Merger & Acquisition Focus

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Staying on your bank's best side

Ins and outs of private equity funds

6 financing sources for acquisitions

PLUS! What's happening to our nation's capital?

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Which Is Your Bank's Best Side And How Do You Stay on It?

Middle-market commercial banking is, and always has been, a relationship business. To make it mutually beneficial, lenders and entrepreneurs should establish and maintain close relationships. To the entrepreneur, it means getting quality products and services and a timely response to requests. To the bank, it means frequent and truthful financial reporting, higher deposits, and more ancillary business. Here's how you can help ensure the connection between business and bank remains solid.

Making a Date

Often middle-market companies maintain banking relationships because they need credit products, such as intermediate-term fixed-asset loans, or commercial real estate loans for offices, warehouses or manufacturing plants. When a relationship doesn't work, including when a lender seems unresponsive to the business's needs, a company may choose to switch banks. Whether a new or existing relationship, certain things can strengthen the ties that bind:

Give the bank your business plan. Lacking a plan doesn't inspire confidence in someone you owe or will owe money to. Periodically update the plan and always inform the bank when you do so. If you've started a second or third line of business outside the core one, always have an exit strategy retreating back to the core business.

Turn over requested financial information immediately. Then, schedule meetings with the bank to discuss the results.

Have an experienced internal CFO or controller. Also, retain a competent outside accounting firm sized to handle, understand and grow with your business.

Understand that the bank is your lender, not your partner. Banks don't usually lend into heavily leveraged situations, which require equity or junior debt. Banks frequently require personal guarantees from the majority shareholders of privately owned businesses.

Adhere to the bank's covenants and other financial tests and requirements. These are normally spelled out in proposals, commitment letters and, certainly, in loan documents. Make sure you understand how the covenants underlying the ratios and tests are determined and calculated, and which factors influence the numbers. Be prepared to discuss with the bank any factors jeopardizing adherence to the covenants.

Getting To Know Each Other

If you have major loans, especially complex ones or those based on an advance against assets, your banker should be meeting with you at least twice a year. Less highly structured or secured loans probably require less frequent contact. If the banker doesn't call you, take the initiative. The more frequent the connections, the closer the relationship, and the faster the bank's response times.

Banks don't like surprises. They don't like liquidations either. To avoid a visit to "Special Assets," "Turnaround" or "Workout," keep everyone apprised of pertinent changes. Banks prefer to work through tough times, by analyzing

potential causes and effects. Don't guard information, such as losing a key customer, contract or employee; major downturns in your industry; or your company's potential sale. The more intertwined and complex the relationship, the less likely the loans will make an early trip to Special Assets.

Give the majority (if not all) of your other banking business to the lender. It's unlikely that any bank will lend without the primary deposit relationship. Augment this, if possible and prudent, with other bank services that produce fee income for the bank. This may include cash management services, retail banking relationships for your employees, asset management plans, and personal or private banking and trust services.

Making a Commitment

Chipping through the frozen tundra in today's economic climate, banks work hard to provide a welcoming lending

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and deposit relationships environment. Perhaps they're buoyed by recent M&A activity and the concurrent establishment of *de novo* niche-centric commercial banks focused on the middle-market's lower end.

Once the relationship solidifies, the bank isn't going to risk it unless threatened, especially by a loss of principal. To remain on solid ground, don't deliver unpleasant surprises; stave them off with frequent, open, two-way dialogue. Moreover, don't forget to send business the bank's way. All of these actions can fortify your relationship for years. Please call us for assistance.

Private Equity Funds May Be Right for You

A business owner is planning to sell his or her company outright or needs capital for growth. Or perhaps he or she simply wants to take some money off the table. Whatever the need, private equity (PE) funds may be the right solution.

What Are They?

Simply stated, PE funds are vehicles that allow investors to acquire equity in private companies. The universe of PE includes hundreds of funds and more than a trillion dollars of investment capacity. PE comes in many shapes and sizes, including venture capital and mega-buyout funds used to purchase large public companies. Investors may include institutions, like pension funds, or wealthy individuals. By definition, PE funds don't raise capital on the public markets.

To narrow our discussion, let's eliminate venture capital funds, which invest in start-up companies, and further focus on PE funds that invest in privately owned companies with revenues between $10 million and $150 million. A few of these funds are turnaround specialists who create value by investing in distressed companies, but most seek companies with positive cash

flow. In the United States alone, there are hundreds of PE firms — representing billions of dollars of investment capital — interested in private companies of this size.

These small- to midmarket buyout funds typically might be $75 million and make acquisitions with an average transaction size of $10 million to $20 million. Usually, PE funds leverage an acquisition by gaining debt financing for a significant portion of the purchase price.

Many funds invest in specific industry sectors or geographic regions. Some like to buy into companies with management in place while others are willing to hire new management teams. In some cases, the PE firms focus entirely on the company's operation; in others, they seek additional companies to combine with the initial acquisition.

A common thread between PE funds is the intent to own a business for a number of years, ultimately sell it and realize a return on their investment. These funds are usually sharp-penciled financial acquirers who are careful not to overpay. But, a business owner can typically get a fair price by showing the company to multiple funds. In today's market, good companies are hard to find, and a little competition can go a long way.

What Are Their Criteria?

Whether you're looking to sell an entire company or bring in an investor, it's critical to seek the right PE fund. Identify several funds that focus on your industry, geography and company size. If you plan to stay involved after the fund invests, spend significant time with the fund's principals to assess how well you'll work together.

To maximize your ultimate valuation, learn what PE funds look for in assessing and valuing companies. Here are some key factors they seek:

Predictability. In other words, the company's ability to continue sound operations after the investment. For example, PE funds try to avoid companies that are too dependent on their owners. They prefer a strong management team who can forge ahead after the sale.

The funds also look for changes in external factors, such as offshore competition, that can adversely affect the company's continued ability to thrive. In addition, they look for a diverse customer base. Too much concentration of revenue from a select group of accounts increases risk substantially.

Potential for improvement. PE funds want to increase their return by increasing efficiencies (output divided by input). It may seem counterintuitive, but PE funds will sometimes pay a higher multiple for a company showing *unrealized* efficiencies than those whose potential is already maximized.

Leveragable assets. PE funds seek to borrow a portion of the purchase price from a bank. To do so, the private company must have a solid asset base to borrow against. Property, plant and equipment, as well as inventory and accounts receivable, typically constitute the borrowing base.

History. Start-up investors need not apply. PE funds prefer a history (at least five years) of revenues and earnings.

Seller financing. Your willingness to reduce the investors' initial cash outlay by accepting some of the purchase price as deferred compensation significantly affects the price funds are willing to pay. Financing can take the form of subordinated debt (seller paper) or a payment contingent on future results (earnout).

What Can We Do To Help?

PE funds know M&A transactions and employ experienced lawyers and accountants as well. It's critical for business owners to be equally well-represented during the negotiation process. Many of the sale's or investment's terms and conditions can seriously influence the deal's ultimate value. Please call us to help you identify whether PE is right for you and to help you through the entire process.

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The Money's Out There

As our stagnant economy starts flowing, entrepreneurs, lenders and investors are finding ways to get deals done. Fortunately, and somewhat paradoxically, even in challenging fiscal times, available — even abundant — capital exists.

Certainly, most banks tightened up their lending criteria when the boom days ended, and ratios for asset-based lending are typically lower anyway. In other words, banks accept a lower percentage of inventory and accounts receivable as collateral. Though tight cash flow-based lending means some banks hardly do it at all, others rigorously compete for deals that fit their model (that is, requirements).

What if bank lending is insufficient to make a deal work? Other asset-based lenders, as well as junior or mezzanine lenders, are there to pick up the slack. These institutions add another layer of funding on top of senior or bank debt (that is, they take up where banks leave off), albeit at higher rates. In both middle and large cap markets, mezzanine funding, which always increases in a down economy, is often the puzzle piece that completes acquisitions.

On the investor side, after a slow 2002, private equity funds have woken from their slumber and gotten their capital working. Earnings before interest, taxes, depreciation and amortization (EBITDA) multiples too have risen, spurred on by increased competition for good deals. (As some of you already know, valuations are typically calculated as a multiple of EBITDA.) Investment for both buy-outs and growth through acquisition are available for profitable, well-run businesses.

Many entrepreneurs whose businesses successfully weathered the last few years believe the time is right to raise money and consider acquisitions. A confluence of economic events has made this possible: interest rate drops persist, valuations remain relatively low, and the economy continues its progress toward stability. In essence, investors and bankers stand ready to put their resources behind the right initiatives. So this may just be the right time to consider a major strategic move.

6 Financing Sources For Acquisitions

Congratulations. You've decided to buy a company. The only thing that stands between you and the purchase is lack of capital. Fortunately, numerous sources of capital exist that can help you accomplish an acquisition, some simple and straightforward, others more esoteric. Here's a snapshot of the costs associated with six of these financing options.

When considering the use of your cash, note how much risk you're willing to assume because risk grows in proportion to cash expended.

The Big 6

Wading through financing choices — let alone picking one — can be taxing. Here are the basics about six options you can discuss with an acquisition professional.

1. **Purchaser's liquid cash.** On the simple and straightforward side of the ledger sits your bank account. When considering the use of your cash, note how much risk you're willing to assume because risk grows in proportion to cash expended. That said, why should you put up any money at all? Well, keep in mind when approaching third parties for money, they want us to be at risk too, or, as it's sometimes known, they want the purchaser to have "skin in the game." Investors rightly believe that it's in everyone's interest for all investors to be somewhat "at risk."

2. **Purchaser's company stock.** If you are a publicly held company, or a privately held company with plans to go public soon, you may want to consider the use of your company's stock (either preferred or common). But keep in mind that the seller's motivation is usually in creating a "liquidity event." As a result, cash will be "king," so using stock means the stock will be discounted against the cash price, increasing the number of shares you'll need to use and, ultimately, raising the purchase price.

3. **Acquisition target's assets.** Interestingly, many potential acquirers look at the *target's* assets. Frequently, banks and other secured lenders make loans against such assets, including accounts receivable, inventory

How Much Does Cash Cost?

When you consider the various cash sources necessary to complete a purchase, consider the cost of the cash. The least expensive cash source when using other people's money (OPM) is a bank or other asset-based lender. The cost of OPM rises until reaching the height of a pure equity player. Why? An equity player takes the most risk and gets stock for his or her investment. He or she will always be there to share in the large gains that you, the business buyer, anticipate.

(raw material and finished goods only), furniture, fixtures, machinery and equipment. The dollar amount banks will lend against these asset categories varies, usually starting at 80% to 85% of the most liquid assets (receivables less than 90 days old).

Next come raw materials and finished goods. When banks or other lending institutions consider inventory, they normally will advance no more than 50% to 55% of value, and then only when the inventory in question is deemed liquid.

Last, most banks will lend approximately 80% of "liquidation value" (the price a buyer would pay for an asset at auction) against the borrower's fixed assets.

4. Cash flow loan. Some lenders will make a cash flow (also known as an over-advance) loan, when the borrower, target or the combined business's cash flow supports a loan of this type, insufficient assets exist to secure the loan. Usually, these additional advances are made only on a short-term basis. And, if the transaction involves only privately held companies, it's typical for banks to secure personal guarantees from the borrowing entity's principal stockholders.

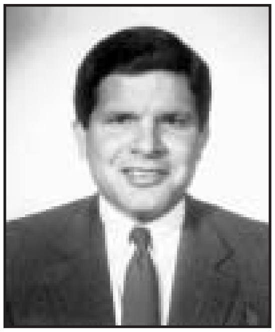
5. Real estate. Another potential cash source is the company's real estate, if you intend to acquire it along with the business. You can mortgage or refinance the building and land if they're already subject to a mortgage, or sell and lease it back.

6. Mezzanine/subordinated lenders. Mezzanine/subordinated lenders comprise many private equity groups. (See "Private Equity Funds May Be Right for You" on page 3). These groups' risk level falls between banks and other secured lending institutions discussed previously, and pure equity investors. Mezzanine/subordinated lenders' compensation is between that of equity providers and secured debt holders.

Mezzanine lenders normally get a cumulative cash yield on their investment of 9% to 15% over the investment's life. In addition, they also get a "kicker" that typically appears in the form of warrants, which will increase this investors' yield to 18% to 25%. The number of offered warrants governs the expected yield on these nominally priced warrants.

Narrowing It Down

There's no such thing as a free lunch or financing option. Every cash source costs money, usually in the form of interest owed to the lender. So, when considering whether to buy a business and how to pay for it, remember that part of the ongoing cost of operating the acquired company will be paying for other people's money (OPM) you used to purchase it. If you need help breaking down funding options — or want to discuss other facets of acquisitions — please call us.



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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.