MERGER & ACQUISITION FOCUS

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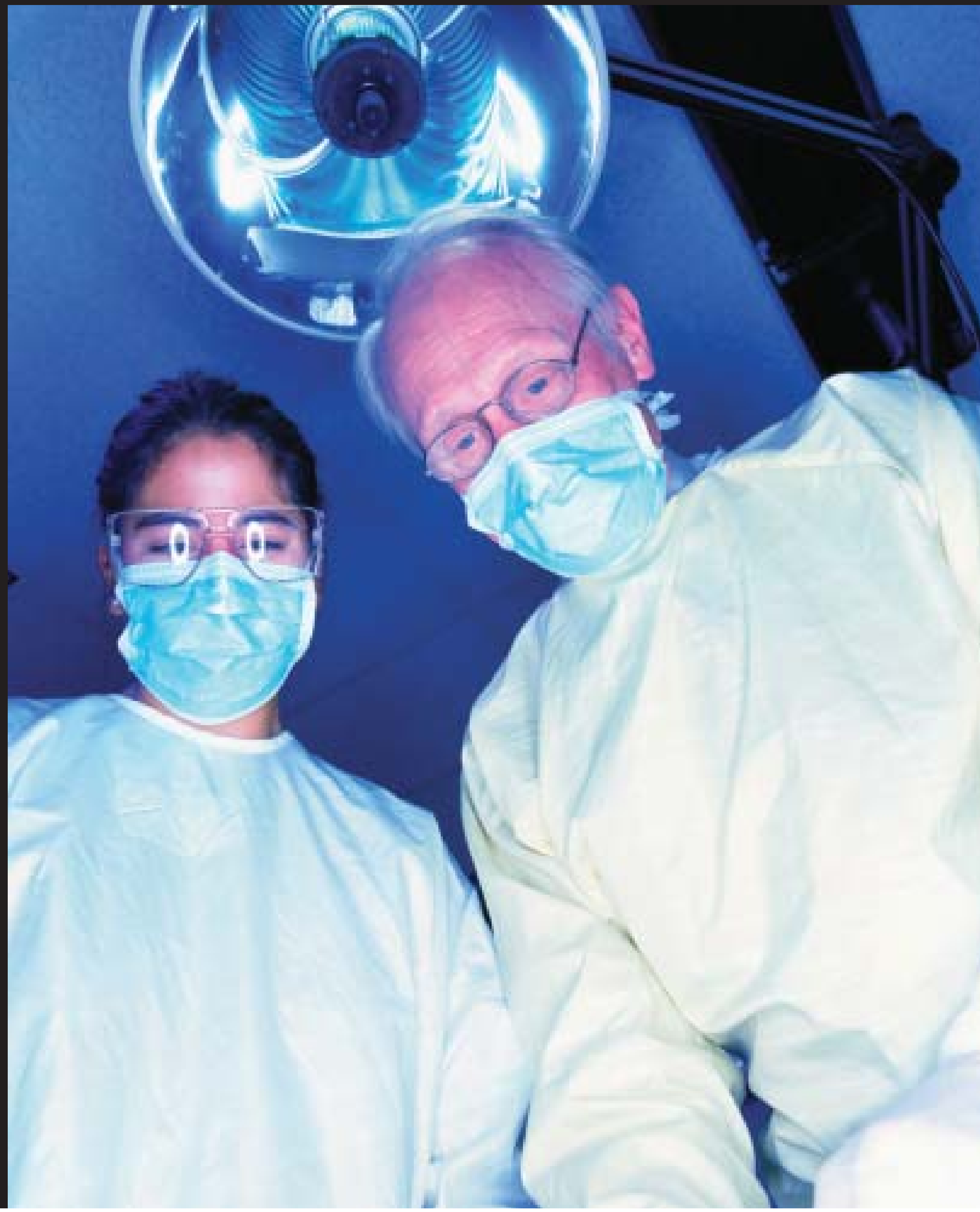
How operational due diligence can cure what *could* ail you

Can acquiring a company be just as good the SECOND time around?

Anatomy of a letter of intent

PLUS! Why it's hard to buy a company today



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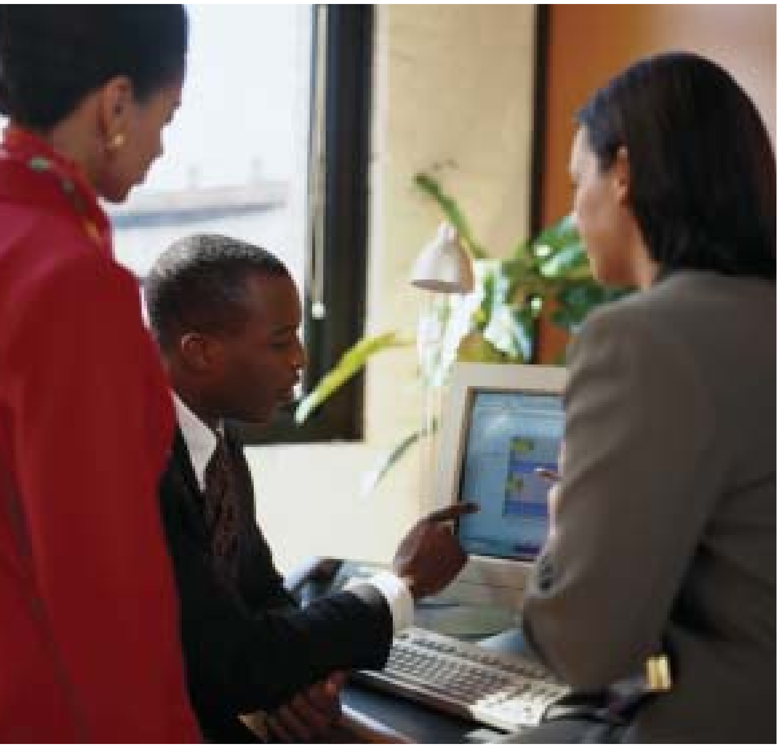
Operational Due Diligence: Don't Buy a Company Without It

Most acquirers understand the importance of financial and legal due diligence. Unfortunately, they often neglect the final component of a good acquisition — operational due diligence. Thoroughly reviewing a target's operations (including line and staff functions) may unveil a deal-breaking flaw. Or it can allow the buyer to accentuate a discovered negative and lower the purchase price. Let's see operational due diligence in action.

The Process Begins

Say you are ready to expand your operations. You've targeted Consumer Goods (CG), a C corporation that manufactures its product line in two facilities and operates a distribution center in a third location.

You've already conducted preliminary due diligence and have signed a letter of intent (LOI) with CG. (For more information about LOIs, see "Anatomy of a Letter of Intent" on page 6.) The LOI indicates that you agree to buy all of CG's outstanding stock. One of the LOI clauses



stipulates that you may cancel the proposed deal if CG's operational performance deteriorates before purchase. Before you close the transaction, ensure you will really get what exists now only on paper. Enter operational due diligence and its exploration of three key areas.

1. **Marketing and sales.** Start by reviewing the firm's largest accounts. Make sure to spend time in the field with the sales team, interviewing them, marketing management and key customers, if possible. If CG has a core of long-term customers, it's a good sign. If the customers remain solid credit risks, it's even better.

2. **Production.** Look closely at production and see what goes into CG's product line. First, review the product's makeup. Be wary if the company relies too much on one supplier for any key component. Then, explore the available production capacity. Too much may signal sloppy management, while too little may indicate significant capital expenditures soon. Look closely at the production equipment for signs of aging and obsolescence. Finally, determine if one of the two manufacturing facilities is significantly more efficient than the other. Perhaps you could combine the three operations into one, creating more efficiency through economies of scale.

3. **Administration.** As innocuous as this area may seem, don't ignore it. For example, personnel records will reveal whether CG has a record of discriminating or harassing its employees. If so, that could mean a major transfusion of time and money to eliminate the bad blood and rectify any pending litigation. Also make sure salaries and wages align with local standards. Last, review workers' compensation claims and proceed with caution if they reveal a suspicious pattern.

Operational due diligence does more than just identify pitfalls, however. It also can smooth the post-sale transition. After all, every facility harbors pet peeves and disagreements that a buyer can address with minimal exertion. Problems rectified quickly can maximize

Case in Point

While our scenario was fictional, real-life examples of operational due diligence's benefits abound. An entrepreneur who completed several successful acquisitions relates the following anecdote: "Once, when I was conducting due diligence on a company I was acquiring, I noted that the copy machine (a 15-year-old relic) was a source of constant complaint from almost everybody who used it. The day after the close, I came into the office with several catalog sheets of different brands of inexpensive modern copy machines. I gave them to the office manager and suggested he pick out one and replace the antique as soon as possible. Overnight, I was the office staff hero, and added efficiency to boot."

goodwill between buyer and staff and perhaps improve production too. (See "Case In Point" at left.) Please note that an operational due diligence checklist is much longer than space constraints allow. If you would like a more comprehensive list, give us a call.

The System Is Go

Surprises are welcome in many situations, but acquisitions aren't one of them. Operational due diligence is often ignored, which is regrettable — and dangerous. After all, it's another opportunity for the buyer to find out everything possible *before* the deal is done. So, whether you're on the buying or selling side of an LOI, please call us. We can help ensure your interests are represented, not just in word but also in fact.

How to Successfully Buy Your Second Company

After Successfully Selling Your First

An accomplished entrepreneur who has sold his or her first business often seeks to re-enter the business world by acquiring and operating another company. But the acquisition likely involves new partners and different strategies than those previously employed. Presuming you're the purchaser in question, let's examine one scenario.

Plan Before the First Move

You built your business over more than a decade. You saw it through difficulties and, when the time was right, you sold it for a great price. Perhaps you even stayed on for a couple of years to facilitate the transition. But ultimately, you walked away, successful, financially secure and ready for the good life.

And then, if you're like many executives in this situation, you discovered early retirement wasn't as appealing as you'd thought. Within 12 months, you decided to get back into the fray. Of course, you want to take your time and choose the right situation.

Most PE funds enthusiastically welcome leaders with solid histories and the willingness to put their own money on the line.

So you start to look for a business to buy. You're about to run into the first major surprise: It's unlikely you can afford to purchase a company the size of your former one. While your business acumen certainly qualifies you to run a firm at least as big, you may now lack the capital to buy a company that large. After you paid the capital gains tax, you deployed the money wisely, creating a secure financial

base for you and your family. Because you received $10 million pretax, it's unlikely you'd want to devote more than $2 million to the next venture. Now you need additional capital sources.

Leverage Purchasing Power With Debt

The first option is to leverage your investment with debt. Although commercial banks actively participate in M&A, they must follow rigid guidelines (based on assets and cash flow) covering the amount of debt a company can carry. Your accomplishments and prior banking relationships are critical to your getting in the door. But rarely will a bank exceed its guidelines, no matter how good your previous performance.

In the event you can't secure enough financing or require additional debt leverage, you can turn to junior or mezzanine lenders. They can provide extra cash — on top of your original loan. Finally, there's seller financing. And in this uncertain economy, sellers commonly must accept terms such as receiving some payment over time.

Numerous factors affect each type of lender's capacity to provide debt financing for a given deal, but it's rare to get the deal done with less than 25% equity. Even if you can get the financing, beware of operating a company that is overburdened with debt. It leaves you a razor-thin margin for error, as evidenced by the recent demise of formerly heavy hitters buried under enormous debt loads.

Consider Outside Investors

Now comes a critical decision point for the returning entrepreneur. Perhaps you've heard negative comments about venture capitalists (VCs) and are leery about the issues brought on by outside capital, but additional investors may represent the only way to buy a company as large as — or larger than — the one you sold. Here are a few options.

A natural ally for a seasoned CEO may be private equity (PE) funds. Most PE funds enthusiastically welcome leaders with solid histories and the willingness to put their own money on the line. Good PEs will give you the operational autonomy required to run the company while providing you with board-level advice and support. Look for a fund that acquires appropriately sized businesses in your industry.

Your carefully chosen investor partners will also have a strong working knowledge of M&A transactions' complex terms and conditions.

PE funds tend to deal with mature companies. Like VCs, they often invest other people's money. But the investment percentage coming from PE professionals' pockets is typically higher than a VC's layout. PE deals may range from a few million dollars to billions.

PE investors usually use debt leverage to increase their return on investment (ROI). They will add debt to your combined equity capital to make the acquisition. Again, by aligning with them, you create the opportunity to own and operate a much larger business than otherwise possible.

Utilize Professional Expertise

There are benefits beyond additional capital when working with professional investors. First is price. PE professionals apply rigorous valuation methods to calculate price and will walk away rather than overpay. And they perform thorough due diligence to uncover any company issues that may affect future performance. Having completed many acquisitions, your carefully chosen investor partners will also have a strong working knowledge of M&A transactions' complex terms and conditions.

Your enthusiasm no doubt powers your entrepreneurial drive. However, your zeal for a particular company, and what you believe you can do with it, can make the journey treacherous. Your investor partners will be thoroughly objective. The result? You'll typically get the company for less, or, in some cases, avoid an acquisition with hidden pitfalls.

While your co-investors' interests in making a fair, reasonable acquisition may parallel your own, be careful about how you slice up the pie. Will your investment be on the same terms as theirs? Will you get additional stock options for successful operational results? What are your compensation terms? What happens if major disagreements arise? These are just a few of the questions you and professional investors may face. It's usually expedient to have an extremely knowledgeable M&A firm working for you on these issues.

Step Carefully Toward Your Goal

M&A professionals (investment bankers, business brokers or intermediaries) with experience in your industry, geography and business size can guide you through every step of the process. In addition to locating and screening target companies, they will know the PE groups in your area and can match you with compatible investment partners. Most important, as your agent, they can negotiate with investors to secure the right terms for you.

Many successful entrepreneurs who have built great companies have little or no experience making acquisitions. Aligning yourself with the right partners can make the second time around even more rewarding than the first. Please call us to help make your next acquisition successful.

Why Is It So Hard To Buy a Company These Days?

Whether you're a buyer, a seller or an M&A facilitator, you know it's a tough market — the toughest in a long time. Perhaps the best way to describe the problem is a wider than usual disparity between sellers' prices and what buyers will pay. The fact is, sellers always want the highest price possible, and buyers *always* want to pay the least amount possible. But when external factors wedge themselves between seller and buyer, closing deals gets even tougher.

What's pushing sellers' asking price up? Many sellers recall the price they could have gotten just a few years ago when the sky seemed the limit. Multiples were higher and, for many companies, performance was stronger. If a company is still profitable, management may prefer to wait and see whether things improve in a year or two — unless someone will pay a great price for the company in the interim.

What's pushing buyers' price offerings down? In two words: tight credit. With record low interest rates, borrowing money is cheap. The problem? Buyers can't get much of this money because banks are strictly following conservative formulas for asset-based lending, with little additional allowance for cash flows. In fact, the percentage of a transaction a purchaser can finance through debt has typically decreased by at least 10% compared to 2000. Debt financing has always been the cheapest component of M&A purchases, because buyers can dramatically boost return on investment (ROI) by leveraging a purchase with debt. Less debt means a higher overall cost of money and a lower ROI. Therefore, to bring the ROI back to a desirable level, the buyer must pay less.

Most likely, only economic recovery will greatly improve the M&A climate for all concerned. As things pick up, more buyers will enjoy liberal credit terms, and more sellers will get the prices they want. Until then, sellers will have to take less than they'd like and buyers will have to pay a little more. But that doesn't necessarily mean you have to wait for the perfect time to make the right deal. That time may well be now. Please call us to help you identify and close doable deals.

Anatomy of a Letter of Intent

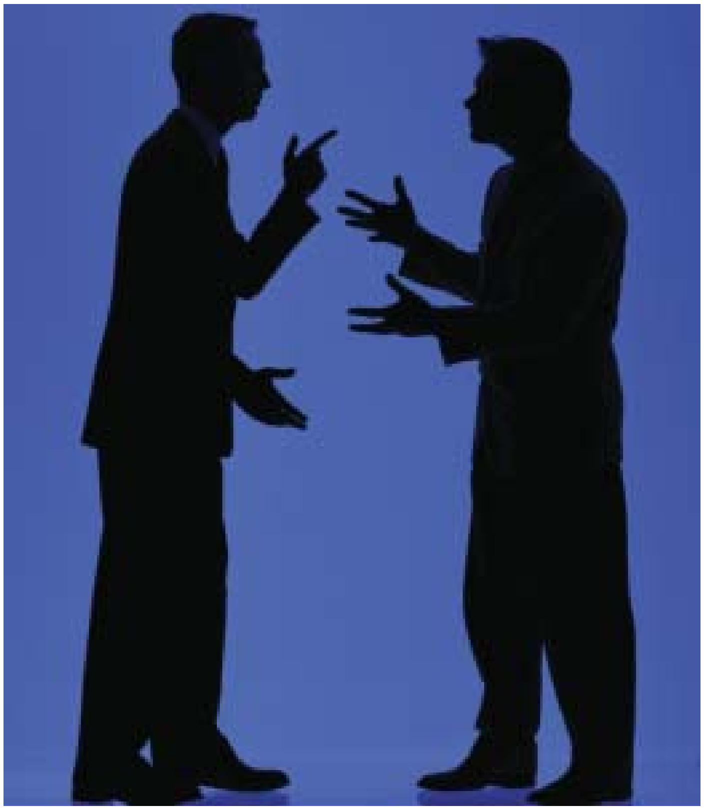
A letter of intent (LOI) is a documented handshake between a potential buyer and a potential seller that sets forth the principal points of the agreement. In this way, an LOI mitigates the risk that prolonged negotiations may not result in a closing. In addition, with transactions requiring financing, the buyer's lender may require a signed LOI before issuing a commitment to finance the acquisition. An LOI may even enable accelerated compliance with regulatory requirements such as those under the Hart-Scott-Rodino Antitrust Improvements Act.

But to be most effective, it's critical that an LOI clearly delineate the binding provisions from the nonbinding ones. Briefly: The binding provisions regulate the negotiation process; the nonbinding provisions outline the transaction and its structure. Note that even though they're nonbinding, there is a "moral commitment" by both sides to abide by the nonbinding provisions.

Binding Provisions

Binding provisions may include buyer access to the target company's facilities, books and records, and require the target's cooperation in the due diligence process. They may also contain a "no-shop" or "exclusive-dealing" provision that prohibits the acquisition candidate from directly or indirectly soliciting or entertaining offers from, or negotiating with, third parties in a transaction similar to the one the LOI outlines. Another common binding provision is that the seller must operate the company in the ordinary course of business. A mutual, comprehensive confidentiality provision protecting both parties and encouraging forthright dealings is also customary.

Each party typically bears its own costs and expenses and helps the other prepare and file for any necessary consents or approvals from lenders, landlords or third parties. It's advisable to include a statement that the binding provisions constitute the entire agreement between the parties, superseding all prior oral or written agreements, and that the LOI may be modified only in writing, signed by both parties.



The binding provisions may also specify jurisdiction and venue for any disputes involving the LOI. It may be wise to include a provision relating to the LOI's termination, perhaps incorporating a breakup fee. But note that the breakup fee normally isn't the only remedy in the event of a breach by the seller.

Nonbinding Provisions

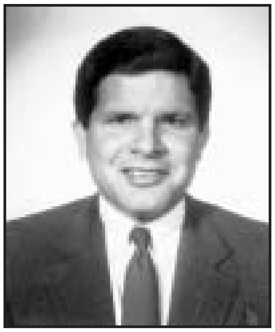
The nonbinding provisions may be broadly scoped, including a description of the transaction type, a good-faith estimate of the closing date and a summary of the target executives' employment agreements. They may also incorporate an adjustment to the purchase price based on changes in the consolidated stockholder's equity following a specified date. In addition, they would address the preparation and approval of definitive documentation that would contain customary and comprehensive representations, warranties, indemnities, terms and conditions. Last, they could set forth escrow provisions for holding back a portion of the purchase price for specified contingencies.

The courts have given significant weight to communications and other actions between parties.

One caveat: The LOI drafter must ensure that the nonbinding provisions cannot morph into binding provisions. The most powerful weapon against this danger is clear and concise draftsmanship. However, the courts have given significant weight to communications and other actions between the parties. For example, a statement such as "We have a deal," followed by handshakes all around, may persuade a court that the parties *intended to be bound*.

Safety's Sake

Nothing guarantees that a deal will close successfully — or at all. But a carefully crafted LOI certainly paves the way to a smoother transaction. In essence, they're written agreements with the target made before the purchaser incurs full-blown negotiation and due diligence costs. Please call us for assistance with LOIs or any other aspects of an acquisition or merger.



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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