MERGER & ACQUISITION FOCUS

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Sarbanes-Oxley:

There's a New Sheriff In Town

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What you need to know about Accounting Standards 141 & 142

G.A. HERRERA & Co.
Investment Bankers
a limited liability company

www.herrera-co.com

1502 Augusta, Suite 260 ♦ Houston, Texas 77057
(713) 978-6590 ♦ Fax (713) 978-6599

Will the Sarbanes-Oxley Act Spur On or Rope In M&A?

For some, the accounting status quo reeked of injustice and any whiff of change was welcome. For others, business as usual provided the loopholes through which ill-gotten gains could pass. One thing's certain: Whether invited or not, change has come — and in a big way. There's a new act in town, and its name is Sarbanes-Oxley.

Just when it appeared malfeasance was running roughshod over America's corporate landscape, Sarbanes-Oxley rode in to make honesty not only the best policy, but the *only* policy. What does all of this mean on the M&A side of town? While the new reform probably won't be the decisive shot the anemic M&A environment needs, some of the act's effects may eventually precipitate its resurgence. Let's rustle up some Sarbanes-Oxley facts and see how the private equity marketplace may react.

The Round Up

This 2002 act raised the bar financial professionals must vault when developing and presenting opinions about financial integrity, accountants' standard of care, fiduciary responsibility and litigation matters. In a kinetic burst, the government has already enacted most of these reforms.

In conjunction, NYSE, SEC and NASDAQ changes continue evolving and spreading. As of this writing, Sarbanes-Oxley Act provisions apply to:

1. **Listed companies.** Companies with equity or debt securities listed on a national securities exchange or the NASDAQ are subject to all act provisions.

2. **Companies with 500+ equityholders.** To fall into this category, a company's assets must total more than $10 million and it must possess more than 500 equityholders.

Also subject to act provisions are companies that previously sold equity or debt securities under a registration statement. In fact, the act might even cover firms that filed a registration statement covering debt or equity securities that aren't yet effective or have already been withdrawn.

Herding the Facts

Embedded in Sarbanes-Oxley and other reforms are several points that will influence private-equity M&A:

First, no personal loans can be made to public entities' key executives and directors. Credit extensions or maintenance — or arrangements to extend credit through personal loans by a company to an executive officer or director — were prohibited as of July 30, 2002. These restrictions are significant, because many public companies previously extended loans (some more successfully than others) to their executives.

Also, these changes will affect numerous midsize and large portfolio companies, because many private-equity portfolio companies and midsize private companies have public debt. The statute's broad language prohibits numerous practices — with which some may have grown comfortable — including commercial banks advancing funds to officers wishing to exercise stock options. In fact, most leveraged-buyout sponsors have used company loans to help key executives finance their stock purchases. Now, if a private-equity portfolio company wants to go public and had issued loans to directors and officers after July 30, 2002, it must repay or forgive those loans before publicly filing a registration statement.

Conventional stock options are also coming under pressure from institutional investors, and accounting and disclosure regulations. Historically, stock options have been management's primary motivator for increasing a company's value. While the pending reform program doesn't directly affect stock options, large-scale option programs' economic desirability and accounting consequences are under the microscope. One nagging issue: Did the large-scale use of options abet the accounting scandals that rocked high finance? This debate may make it harder to align manager and investor interests.

A third and even more daunting issue is imposing boardroom reforms on public companies. The NYSE and NASDAQ have each proposed that the majority of a listed company's board of directors be "independent" unless the company is a "controlled company." NYSE rules consider a director independent if he or she has no material relationship with the listed company, either directly or even as a partner, shareholder or officer of an organization that has a relationship with the company.

What's more, the company's annual proxy statement must specifically disclose how independence was determined. NASDAQ's proposed rules generally define an independent director as someone other than a company (or subsidiary) officer or employee. In addition to the general board requirements, the new reforms require that listed companies' audit, nominating and compensation committees consist entirely of independent directors.

Making Their Mark

Truth is, because of these changes, many existing directors will no longer meet independence standards for board and audit committee memberships. Portfolio companies' boards and committees most certainly will change. And public companies' board size may increase significantly to meet these requirements, without removing insiders from boards.

On a positive note, directors who do manage to meet the new independence standards will have to be more involved with the companies on whose boards they serve. Private equity funds' minority co-investors may even feel pressured to serve as independent directors. In the Sarbanes-Oxley era, many private equity fund managers are unsure whether their board representatives meet the proposed independence rules.

Here's where the act and related reforms get really tough: public company directors' increasing accountability and liability. The act added criminal provisions and raised penalties for some existing offenses. Indeed, the reforms impose severe criminal penalties for false certifications, retaliation against whistleblowers and destroying pertinent documents. Directors' and officers' liability premiums have therefore increased significantly. As a result, private equity and leveraged buyout firms — and more importantly their principals — will have to rethink whether they can afford to help govern their portfolio companies after they've gone public. Also, these reforms may have the unintended consequence of making it harder to find qualified board members.

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Maintaining a public company has never been simple. Now, Sarbanes-Oxley as well as ongoing disclosure and accounting reforms will continue to add layers of legal and accounting complexity. So the classic private equity exit strategy of an initial public offering suddenly looks dicey. With that loss of arbitrage between private and

public multiples, the private equity market will be challenged to deal with this new dynamic.

Okay. So for awhile things might be tough. But, ultimately, small- to medium-cap public companies will need to spread the cost of these regulations and reforms over a larger revenue base — thereby increasing their desire to acquire companies. Conversely, they may decide the rewards of being a public company are outweighed by the new "costs" and they may sell or go private. That means leveraged buyout and private equity firms scouring for suitable candidates will see an increased number of transactions driven by Sarbanes-Oxley.

Bring Them Home

LBO firms will still avidly buy private companies whose owners seek liquidity but no longer can tap the public equity market. Or, in some instances, they may have no desire to plow into public equity markets, given the new regulatory and disclosure landscape. But opportunities will also arise to buy public entities that cannot — or will not — cope with enhanced liability and disclosure complexities. These openings could take the form of outright mergers and acquisitions, or an increase in going-private transactions. Nevertheless, as reform fallout settles, M&A activity will undoubtedly increase. Please call us with questions about Sarbanes-Oxley specifically or M&A issues in general.

Designing Tomorrow's Insurance Transaction Strategy Today

Just a few years ago, the news was rife with tales of rapid-fire consolidations. One minute there were two companies, the next minute, one. It certainly was true in the insurance industry. But now — as then — the issue isn't whether companies *should* divest or join forces; the issue is how to do so most effectively. It all starts, rather undramatically, with strategic vision — whether you're planning to sell your company, grow internally or acquire another entity. Sometimes, they who don't hesitate can be lost, so consider several factors before proceeding.

Stop, See, Study

Both sellers and buyers maximize M&A transaction value by analyzing competitive strategy and attributes — their own and the other parties'. A seller must understand how its business and financial qualities may contribute to another business's competitive strategy. Why? Because ultimately these qualities will dictate the sale price. A buyer must examine how the target will further its competitive strategy without overpaying. After all, prevailing market conditions influence a target's value and price. Let's see what it takes to buy or sell.

Seller attributes. To maximize a company's sale price, a potential seller must clearly understand its own attributes and how they might offer competitive advantages to a potential buyer. In its valuation, the seller must consider major business and financial attributes as described in the table on page 5.

The seller must understand how these attributes could translate into its price tag. For example, it may possess an excellent distribution channel that yields strong revenue growth, yet have inefficient operations with high overhead and low profits. Accordingly, any valuation premium paid for the distribution channels would decrease by the expected costs the acquirer bears to increase operational efficiency.

Buyer rationales. For their part, potential buyers must understand how an acquisition will add to their competitive positioning over the long run and factor these perceived synergies into the price tag. Insurance companies have recently focused on three acquisition strategies, as we see on page 5.

Examples of Business Considerations

- ***Products and Size of Company***

  Seller has high-quality, competitive product(s). Seller offers high-growth products (such as annuities or nonstandard auto insurance) rather than just commodities.

- ***Distribution Channels***

  Seller has strong/unique distribution channels (for example, the Internet), a diverse general agency system, etc.

- ***Management***

  Seller's management is strong, has a clear vision, aggressively sets direction and is quick to react to challenges.

- ***Underwriting***

  Seller has stringent underwriting procedures/standards and low losses.

- ***Technology/Operations***

  Seller has up-to-date technology and good operational efficiency.

Examples of Financial Considerations

- ***Growth***

  Seller's outlook for premium growth is higher than normal.

- ***Profitability***

  Seller has underwriting profits. Seller's investment portfolio offers higher-than-normal yields or earnings. Seller has efficient overhead management.

- ***Capital Position***

  Seller has strong return on capital (ROC). Typically, a 15% ROC is considered high; 5% is considered low. Seller has good operating leverage and capitalization.

- ***Contingent Liabilities/Other***

  Seller has no significant contingent liabilities. Seller does not require significant capital expenditures/investments in computer systems to remain/become more competitive.

1. **Expand – build scale and reduce costs.** Companies that employed this strategy include American General, which has acquired numerous life insurance providers in recent years. Increasing size allows the company to maximize efficiencies and build profit margins through economies of scale.

2. **Specialize – enhance focus in a core product area.** Players in this strategy include Cigna, which sold off its individual life and annuity business in 1997 to Lincoln National. Then the combined entity focused on building a core healthcare business. Lincoln National sold its property/casualty business (American States Financial) and bought Aetna's domestic life insurance business in 1998 to focus on providing life insurance and asset accumulation products. Afterward, Provident and Unum merged to create a preeminent disability insurance provider. Building depth in a core area allows a company to gain expertise and, potentially, become that area's provider of choice.

3. **Diversify – diversify markets or build product differentiation.** Nationwide Mutual historically had markets in the eastern United States. In 1998, it acquired Allied Group to gain its predominantly western U.S. markets. In another case, Fortis SA acquired John Alden Financial in 1998 and, more recently, American Bankers Insurance Group to focus on product differentiation and specialty insurance lines. Expanding geographic reach or product selection can help a company increase its revenue and profitability.

Premium Disparity

Sellers and buyers alike should prepare for disparity between sale premiums and valuations of large-capitalization companies versus those of small players. Typically, smaller companies don't offer the same synergy level as their larger counterparts. Thus, smaller insurers shouldn't expect premiums or multiples like those realized in sales of larger corporations.

Current market conditions are fair to poor for selling a business. The economy continues to quiver, but interest rates remain at historically low levels. M&A activity slowed somewhat in the first 11 months of 2002 compared with the same period one year earlier, in part because insurance company stock, overall, performed weakly. Dow Jones' property and casualty stock price index was down 4.2% from January 2002 through January 2003, while the Dow Jones life stock price index was down 4.7%. Obviously, this performance negatively affected the stock currency many of the larger insurance companies use for acquisitions.

When negotiating a price, both sellers and buyers must watch market conditions, including M&A activity, valuations and the stock market. With the recent slowdown in M&A activity and shaky stock market performance, buyers' negotiating leverage may have increased moderately — particularly in the property and casualty area, where there are many potential sale candidates. This is largely because of insurers streamlining operations and refocusing their business strategies in the wake of the Sept. 11 terrorist attacks.

Consult, Assess, Proceed

Current insurance industry dynamics underscore the need for strategy before action. If the strategy involves a sale, thoroughly study the business and financial qualities that are salable (or that will add competitive value). That will help executives on either side of the M&A table to maximize their value. Please call us; we're aware of current market conditions on valuation and can adjust your expectations — or price — accordingly. Thus armed, insurance executives can enter the M&A arena confidently. No one can ensure market ups or downs, a merger's success or failure. What we can do is apply years of experience to prevailing conditions to predict where your best wind will blow.

Take Note of New Financial Reporting Standards

Combining two businesses is never simple. Myriad factors — many beyond anyone's control — can affect each step along the way. The best-case scenario is an honest accounting of assets and fair third-party mediation throughout the merger process. Toward that end, the Financial Accounting Standards Board (FASB) rigorously deliberated accounting treatment of business unions. The results? Statements of Financial Accounting Standards 141 and 142.

Goodwill Hunting

Statement 141 addresses business combinations, while Statement 142 focuses on goodwill and other intangible assets.

Statement 141. Intangible assets are now recorded separately from goodwill at their fair values and amortized over their remaining lives. Previously, many companies recorded as goodwill any purchase price not allocated to an acquired company's current assets' fair market values and real and personal property.

Statement 142. This prescribes a new method of testing goodwill for impairment by establishing a separate test using fair value, which is based on market evidence or standard valuation techniques. If the goodwill's fair value is less than its book value, goodwill is impaired. Impairment loss is measured by the amount that goodwill's carrying value exceeds its implied fair value.

It's now important to have an expert perform a business enterprise valuation of the reporting unit to estimate its value as an operating business and then value identifiable assets, such as working capital and real property.

The valuation's underlying assumptions must be based on market participants' transaction price expectations. For asset valuations, this would include assessing the asset's current use. For reporting unit valuations, your expert should consider whether the acquiring entity would be willing to pay a premium for a controlling interest. If so, a publicly traded reporting unit's market capitalization may not represent the unit's fair value as a whole, because such a control premium would cause the unit's fair value to exceed its market capitalization.

Now, only the purchase method accounts for business combinations. So why should you care? Well, that involves valuing acquired intangible assets as well as valuing current assets and real and personal property. Intangible assets that are separable from goodwill must be recorded at their fair values and amortized over their remaining useful lives. But, goodwill (both existing and future) and intangible assets with indefinite lives won't be amortized under any circumstances.

Within six months of the closing, existing goodwill must have a benchmark value assessment, which must establish whether the existing goodwill's book value is impaired.

Assessing Goodwill Impairment

Under the new statements, the goodwill impairment test requires a market-based valuation of the reporting unit (that is, the unit reporting the goodwill). There are several impairment hot spots, including:

1. The reporting unit's current-period operating or cash flow losses, combined with a history of losses or a forecast of continuing losses, or

2. Significant adverse change in one or more of the assumptions or expectations (including competitive factors and loss of key personnel) used to determine fair value.

Other existing goodwill doesn't require an immediate impairment test; however, such goodwill will need a benchmark assessment.

Finally, FASB itemized 29 intangible assets separable from goodwill. They're based on the following categories:

- Marketing
- Customers
- Contracts, and
- Technology.

Fortunately, assessment isn't as onerous as it might appear, because not all of the enumerated intangible assets exist within every business.

What's It Worth?

Statement 142 requires measuring goodwill impairment based on market value. This means valuation by independent professionals specially trained in fundamental, discounted cash flow and market pricing analyses. So please call us to facilitate a FASB 142 valuation.

More Than Words

In addition to changing the rules, Statements of Financial Accounting Standards 141 and 142 have altered a few definitions. Here are two frequently encountered expressions:

1. **Reporting unit.** Goodwill can often be associated with a specific operating or business unit. Statements 141 and 142 define a reporting unit as the "lowest level of an entity that is a business and that can be distinguished physically and operationally and for internal reporting purposes from the other activities, operations, and assets of the entity."

2. **Fair value.** The new accounting statements define fair value as "the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." Thus, fair value is not a book value concept. A reporting unit's fair value is "the amount at which the unit as a whole could be bought or sold in a current transaction between willing parties." According to Statement 142, quoted prices on active markets measure fair value best. But, if such quotes don't exist, estimate fair value using standard valuation techniques.

GILBERT A. HERRERA

Founded the firm in 1992 and was previously the director of Coopers & Lybrand's Southwest region corporate finance group, responsible for building a new practice consisting of private placements, mergers and acquisitions and valuations. As the senior investment banker for Underwood, Neuhaus & Co.'s corporate finance department, he revitalized the firms private placement and merger and acquisition effort.

Mr. Herrera graduated from the University of Texas at Austin, where he is a member of the Dean's Council for the McCombs School of Business, Longhorn Foundation for Intercollegiate Athletics, Advisory Council of the Ex-Students' Association, the Littlefield Society and the Executive Committee of the Chancellor's Council of the University of Texas System.

He currently serves as the President-elect of the Turnaround Management Association, Houston chapter the leading education and advocacy group dedicated to the corporate renewal industry. Additionally, Mr. Herrera was recently appointed to The Commission of 125, *Planning for the Future of the University of Texas at Austin.*

In 2001, Mr. Herrera was appointed by Governor Rick Perry to serve as Chair of the General Services Commission and its transition to the Texas Building and Procurement Commission. Previously he was President of the Briargrove Property Owners, Inc. and Chair of the Facilities Committee for Post Oak Little League, Inc. By appointment of the Supreme Court of Texas, Mr. Herrera served as a member of the Commission for Lawyer Discipline from 1993 to 1999 and Chaired their Budget Committee.

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