998 Green Flag derived an average gross premium income of £39 per vehicle from some 2.3 million insured vehicles. Gross premium income per vehicle for Green

Flag's 555,000 direct retail members at £61 was considerably higher than the overall average (see Table 4.26 for a more detailed analysis of Green Flag's average realized prices).

3.66. There are, however, significantly different costs associated with acquiring a direct retail member as opposed to other categories of member and, because of the high churn rates, the costs of customer (member) acquisition form a significant proportion of the total costs of servicing customers. A retail customer is normally acquired through advertising or other promotional activities, whereas for a member recruited by other means Green Flag will either sell at a wholesale price, or pay a commission, to an intermediary body. Green Flag has historically found it comparatively costly to acquire and difficult to retain retail customers, largely because of its relative lack of brand strength and the entrenched positions of the AA and RACMS. It is largely because of these different costs of acquiring customers, differences in call-out rates (see paragraph 3.68) and the purchasing power of intermediaries that premiums vary so much between different types of customer.

Average call-out rates

3.67. Average call-out rates (ie the annual ratio of call-outs to vehicles insured) vary enormously between different types of customer from around 10 to 80 per cent, with an average of 38 per cent. For Green Flag's direct retail customers the average call-out rate is around 51 per cent.

3.68. Customers of different types of breakdown scheme tend to have significantly different expectations of the levels of service they require. Mandatory schemes tend to have very low call-out rates perhaps because customers often do not realize that they have breakdown cover. Likewise motor manufacturer schemes also tend to have low call-out rates because they generally provide cover only for the first year of a car's life and also because the end-user has not chosen to buy the breakdown cover or paid a separate price for it (further details of these different sales channels are given in paragraphs 4.12 to 4.24).

Average costs per call-out

3.69. Green Flag's costs per call-out do not vary significantly between different breakdown schemes. The cost per call-out is calculated as the total amount invoiced to Green Flag by contractors divided by the number of call-outs. For the year ended 31 March 1998 this figure was £[88].

Call-centre costs

3.70. Call-centre costs amounted to around £3.50 per call-out in the year ended 31 March 1998. Since there is a very uneven but predictable demand arising out of breakdowns, call-centre usage is generally optimized by combining various different inquiry lines within one centre. Peak demand for breakdown services occurs at popular travel times such as Monday mornings or Friday evenings and demand is greater in bad weather and in winter.

Financial performance of RAC Motoring Services

3.71. Profit and loss accounts for RACMS for the three years ended 31 December 1995, 1996 and 1997 and a forecast profit and loss account for the year ending 31 December 1998 are set out in Appendix 3.3. Balance sheets for RACMS as at 31 December 1995, 1996 and 1997 together with a forecast balance sheet as at 31 December 1998 are set out in Appendix 3.4. Some of the more significant figures derived from those appendices are analysed in Table 3.2 and the performance of RACMS is considered further in the following paragraphs.

TABLE 3.2 RACMS: group financial performance, 1995 to 1998

£ million

	Years ended 31 December			
	Actual	Actual	Actual	Forecast
	1995	1996	1997	1998
Net revenue	309.6	251.1	268.8	[₤]
Operating margin	[Figures omitted. See note on page iv.]			
Contribution				
Trading profit/(loss)				
Profit before interest and tax				
Profit/(loss) after tax	[₤]*	[₤]†	[₤]	[₤]‡
Capital employed	[Figures omitted. See note on page iv.]			
	per cent			
Operating profit margin	[Figures omitted. See note on page iv.]			
Return on sales§				
Return on capital employed§				

Source: RACMS.

*Includes reorganization provision of £[₤] million.

†Includes exceptional profit from sale of RAC Insurance Brokers Ltd of £[₤] million.

‡Includes a £[₤] million payment to The Royal Automobile Club Foundation for Motoring and the Environment Limited and £[₤] million of costs in connection with the merger with Cendant.

§Based on trading profit/(loss).

3.72. The figures in Table 3.2 include all the operations of RACMS group, with the exception of BSM. Roughly 75 per cent of turnover and over 100 per cent of profit before interest and tax is attributable to insured breakdown services for light vehicles in the UK. This is because other services (such as travel information) are provided at an overall loss.

3.73. The forecast for the year ended 31 December 1998 envisages an increase in turnover of about 13 per cent over 1997. This is largely attributable to the impact of three price increases totalling some 11 per cent since January 1997. A large element of these price increases was linked to product improvements and the introduction of a no-call-outs discount as part of the Standard Cover package (see paragraph 4.9).

3.74. The no-call-outs discount is structured so that members can obtain a discount when renewing membership after a year with no call-outs. Consequently the benefit to turnover and profits from the higher prices occurs one year before the disbenefit from lower discounted premiums. RACMS told us that the temporary increase in profits in the year ended 31 December 1998 as a result of this was expected to be of the order of £[₤] million (net).

3.75. Although RACMS made a trading loss in two out of the four years considered in Table 3.2, these losses were struck before normal investment income (taken to be a risk-free rate of interest) is taken into consideration. It is not uncommon for insurance businesses to make a loss before accounting for investment profits, which were particularly large in 1997.

3.76. Profit before interest and tax is regarded by RACMS as the most significant measure of underlying profitability. This measure excludes exceptional items (such as the sale of RAC Insurance Brokers Ltd in 1996) and super- or sub-normal profits on investments (shown as investment mix variance in Appendix 3.3). This latter item has in fact been a major source of profits to RACMS.

3.77. The following paragraphs consider some of the main determinants of RACMS's profitability in relation to the forecast for the year ending 31 December 1998.

Average revenue per vehicle

3.78. RACMS is forecasting a total membership (which in this context means the estimated number of vehicles covered) at 31 December 1998 of 5.5 million, including 1.9 million individual

retail members (this increases to 2.4 million if additional cars and other family members are included). Forecast average revenue per vehicle insured for the year ended 31 December 1998 equates to £41 overall and for retail members to £67 (see Table 4.25 for a more detailed analysis of RACMS's average realized prices over time).

Average call-out rates

3.79. Average call-out rates vary from around 70 per cent for retail members (based on vehicles covered) to around 20 per cent for motor manufacturer and mandatory schemes. The overall average call-out rate is around 46 per cent.

Average cost per call-out

3.80. RACMS provided us with the average cost of a call-out, based on the costs of managing a call-out (excluding call-centre costs), dispatching resources to deal with it, the cost of patrols and contractors and the cost of extended services and European services. The overall average cost is expected to work out at around £[§<] for the year to 31 December 1998. The equivalent figure for the AA is £[§<] (based on management accounts figures for the year ended 31 December 1997).

3.81. Both the AA and RACMS advised us that making any such comparison of costs between rival organizations was extremely difficult without knowing precisely what costs were being included in the figures. A significant factor accounting for the higher costs faced by Green Flag (see paragraph 3.69) is likely to be the cost of irrecoverable VAT paid to its contractors. Insurance premiums charged by Green Flag and RACMS are treated as exempt supplies for VAT purposes. As a result VAT input tax paid to garage contractors is only partially recoverable by breakdown organizations. In contrast there is no VAT incurred on payments to an employed workforce.

Call-centre costs

3.82. Call-centre costs for RACMS are forecast to be around £4.17 per call-out in the year ending 31 December 1998.

Comparison of performance indicators and variables

3.83. Table 3.3 sets out a comparison between Green Flag and RACMS of the performance indicators and variables described in paragraphs 3.58 to 3.70 and paragraphs 3.71 to 3.82, including previous year comparatives.

TABLE 3.3 Comparison of Green Flag and RACMS performance indicators and variables

	<i>Green Flag</i>		<i>RACMS</i>	
	<i>Years ended 31 March</i>		<i>Years ended 31 December</i>	
	<i>Actual</i>	<i>Forecast</i>	<i>Actual</i>	<i>Forecast</i>
	1998	1999	1997	1998
Return on sales (%)	[<i>Figures omitted.</i>]			
Return on capital employed (%)	[<i>See note on page iv.</i>]			
Number of members (m)*	2.2	2.4	5.5	5.5
Number of direct retail members ('000)*	555	540	2,500	2,400
Average revenue per vehicle (£)	39	39	38	41
Average revenue per direct retail vehicle (£)	61	62	59	67
Number of call-outs ('000)	826	900	2,577	2,525.5
Average call-out rate	0.38	0.38	0.47	0.46
Average direct retail call-out rate	0.51	0.51	0.7	0.7
Average service cost per call-out (£)	[✂]			
Average call centre cost per call-out (£)	3.50	3.70	3.50	4.17

Source: MMC derived from Green Flag and RACMS figures.

*Estimated number of vehicles covered at year-end.

The position of Cendant and the rationale for the merger

3.84. In the following paragraphs we consider the position of Cendant following the discovery of accounting irregularities in April 1998, its capacity to proceed with the merger, the price to be paid for RACMS and the synergies that Cendant envisaged would result from the merger.

The financial position of Cendant

3.85. As explained in paragraph 3.21, Cendant was created in December 1997 as the result of a merger between two quoted US companies, HFS and CUC. However, as has been well publicized, shortly after the merger Cendant was plunged into a crisis as a result of the revelation that CUC's financial statements were subject to fraudulent accounting. This had significant potential implications for Cendant's financial stability and future course of action. The following paragraphs deal with the discovery of the financial irregularities and the action taken, the need to restate and refile Cendant's accounts with the SEC, other implications, the current creditworthiness of Cendant, legal actions brought against Cendant and the effect on Cendant's investment strategy and planned acquisition of RACMS.

Discovery of financial irregularities

3.86. Following the merger between HFS and CUC a reorganization of accounting staff occurred and certain accounting functions, which had been carried out by CUC personnel, were transferred to HFS personnel. As a result of this transfer and the removal of certain members of CUC's management, certain accounting irregularities came to light in April 1998. At the instigation of the former management of HFS, Cendant commissioned a full-scale investigation covering three years of CUC's financial statements. This investigation was conducted by independent legal counsel and independent accountants who reported to the audit committee of the board of Cendant.

3.87. Their report was made public on 28 August 1998, when it was filed at the SEC. The report concluded that there had been numerous occurrences of fraudulent accounting at CUC over the three-year period up to 31 December 1997, the effect of which had been to overstate CUC's income before unusual charges and taxation by some \$500 million (approximately one-third)—see Table 3.4 for an analysis of the eventual restatement of net income.

3.88. Four principal irregularities were identified:

- (a) topside adjustments—these were adjustments made quarterly to CUC’s profits before the financial results were presented to the board of CUC and published. Their objective was to bring the actual results of CUC up to the levels expected on Wall Street;
- (b) the improper reversal of provisions established in respect of merger costs in order to inflate income or reduce expenditure;
- (c) the improper reallocation of revenue between different products, so as to accelerate the recognition of income over the related costs of earning that income; and
- (d) improper reductions in reserves set up to account for cancellations of memberships.

3.89. The accounting irregularities had involved the compliance of large numbers of accounting personnel in most of the business units within CUC. Cendant’s audit committee concluded that ‘the fact that there is evidence that many of the senior accounting and financial personnel participated in irregular activities and that personnel at many of the business units believed they were questionable suggests that an appropriate environment to ensure accurate financial reporting did not exist’.

3.90. The involvement of so many people and the attribution of blame (directly or indirectly) to the senior management of CUC resulted in the dismissal of all those personnel who were involved in the fraud or who should have been aware of it. The board of Cendant now includes only one director (non-executive) who was at CUC at the time of the fraud.

3.91. In addition, subsequent to the investigation the SEC imposed a requirement on Cendant that it should change its accounting policy with respect to membership income received under cancellable contracts so that this income should not be recognized in Cendant’s accounts until the end of the period of optional cancellation of membership.

3.92. The investigation also discovered accounting errors, which were considered to be unintentional and hence not fraudulent.

Refiling of financial statements

3.93. Since Cendant’s accounts had been seriously mis-stated it became necessary to file restated accounts with the SEC. In fact HFS and CUC had until March 1998 filed accounts separately. However, it was agreed that new accounts should be prepared covering the whole three-year period up to 31 December 1997 as if the merged company had been in existence throughout. The effect of the restatement on Cendant’s net income is set out in Table 3.4.

TABLE 3.4 Cendant: restatement of net income, 1995 to 1997

Net income/(loss)	Years ended 31 December			Total
	1995	1996	1997	
As previously stated	302.8	423.6	55.4*	781.8
Errors and irregularities excluding those relating to unusual charges	(73.0)	(117.2)	(303.6)	(493.8)
Errors and irregularities relating to unusual charges	0.0	23.6	314.1	337.7
Prior year adjustment arising from change in accounting policy	-	-	(283.1)	(283.1)
	<u>229.8</u>	<u>330.0</u>	<u>(217.2)</u>	<u>342.6</u>

Source: Cendant.

*After one-time charges related to mergers and acquisitions of \$816.8 million.

Cendant’s restated results

3.94. Cendant’s restated financial statements for the years ended 31 December 1995, 1996 and 1997 were filed with the SEC on Form 10-K/A on 29 September 1998. Financial information relating to the profit and loss accounts for 1995, 1996 and 1997 and the balance sheets for 1996 and 1997, together with the same information for the nine months ended 30 September 1998 (filed on Form

10-Q), is set out in Appendices 3.5 and 3.6. Some of the more significant figures derived from those appendices are analysed in Table 3.5 and considered in the following paragraphs.

TABLE 3.5 **Cendant: financial performance, 1995 to 1998**

	\$ million			
	Years ended 31 December			9 months ended 30 September
	1995	1996	1997	1998
Revenues	2,616.1	3,237.7	4,240.0	3,865.1
Profit before other charges	447.3	642.9	961.4	903.4
Profit before tax from continuing operations	350.3	533.5	257.3	769.2
Net profit/(loss)	229.8	330.0	(217.2)	436.9
Capital employed	*	5,732.1	6,851.1	8,656.7
				<i>per cent</i>
Return on sales†	17.1	19.9	22.7	23.4
Return on capital employed‡	*	11.2	14.0	13.9‡

Source: Cendant.

*Not available.

†Based on profit before other charges.

‡Based on annualized profit (ie 12/9ths times profit for the first three quarters).

3.95. Over the period from 1995 to 1997 Cendant's turnover has increased by 62 per cent from \$2.6 billion to \$4.2 billion and profit before other charges has increased by 115 per cent from \$447 million to \$961 million. Significant acquisitions underlying this growth were Century 21, Coldwell Banker, Avis, PHH and RSI.

3.96. Capital employed has increased by 51 per cent from \$5.7 billion at 31 December 1996 to \$8.7 billion at 30 September 1998.

3.97. Cendant's return on sales increased from 17.1 per cent in 1995 to 23.4 per cent in the first three quarters of 1998. Return on average capital employed rose from 11.2 per cent in 1996 to 14.0 per cent in 1997 and fell marginally to 13.9 per cent in the first three quarters of 1998.

Other implications arising from the financial irregularities

3.98. So long as Cendant had not filed certified accounts with the SEC, it ceased to be an 'effective registrant'. This meant that it was unable to raise any funding by way of the public issuance of debt or equity. Furthermore in the absence of properly filed, accurate and certified accounts Cendant would have been in breach of its borrowing covenants and SEC requirements. Cendant therefore had to approach its bankers in order to obtain amendments and waivers from over 200 lenders.

3.99. By 13 October 1998 all reports required under the terms of Cendant's borrowing covenants had been correctly filed. Cendant told us that it successfully raised new funds by a public issuance of debt on 24 November 1998.

3.100. Cendant also told us that it was the management of HFS (and not CUC) which sponsored the acquisition of NPC and which had initiated and been involved in the potential acquisition of RACMS. There is therefore no reason to believe that either of these acquisitions were part of the scheme to inflate CUC's profits.

Borrowings

3.101. As already explained, the financial irregularities meant that Cendant was unable to access the capital markets to raise new funds. Cendant was able to borrow from its bankers but it remains a relatively low-g geared company, in terms of interest cover (see paragraphs 3.105 and 3.106). A major reason for its low gearing is the fact that the merger of HFS and CUC was a share-for-share exchange. As a result no capital left the combined company. However, as a consequence of the restatement the former shareholders of HFS received a smaller share of the merged company than they would have done if the true level of profitability of CUC had been known.

3.102. Cendant effectively has two tiers of debt. As set out in Appendix 3.6, Cendant has within its balance sheet a separate class of assets and liabilities described as being under management and mortgage programmes. These assets and liabilities belong to its subsidiary PHH, which is a finance company that operates mortgage, relocation and vehicle leasing businesses. PHH is a separate SEC registrant—that is to say, it files accounts, and can access the capital markets, independently of Cendant. Its debt is also without recourse to Cendant.

3.103. At 30 September 1998 PHH had about \$7.3 billion of assets relating to these businesses. Cendant told us that these comprised cars and relocation or mortgage receivables from blue chip customers. These assets were matched by roughly \$6.2 billion of borrowings (a safety margin of some 18 per cent).

3.104. On Cendant's own balance sheet at 30 September 1998 there was about \$4 billion of additional debt (drawn on total facilities of \$5 billion), of which \$2.7 billion was short term. It also had \$1.6 billion of cash. Roughly \$1.3 billion of short-term debt has subsequently been repaid by an issue of medium-term notes in the public capital markets.

3.105. This level of borrowings would give rise to a net annual interest charge of about \$120 million. Given Cendant's projected earnings before interest, taxation, depreciation and amortization (EBITDA) of roughly \$1.6 billion for 1998 this implies an interest cover of roughly 13 times.

3.106. This analysis excludes \$1.5 billion of FELINE PRIDES, which were issued by Cendant on 2 March 1998. These are a form of mandatorily redeemable convertible preferred security paying a dividend at a rate of 6.45 per cent (disclosed as a minority interest in Cendant's accounts). If these dividends were included as interest, interest cover would fall to approximately seven times, which could still be considered fairly conservative.

Legal actions and credit rating

3.107. Following the disclosure of the financial irregularities on 15 April 1998 and a further statement concerning them on 14 July 1998, Cendant's share price fell from a closing price of around \$35 on 15 April to open at just over \$19 on 16 April and from almost \$19 at the close of business on 13 July to just over \$15.5 at the close of business on 14 July. In fact Cendant's share price subsequently fell as low as \$6.5, although it had recovered to \$19 as at 16 December 1998.

3.108. To the extent that shareholders have suffered financial loss from a fall in the value of their shares, they may have a potential claim for damages against Cendant on the alleged grounds that Cendant knew, or should have known, that its financial statements were false and misleading and had thereby caused its share price to be artificially inflated. Certain other categories of person may have claims for similar reasons.

3.109. A total of some 74 lawsuits (including 71 claiming to be class actions) have been filed against the company arising out of these matters. Cendant told us that the time limit for filing such claims had now expired. These actions have mainly been consolidated into a single lawsuit with two lead plaintiffs, one pertaining to holders of the company's common stock and the other in respect of the holders of the FELINE PRIDES.

3.110. Cendant told us that it was not feasible to predict or determine the final outcome or resolution of these proceedings or to estimate the amounts or potential range of loss with respect to the resolution of these proceedings. In addition, the timing of the final resolution of these proceedings was uncertain. It could take anything from less than a year (if a settlement acceptable to all parties could be reached) to six or seven years. The possible outcomes or resolutions could include judgements against the company or settlements and could require substantial payments by the company.

3.111. As stated in the Form 10-K/A filed by Cendant on 29 September 1998, an adverse outcome in respect of such proceedings could have a material adverse impact on the company's financial condition, results of operations and cash flows. It was highly likely, however, that other parties, such as the auditors and management of CUC, would be named as co-defendants in these actions (or sued independently) in order to recover some or all of any damages awarded against the company.

3.112. Cendant also told us that it hoped its major shareholders might be prepared to accept some form of equity (for example, a warrant) in early settlement of their claims in order to avoid both sides incurring massive legal costs, which would have the effect of damaging Cendant further.

3.113. In assessing the implications of the lawsuits for Cendant's prospects it is to be noted that Cendant's publicly issued debt is still accorded an investment grade credit rating. Cendant's credit rating had effectively been in suspense since the announcement of accounting irregularities in April 1998.

3.114. On 16 October 1998 Standard & Poor's credit-rating agency restored its long-term credit rating for Cendant, but at the level of BBB rather than A, and removed Cendant from credit watch. The lower rating allows for some susceptibility to changing circumstances. This almost certainly takes into account the possible impact lawsuits could have on Cendant. Other credit-rating agencies have reacted similarly.

3.115. The credit-rating agencies are likely to have reached their conclusion regarding the status of Cendant's creditworthiness only after a long and thorough examination of the facts surrounding the case and the impact of the pending litigation.

Investment strategy

3.116. In October 1998 Cendant announced the cancellation of two potential acquisitions, involving Providian Auto & Home Insurance (Providian), which would have cost \$219 million, and American Bankers Insurance (ABI), which would have cost \$3.1 billion. In the latter case Cendant has paid a \$400 million fee as part of the mutual termination of the agreement.

3.117. Cendant has also announced the granting of powers by its board to buy back up to \$1 billion worth of its own shares and its intention to divest non-core assets (ie those not directly involved in brand management or alliance marketing). In a letter to shareholders dated 4 November 1998 Cendant said that two such divestments had been identified to date, namely Cendant Software (a consumer software business) and Hebdo Mag (a classified advertising business). In August 1998 Cendant had announced the sale of Hebdo Mag to a management-led group for approximately \$400 million in cash and the return of 7 million of its shares. It subsequently agreed to sell Cendant Software for around \$800 million in cash plus future contingent cash payments of up to some \$200 million during 1999.

3.118. These steps were taken by Cendant for a variety of reasons, one among them being to retain cash and use it instead to repurchase its own shares, which was perceived by Cendant's management to represent a more attractive and less risky investment in its present circumstances than the deals from which it had withdrawn. In addition the acquisition of these divested companies had been sponsored by the former management of CUC and they were no longer perceived as representing a core part of Cendant's business.

3.119. Notwithstanding the above, Cendant confirmed to us its strong intention and desire to go ahead with its acquisition of RACMS, on the terms agreed and in accordance with its contractual obligations, if the merger received clearance following our inquiry on terms acceptable to it.

3.120. In the event that the shareholders of RAC Holdings wish to withdraw from the deal, there is an option agreement that would enable Cendant to enforce the sale of RACMS to it, but on terms likely, for tax reasons, to be less favourable to the vendors (see paragraph 3.18).

3.121. Cendant's acquisition of RACMS is likely to cost some £480 million (\$800 million) in total, including transaction costs and interest since 16 September 1998. As part of the process relating to the proposed acquisition of RACMS, Cendant's principal bankers, The Chase Manhattan Bank, provided Merrill Lynch (Cendant's advisers) with a comfort letter confirming that adequate funding would be available to enable Cendant to complete its purchase of RACMS on the terms set out in the offer document.

The price to be paid by Cendant for RAC Motoring Services

3.122. Merrill Lynch prepared a presentation to the board of Cendant on 19 May 1998 which showed the impact the merger would have on Cendant's earnings and also the multiple of EBITDA that Cendant was paying for RACMS. Its analysis was based on a total transaction cost of £466 million (ie the purchase price of £450 million plus expenses of £16 million, but excluding any further interest costs).

3.123. The starting point for Merrill Lynch's analysis was the projected results of RACMS and BSM for 1998 and 1999 as set out in the RAC group's five-year plan. Merrill Lynch's calculations are summarized in Table 3.6.

TABLE 3.6 Projected impact of acquisition of RACMS on Cendant's earnings

	Years ending 31 December			
	1998		1999	
	\$m*	£m	\$m*	£m
EBITDA (pre-synergy as computed by Cendant)				
RACMS		[⌘]		[⌘]
BSM				
<i>Assuming RACMS owned by Cendant from 1 July 1998</i>				
EBITDA (pre-synergy)	[⌘]	[⌘]†	[⌘]	[⌘]
Synergies and cost savings				
EBITDA (post-synergy)				
Depreciation and amortization				
Accounting adjustments to US generally accepted accounting principles				
Other adjustments				
Interest on purchase consideration				
Taxation				
Net income				

Figures omitted. See note on page iv.

Source: Cendant.

*Exchange rate used £1=\$1.68.

†Half of the EBITDA (pre-synergy) for the whole year.

3.124. Merrill Lynch's analysis assumed that Cendant would acquire RACMS on 1 July 1998. Accordingly half of RACMS's results for the year ended 31 December 1998 would be included in Cendant's results for that year. Included in the analysis are synergies and cost savings which were expected to amount to £[⌘] million a year by the year 2000. These are considered further in paragraphs 3.127 to 3.132.

3.125. The analysis shows that the acquisition would add \$[20] million to Cendant's 1998 earnings and \$[20] million in 1999, after the payment of interest on the purchase consideration. Hence the acquisition was considered to be earnings enhancing. These figures were projected to represent [20] and [20] per cent respectively of Cendant's total earnings in those years.

3.126. The purchase price (including transaction costs) of £466 million represents [20] times 1998 projected pro forma pre-synergy EBITDA of £[20] million and [20] times projected pro forma post-synergy EBITDA of £[20] million (assuming a full year's savings of £[20] million (see Table 3.7)).

Synergies and cost savings expected to arise from the merger

3.127. Cendant and its advisers identified a number of synergies, cost savings and benefits deriving from the merger. These would be expected to bring a total benefit, once fully implemented (by 2000), of £[20] million a year. The synergies and their projected impact in 1998, 1999 and 2000 are summarized in Table 3.7 and discussed in the following paragraphs. The timing of synergies assumed that ownership of RACMS passed to Cendant on 1 July 1998.

TABLE 3.7 Projected synergies arising from the merger

General description of principal saving	£ million		
	Years ending 31 December		
	1998	1999	2000
Improved terms from garage contractors ([20] per cent cost reduction)	<div style="display: flex; align-items: center; justify-content: center;"> <div style="font-size: 3em; margin-right: 10px;">{</div> <div style="text-align: center;"> <p>Figures omitted. See note on page iv.</p> <p>[20]* [20]* [20]</p> <p>Figures omitted. See note on page iv.</p> </div> <div style="font-size: 3em; margin-left: 10px;">}</div> </div>		
Call-centre rationalization			
Reduction in RACMS headquarters			
Amalgamation of RACMS and PHH accident services			
Amalgamation of RACMS and Green Flag marketing effort			
Relocation of RACMS (Europe) call centre			
Rationalization of RACMS information technology			
Rationalization of BSM branch network			
Reduction in marketing spend at London Wall (warranty insurance)			
Business enhancement opportunities			

Source: Cendant.

*Excluded from Table 3.6 as treated as a discontinued operation.

3.128. Cendant told us that it could make savings of £[20] on call-centre costs, primarily by amalgamating call centres at fewer locations [Details omitted. See note on page iv.].

3.129. Cendant also envisaged [20] savings within the head office functions of RACMS, [Details omitted. See note on page iv.].

3.130. Cendant told us that it would maintain both the RAC and Green Flag brands. Nonetheless it believed that there should be savings of £[20] from combining the marketing functions of both companies and from exercising greater media buying power.

3.131. Savings from IT were estimated by Cendant to reach £[20] Details omitted. See note on page iv.].

3.132. Finally, Cendant envisaged benefits from business enhancement opportunities of the order of £[20] million a year by [20]. Of this, £[20] million related to improvements in the retention rate of Green Flag direct retail customers (as a result of bringing to bear RACMS's expertise in this area) and a higher conversion rate of RACMS wholesale customers to direct retail. In addition opportunities to cross-sell other Cendant products and services were identified, which were expected to lead to benefits of £[20] million by [20].