Merger & Acquisition Focus

Year End 2003

Raising money for your company:
How the CEO can affect valuation

Compensation plans
What you pay now may pay off later

The M&A year past — and what 2004 may bring

PLUS! Don't be retiring about your future income

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Raising money for your company:

How the CEO can affect valuation

How much is your company worth? Do you know all of the variables — such as earnings, market opportunity and the value of recent comparable sales of companies within the industry — that affect its value? There's one more important factor … you, the CEO. What are the things that you can do to increase the company's value?

Understand what investors want

Investors generally rely on a current management team's ability to execute its business plan and adapt to changing circumstances. Contrary to common belief, the last thing investors want to do is remove existing management.

Rather, they want to see the present team succeed and help management augment its skills wherever necessary. While some investors have plans to integrate the business into their own, many investors, even when acquiring a majority interest, want to let the in-place management team operate almost autonomously.

Appealing or "bankable" executives have a history of success. Investors love to back a CEO who repeatedly made money for prior companies. Both investor and acquirer know that the leader learned tough lessons along the way and, presumably, knows what it takes to bring a company's plan to fruition. In fact, in an investment situation, a highly bankable CEO can *demand* that the capital required to execute the business plan already be in place as a condition to joining a firm. During an acquisition, a CEO can decide whether to be part of the acquiring company and, if so, can have much to say about his or her ongoing role.

Demonstrate your commitment

The days of easy money for inexperienced management teams are gone. But as one angel investor recently noted, "This is a great time to start a company. The ones who make it in this climate have the toughness to survive." Here are a few things you can do that prove you can thrive:

Put "skin in the game." For early-stage companies, the beacon welcoming potential investors is that you have enough faith in this entity to put something significant on the line. Have you mortgaged your house to fund the business? Have you persuaded your friends and relatives to invest? Have you worked without pay while getting the business off the ground? All of these indicators signal prospective investors that you will do whatever it takes to ensure the company succeeds because you, too, have a huge stake.

Know your company's numbers. A major credibility builder is a thorough command of your business's quantitative side. Do you know, for example, how much available cash the company has at this moment? Can you accurately quote profit margins for each product and service that you offer? Are you realistic about sales forecasts? Once you establish *your* credibility, you'll have the investor's or acquirer's attention.

Present your case for the company's value. Before meeting a deal's investment or acquisition principals, review your current financial statements and forecasts. Become

Case in point

A company CEO can powerfully affect his or her company's market value — pro or con. Let's take the example of Jim, a CEO who successfully raised capital for his company. How did he do it?

Jim left much of his company's day-to-day management in the hands of the chief operating officer so he could lead the charge on the sales side. For now, the salespeople report to him, and they all know that he'd drop everything to help them close another deal. By doing this — and spending quality time with his clients — he culled invaluable information for his operations team that fine-tuned his company's product and sales.

conversant about the details and take the time to anticipate questions potential investors may ask. Having additional particulars in print and at hand in response to a question is a phenomenally positive signal about your credibility.

Keep good company. Who is your brain trust? Have you already developed a board of directors and perhaps an advisory board? Have you sought out people whose industry experience exceeds your own?

The presence on your board of accomplished people in your industry adds a great deal of authority because they are associating their reputations with you and your company. Additionally, investors will be reassured, knowing you're the kind of person who seeks others' counsel and, presumably, listens to advice and admits to weaknesses.

Display your leadership skills. Nothing inspires confidence more than a CEO who knows when to get his or her hands dirty and when to let others do their jobs. Investors — and your employees — understand that at startup, for example, you need to do everything from assembling the office furniture to cold calling prospective clients. The CEO of any startup is willing to do whatever it takes to make the operation fly.

Somewhat paradoxically, make yourself replaceable by filling key management roles with capable people. Recruiting and empowering an accomplished team can significantly raise your company's valuation. Stepping out of the spotlight may seem counterintuitive, but it's just what most investors want — and need — to see.

Show them that your product sells. Of course, you and your team believe your services are superlative, but show potential investors that *others* believe it enough to write a check. Then you really have their attention.

Great revenue numbers not only speak to what you've already accomplished, but also add tremendously to the viability of your forecasts. Generally, investors know that they always can cut costs but believe that only management can truly increase the top line.

Seek help when necessary

The CEO in an early-stage company must be its No. 1 salesperson. Inspire investors by showing them you're the type of CEO who wants to stay on the front lines. While exceptions exist, investors generally bet on the existing management team's experience, competency and credibility, starting at the top. If the first prospective investor or buyer rejects your pitch, we can help you determine how your team can win over the next prospect.

Compensation plans

What you pay now may pay off later

A clear compensation plan helps businesses effectively recruit talent, rewards the best of them for productivity gains and engenders longevity with the firm. Less obvious but equally important is the role of compensation plans in a business sale and succession planning. Motivated firms develop remuneration techniques geared to retain key personnel as well as retire them in a manner that meets their highest expectations.

To increase the likelihood of successful transitions, many M&A professionals look beyond the buy-sell agreement and conventional funding techniques. They whet the appetites of prospective buyers by helping define workable and attractive compensation plans for business owners and their executives.

So if you're planning to exit your business, an unambiguous succession and compensation plan will enhance its value. Both qualitative and quantitative techniques can be used to assess this often-overlooked facet of selling a business.

Qualitative techniques

Business owners occasionally think about selling their business and perhaps have even identified what's needed to grow it. It's the next step people often skip. Many company leaders have not implemented both the qualitative and quantitative techniques necessary to ensure a successful transition. It's important to demonstrate to your management team that the company will continue to flourish, no matter whose hands are at the helm.

Communicate early and often. Share your expectations with key management team members, including your belief that the business will continue and flourish after your exit. Conversely, as the business owner, it's crucial that you understand your team's expectations. If yours and theirs vary greatly, the likelihood for future success diminishes.

Integrate your management team. Continual coordination with your banker, accountant and attorney, as well

as your investment and insurance advisors, will nurture a seamless succession. Generally, these relationships have developed over many years so these professionals understand the essence of prior decisions and can help deliver future results. Often, for example, an investment banker helps maintain stability by managing cash for growth needs as well as any potential acquisition or sale of the entity.

Validate corporate direction. An external "advisory board" promotes growth and provides an objective view of an enterprise. The advisory board may comprise eight to 12 friends, clients or colleagues acting as a beacon through uncertain times. Ready access to opinions and wisdom from experienced professionals concerned and interested in your company's future achievements is invaluable.

4 questions to consider

Every business owner's mind occasionally turns to what will happen financially if he or she decides to exit the company. To crystallize your thinking and prepare for that eventuality, ask yourself these four questions:

1. Will my qualified retirement plan provide enough annual retirement income? And if so, for how long?
2. Do I have family members who will be able to carry the business to the next level?
3. Is my management team willing to work with my family? Will the team remain focused and productive in my absence knowing they may never become a "stakeholder" in the business?
4. If I don't have family groomed to succeed me, is my management team in a position to safely purchase my stock following my retirement?

Quantitative techniques

Thus far, we've looked at several of the more amorphous methods for making your company a "better sell." Now let's look at "measurable" ways to increase your company's value and help ensure a smooth succession for your executives. Such measures include:

Phantom stock options. These arrangements provide the management team with an interest in the future growth of the business. They acquire a vested stake in the company and benefit financially, through distributions, during periods of geometric growth or at future sale. Frequently, these plans

> ***Continual coordination with your banker, accountant and attorney, as well as your investment and insurance advisors, will nurture a seamless succession.***

are immunized, matching liabilities with assets to diminish prospective buyer concerns about any financial liability.

Nonqualified deferred compensation. These plans allow management to delay income tax on a portion of their compensation until a later point in time. They typically supplement qualified retirement plans and allow selected executives to receive an annual retirement income in excess of the limits imposed on tax-qualified plans.

Deferred bonus arrangement. In lieu of receiving a cash bonus, the company defers a portion of compensation for future delivery with interest.

Personal and portable disability income. These plans ensure an income stream for executives to compensate for lost earnings (or the ability to earn their own occupation income) during a pre-retirement period of disability. But keep in mind that, unlike typical group or association programs, disability income from individual plans isn't offset by tax-qualified distributions, workers' compensation or any other benefit income.

Elder care benefits. These plans provide a monthly income for a period of years while the insured is chronically ill and unable to perform activities of daily living, such as when suffering severe cognitive impairment. The triggering event may result from an accident or sickness, or simply be an unfortunate facet of aging. Benefits may be prefunded, are guaranteed by large financial institutions, and are often paid income tax free by the executive, spouse or both.

Thinking ahead

By focusing on your management team's needs, you nurture an environment that can promote both personal and professional growth, management longevity, and future success. In fact, develop a strategic model for, say, your business's next five years. It'll pay off in the end. Please call us to help you assess your succession planning.

The M&A year past — and what 2004 may bring

America moved through early 2003 with war on its collective consciousness and an economy standing almost stock-still during the first quarter. Not surprisingly, many businesses clung to the status quo rather than risk new ventures. As 2003 nears its conclusion, let's reflect on the year past and anticipate what 2004 may bring to the marketplace.

Visiting the past

Several factors played a role in M&A's drastic slowdown. Most revolve around pricing and financing acquisitions. During the boom of the late 1990s, the multiples of earnings before interest, taxes, depreciation and amortization (EBITDA) that buyers paid for middle-market companies reached staggering heights, with multiples of 7x and 8x even for run-of-the-mill firms.

In tandem with the malaise, the banking industry began consolidating and continues to do so today. As the lending pool shrank, survivors tightened their lending standards, making financing for deals less readily accessible. And when bank financing *was* available, banks called for much larger tranches of equity than was the norm.

The net result: Many sellers thought their companies were worth multiples in excess of 6x, in contrast to buyers who thought companies were worth significantly less (4x to 5x at best). Even when a buyer and a seller agree to a price, securing the necessary financing at a reasonable cost remains difficult.

In the second quarter of 2003, the end of major combat in Iraq removed some market uncertainty and helped buoy the M&A field. During the following months, the M&A middle-market began to sluggishly grow — and economic indicators plodded a slow upward trend that may continue for 12 to 18 months.

Economic indicators and PEGs

Many significantly endowed U.S. private equity groups (PEGs) await deployment. PEGs have raised considerable capital from their limited partners (LPs), who are promised a high rate of return on their investment. But most PEGs weren't making many acquisitions from the latter half of 2001 through the first quarter of 2003. In other words, hundreds of millions of dollars of capital remain unspent in the middle market.

Appropriate investments generate high returns. If money is sitting relatively idle drawing interest only, the LPs don't make the returns promised when they first decided to invest in the PEG. With all this money available, the prices buyers pay for good companies will likely escalate, raising multiples from today's low levels.

Sellers should keep in mind, however, that while multiples have started to rise, it's unlikely they will attain the highs of the late '90s. As the economy continues to grow, and the overhang begins to be spent, the multiples offered for typical middle-market companies will move up somewhat.

In addition, industry veterans liquidating interests in their middle-market enterprises are passing the torch to a younger generation. Ownership wants to relieve itself of its illiquid assets, and PEGs have dollars to spend. But will there be debt available to deploy alongside private equity money? The answer is a qualified yes.

Banks are healthier than they have been coming out of earlier recessions and, since nature abhors a vacuum, a new class of secured lenders has emerged. One could accurately call them "nonbank banks," meaning nonbank asset-based lenders.

And another class of lenders is growing. Mezzanine lenders provide funding beyond what the more familiar asset-based lenders offer. But mezzanine lenders charge more “rent” for their money because they are taking a greater risk than their asset-based brethren. Even with the higher return, the cost of mezzanine debt is lower than the cost of equity.

In the next six to 12 months, the economy should improve but not to late 1990s levels when multiples were altogether too high. If the economy continues growing, multiples for solid companies with defensible market positions will likely climb out of the 4x to 5x range into the 5x to 6.5x range over the next year.

Stay tuned

M&A intermediaries see an ample cross-section of economic indicators while we’re getting deals done for our clients and all indicators seem to point toward a more robust economy. Please call us if you need assistance assessing whether financial indicators call for clear sailing.

Don’t be retiring about your future income

It’s natural to worry about what will happen to your finances — and your firm’s health — once you retire. Let’s visit with Dan, the fictional patriarch of a 50-year-old property and casualty insurance agency, to see how he dealt with this eventuality. The company has grown substantially through acquisition and invested heavily in automating its infrastructure. It now enjoys sustained, above-market productivity gains in addition to firmwide increased income from tighter insurance markets.

Owner’s challenge

Dan, a 65% shareholder, is approaching retirement in about five years. Understandably, he’s concerned about his financial future and that of his company. He’s particularly worried that a conservative projection of corporate equity may exceed his partners’ ability to purchase his stock and fund his retirement income.

Dan doesn’t want to sell out to a major institution (nor does his management team). So how will he fund a successful transition without subjecting his retirement income security to his partners’ future personal (or corporate) creditors?

The solution

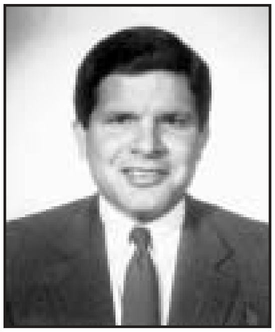
Overwhelmed by myriad options, Dan sought advice from an M&A professional. She recommended a split-dollar arrangement, which would be funded by his company in lieu of current compensation to all shareholders. With this financing method, she explained, his company pays the full premium for the coverage and he picks up only the “imputed income” on the amount of the pure life insurance.

Simply put, Dan ends up with a policy that he minimally paid for but owns permanently. The company owns an interest in the policy’s cash value and death benefit equal to its cumulative premium contributions.

In addition, cost projections associated with tax law handling of corporate-funding loans were revised. A reserve was then created to provide a substantial down payment toward the future stock purchase. (Please note that critical tax implications are involved in all compensation plans; consult a professional before deciding what will work best for you.)

Though Dan is similarly contributing toward this “sinking fund,” he appreciates feeling financial leverage and safety. If he dies prematurely, there will be sufficient capital to redeem his stock and fund his spouse’s continued retirement income needs, as well as provide a contingency or transition fund for the firm.

In the statistically more likely scenario of his healthy retirement, the firm would accumulate an off-balance-sheet asset and materially reduce the credit risk involved in utilizing a traditional note to purchase the balance of his stock.



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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