Merger & Acquisition Focus

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Passing the company torch without getting BURNED

Mitigate HIGHLY leveraged transaction risk: The lowdown on solvency opinions

Guarantee a smooth sale with an investment banker

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Preparing for Tomorrow's Graceful Exit Today

What a dilemma. After years of low numbers and much debating, the owner of Sturm and Drang Consultants finally decided to sell the business — and once N. A. Stupor finally decides something, he expects it to happen yesterday. Why should the sale of his business be any different? So he called a quick meeting of his management team and gave them a two-week timeline.

Fortunately for Sturm and Drang, owners don't work in a vacuum. Stupor's management team explained that transition experts must be brought in, to maximize not only the company's potential, but his as well.

Know the Ways Out

Specifically, an exit is a sale to a strategic or financial buyer. A strategic buyer purchases another firm because it can, for instance, save money on purchases, consolidate operations or enter new geographic markets. A financial buyer believes it can run a targeted business successfully, perhaps even better than the seller can. Financial buyers also use leverage to maximize their returns.

And occasionally an exit involves a recapitalization with management participation, which is the case with fictional Sturm and Drang. Whatever motivates you toward the door, five steps can help you and your company avoid obstacles along the way.

Step I – Clarify Owners' Vision

This isn't the time to address specifics. First you must look at the current big picture and produce a plan or strategic report that:

- Analyzes the business and its prospects, focusing on the business' strengths, weaknesses, opportunities and threats,
- Projects future performance, (an "over-the-horizon" analysis),
- Identifies shareholders' priorities and goals, concentrating on both qualitative and quantitative factors,
- Evaluates the potential exit options (for instance, sale or management buyout) and their tax implications,
- Identifies obstacles that stand between you and the exit options,
- Selects the preferred exit, and
- Specifies key value drivers that will affect the selected exit.

Avoid extreme time pressure as exit day approaches by considering these issues early — at least two years before actually initiating the exit process.

Step II – Prepare an Action Plan

Now that you've clarified where you want to go, you can design how best to get there. Analyze characteristics that potential purchasers will value. Then make necessary adjustments accordingly. If a strategic buyer seems likely, concentrate on making the business more valuable. If a financial buyer seems likely, perhaps beef up management and reduce debt.

Given cash and time limitations, some changes will spur quicker or more direct value increases than others. At all times, owners and shareholders should stay laser-focused on changes likely to reap the greatest value returns.

Step III – Hammer Out the Details

Notwithstanding tax implications, well-seasoned advisors learn a business' structure and keep its profitability and attractiveness clear to potential acquirers. Experienced tax or estate advisors know the objective is to make the deal happen, but keep in mind that overly creative tax and estate planning can create serious obstacles, such as a delay in closing the deal.

As we alluded to earlier, timing is also important. For instance, it's usually inappropriate for a company to make major changes (such as in legal structure, IT and large capital expenditures) if it's close to being sold.

Step IV – Share Knowledge

Many owners of private companies wrestle with making the business less dependent on themselves. After all, spreading knowledge across the management team can only strengthen it, and the stronger the management team, the stronger the company. If a company's foundation is solid, the buyer will be more comfortable with the owner's exit. A strong management team also increases an owner's exit options.

One caveat: Transferring responsibilities to key management must be real, not window dressing. If management isn't on board, the chance of exiting gracefully grows more remote.

Step V — Work Every Day To Build Value

Not caring for a business is like owning a prize racehorse and feeding and brushing it only once a week because it's more convenient for the owner. The horse will probably die from such neglect, and even if it lives, it certainly won't finish any races. Thus, grooming is not a one-time fix, but should be a continual improvement effort.

The Curtain Call

The time and resources each step demands can differ according to the business' size, sophistication and ownership team. So find a process appropriate for your company and its unique circumstances.

Avoid extreme time pressure as exit day approaches by considering issues early — at least two years before actually initiating the exit process.

Even if your exit seems a long time hence, it's never too early to starting grooming the business. Although there's no one-size-fits-all way to do it, a well-structured process reaps the highest reward.

The sale of a business in the current economy takes six to nine months from inception to completion, so the time to consider a plan may be now. Certainly, it can never be too soon to prepare, but it can definitely be too late. Don't wait until the last minute; please call us for help today.

How a Solvency Opinion Clarifies Risks in Highly Leveraged Transactions

Why do companies sometimes fuel transactions by increasing their debt load? Actually, there's method behind this strategy. Corporations participate in leveraged buyouts and recapitalize and restructure to maximize shareholder value and avoid hostile takeovers. Because these transactions substitute debt for equity in the firm's capital structure, they can exploit debt financing's lower cost and tax advantages. All well and good. But how do companies know that a highly leveraged transaction is worth the gamble?

Savvy companies start the transaction process by getting a solvency opinion from an independent financial advisor. Let's look at how these opinions help mitigate risk for secured lenders and corporate directors, and the ways in which transactional parties can reduce these risks.

Solvency Concerns

In most leveraged restructurings, the financing proceeds are used to either buy out selling shareholders or pay a large dividend. This is in lieu of reinvestment in the business. Therefore, a company's liabilities increase significantly without a corresponding rise in assets.

Could a leveraged restructuring render the company insolvent (the company's liabilities exceed its asset value)? Certainly, such transactions can result in the assets' book value being lower than the liabilities' book value.

However, this fact alone doesn't necessarily warrant concern by the company's lender. Why? Because the *market* value of assets often far exceeds their book value. But, the degree of leverage imposed in many buyout or restructuring transactions *increases* the possibility that a company's assets may be lower than its liabilities, even on a fair market value basis.

Recent market and legal developments have increased solvency concerns among lenders and corporate directors. Certain thinly capitalized transactions have brought into focus questions about borrowers' solvency and ability to pay debts, especially if that solvency is conditional on large asset sales or near-term refinancing of high-yield debt.

In addition, the structure of these transactions provides little comfort that adequate consideration was received, since the loan proceeds are paid out to the company's selling shareholders rather than used in the business. Three situations that may cause problems are:

Increases in interest rates. Higher debt payments may push into bankruptcy highly leveraged businesses already operating with little margin for error.

Constructive fraud tests. Knowledge that the transaction would lead to insolvency, rather than fraudulent intent, is sufficient for a finding that a fraudulent transfer has occurred.

Attempts to apply fraudulent conveyance law when the company isn't insolvent. Fraudulent conveyance claims have been used by unions and competing bidders in leveraged buyout transactions as legal maneuvers to block potential transactions.

What's in a Name …

Fraudulent conveyance laws are ambiguous and court precedents for guidance are few, so it's imperative that a solvency opinion carefully — and appropriately — document the use of key terms. Foremost among them is:

Fair salable value. Although its legal meaning is unclear, this is a critical element of the balance sheet test for determining solvency. Fair salable value is "the amount that might be expected to be realized, as of the valuation date, from an interested purchaser aware of all relevant information, and a seller, equally informed, who is interested in disposing of the entire operation as a going concern, presuming the business will be continued in its present form and character, within a time period which is reasonable for the type of assets in question," according to the Uniform Fraudulent Conveyance Act.

Fair market value. This value doesn't presume a seller's compulsion to dispose of assets within a reasonable period (as fair salable value does). It does, however, presume that property will change hands between a willing and able buyer and a willing and able seller, acting at arms length in an open, unrestricted market. And buyer and seller must both have reasonable knowledge of relevant facts.

Contingent liabilities. Only contingent liabilities with a significant probability of occurring, and that will have a material impact on a company's financial condition, should be considered. Management should disclose all known contingent liabilities to its financial advisor, because he or she relies on that information for the solvency analysis.

The advisor combines the contingent liabilities' value with the other liabilities' value (debt, payables and other obligations) — such as guarantees of subsidiary debt — to determine the company's total liabilities for the solvency opinion (specifically, the balance sheet test).

3 Solvency Tests

To be upheld if challenged, a solvency opinion must address the three key tests embodied in the Bankruptcy Code and fraudulent conveyance laws. These tests are:

1. **Balance sheet stability.** Is the company's fair salable asset value greater than liabilities following the transaction?

2. **Capital adequacy.** Will the company have an unreasonably small amount of capital for the businesses in which it's currently engaged or proposes to engage in following the transaction?

3. **Cash flow sufficiency.** Can the company reasonably expect to meet its obligations as they mature after the transaction?

Rely on an experienced financial advisor to put your deal to the test.

Fraudulent Conveyance Risks

A company's solvency involves more than its ability to repay debt. Fraud risk is also a major concern. In fact, some laws specifically address the potential for "fraudulent conveyance."

These laws (according to the Uniform Fraudulent Conveyance Act and the Bankruptcy Code) set up several tests, or "badges of fraud," to determine actual or unintentional fraud. Fraud has occurred if a transfer is made with actual intent to defraud an existing creditor or if a transfer is made for "inadequate consideration," leaving the company either: **1)** insolvent (defined as the fair salable value of the company's assets being less than the value of its liabilities), **2)** with inadequate capital, or **3)** unable to repay its debts. (For more information about these fraud yardsticks, see "3 Solvency Tests" on page 5.)

Under fraudulent conveyance laws, if a debtor can't pay its obligations and files for bankruptcy, unsecured creditors can attempt to have senior lenders' security claims voided and subordinated.

If the secured loan's proceeds bought out shareholders or paid a dividend, the entire transaction may be voided and the proceeds returned to the seller. Corporate directors face the additional prospect of shareholder suits.

Although the Bankruptcy Code covers transfers occurring up to one year prior to bankruptcy, state fraudulent conveyance statutes allow for a reachback of up to six years.

Solvency Opinion Components

For both lenders and corporate directors, a valuable solvency opinion addresses all key issues comprehensively and reasonably in a way that could withstand potential court scrutiny. There are four questions to ask when reviewing a solvency opinion:

1. Has the analyst evaluating business operations exercised proper due diligence?

2. Have all transaction documents, including loan and shareholder agreements, been thoroughly reviewed?

3. Have management's forecasts been used unquestioned, or have the projections been tested for reasonableness and subjected to sensitivity analysis? This analysis would determine what effect changes in macroeconomic conditions (for example, GNP growth, inflation and interest rates) and microeconomic factors (for example, product demand and price levels) have on company sales and profitability.

4. Has the effect of refinancing been properly considered?

These questions can help you determine whether your advisor has sewn as many potential loopholes as possible. But it's also wise to secure an expert with some experience writing solvency opinions.

Along with objectively analyzing the company's solvency, the opinion shows good faith on the lender's (as well as the company's) part. In addition, an independent and objective third-party opinion comforts smaller banks buying "participations" in large deals. Ultimately, that makes the deal's syndication easier for the lead bank.

An Opinion Worth Seeking

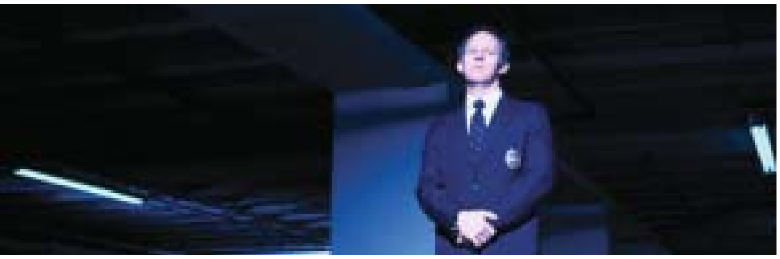
Rising market volatility, a potential return to higher interest rates, increased shareholder activism and the courts' liberal application of fraudulent conveyance law to leveraged transactions — a purpose for which, some argue, it was never intended — suggest that claims against secured lenders and corporate directors will increase in the years ahead.

What can you do? Prudently select an experienced third-party financial advisor to provide your deal's solvency opinion. Please call us; we can help minimize fraudulent conveyance risks — and the earlier we're involved in the financing negotiations, the better. After all, if a company's solvency at transaction time is subsequently challenged, you'll want an expert opinion backing you up.

What's an Investment Banker's Role in a Business Sale?

When you think "investment banker," does your mind immediately jump to Wall Street? Many minds do. Truth is, investment bankers also have a substantial presence on Main Street. As a matter of fact, they're absolutely critical in middle-market company sales.

Investment bankers can immeasurably enhance the sale of privately held businesses, providing valuation counsel, identifying the best potential buyers, creating a competitive auction and negotiating deal terms. The benefits of working with them are measured in both money and time. So how do investment bankers help obtain the highest dollar value for companies? As we'll see, through a streamlined, efficient sales process.



Performing on the Sale Stage

Let's say the owners of Vendme Co. want to sell the business. They retain an investment banker — let's call the firm Greenbacks & Lucre — that takes four big steps toward the company's sale:

1. **Perform a preliminary valuation.** This assessment focuses not only on Vendme's financials and strategic positioning, but also on its competition and conditions within its industry segment. This essential step benchmarks the company's market worth and helps its owner establish realistic expectations.

2. **Identify and weed prospects.** Greenbacks is now ready to identify a pool of potential buyers most likely to pay top dollar for Vendme. Of course, it will also check other similar industries because the right buyer is sometimes found outside the seller's usual operating environment.

Investment bankers check similar industries because the right buyer is sometimes found outside the seller's usual operating environment.

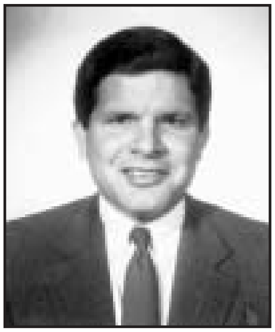
Now the weeding can begin. Greenbacks narrows the buyer pool to the most qualified candidates, based on their strategic alignment and access to capital. Only when the final pool of prospective buyers has been identified will Greenbacks disclose Vendme's financials and other information. By being judicious in its contacts and working at the highest levels of a buyer organization — presidents and CEOs, primarily — Greenbacks helps safeguard Vendme's confidentiality while conveying the strategic fit to key decision-makers.

3. **Hold an auction.** The prospective buying pool has been drained of unqualified parties — now what? Greenbacks immediately shifts to the crux of the sales process: creating a competitive auction. By maintaining a tight timeframe throughout the bidding process, sustaining active contact with prospective buyers and conveying bid information, Greenbacks heightens potential buyers' sense of urgency and Vendme's perceived value.

4. **Negotiate the deal.** Greenbacks' work isn't done when the bidding is through and a successful buyer emerges. It still has to negotiate the best deal possible for Vendme. To that end, Greenback's negotiator will address issues such as type and amount of consideration to be received, contractual terms, extent of the owner's ongoing involvement and retention of key employees.

Paving a Smooth Road to Sale Closing

The story ends happily: Greenbacks secures the most advantageous deal for Vendme — and the highest sales price, too. Although Greenbacks and Vendme aren't real, the good results reaped from this process assuredly are. Please call us; we can help you identify prospective buyers, create a competitive auction and negotiate lucrative deal terms.



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.