MERGER & ACQUISITION FOCUS

April/May 2004

It's never too early to prepare your business for sale

The science behind selling an IT company

Ask the Advisor

Raising your company's sale price with a controlled auction

PLUS! Glossary

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

It's never too early to prepare your business for sale

When selling their companies, entrepreneurs, general managers and chief executive officers likely have one thing in common: The sale of their businesses is among the most important transactions they will make in their careers.

And because the stakes are so high, thorough preparation is paramount. Mistakes made early in the sales process can result in significant costs during the deal and after it closes.

Secure the highest price

To help you obtain the maximum price, preparations to sell your business ideally should begin at least two to three years before you put it on the market. Why start so early? There are numerous reasons, including:

- Rectifying actions that may have been taken years ago, but which no longer fit the operation or make it as salable,
- Updating and assembling books and records in a cogent manner,
- Putting documents in place for potential acquirers,
- Enhancing management, if necessary, and
- Preparing yourself and your staff for the future.

When you start thinking about selling your business, the first thing you should do is assemble an experienced team of experts, which at the very least should comprise an investment banker, a certified public accountant and a transaction-oriented attorney. Your team should be familiar with making M&A deals and know the best avenues to a trouble-free sale.

List potential buyers

After you have assembled an experienced M&A team, make a list of potential buyers. Assess purchasers that fall into one of these four categories:

1. Entrepreneurs,
2. Management teams,
3. Larger businesses in your field (which could include a strategic buyer or buyer executing a consolidation plan), or
4. Private equity groups.

Prospective purchasers' perceptions of your business are influenced by factors including your company's earnings before interest, taxes, depreciation and amortization (EBITDA) or net cash flow; share of market; how clean your financial statements are; and the terms and conditions of the purchase.

Several things increase the value of your business to potential buyers: leveragable assets, perceived growth potential, flexibility of terms, availability, clarity and accuracy of information, and the strength of your management team.

Leverage your best assets

If you are running a manufacturing or distribution business, your receivables, inventory and equipment are leveragable

assets. In other words, financial institutions will loan funds against part of those assets' value.

If you can show that your company is growing its market share in its business and that the industry in which you participate is stable or growing, the perceived value of your company is more than that of a similar-size, stagnant-growth business or one in a shrinking marketplace.

Similarly, if you have a good management team in place that is familiar with the business and its marketplace — and is willing and able to continue under new ownership — the company will be more valuable to potential acquirers.

There are two very important things you can do to enhance your business's value. One is to have ongoing clean audited statements, with extraneous expenses eliminated or, at a minimum, isolated so prospective buyers can easily identify them. The other is to run a "fire drill" in preparation for the due diligence portion of the transaction.

After a letter of intent is negotiated with a potential buyer, the due diligence process begins in earnest. This crucial period is when many buyers try to reduce the price or enhance the contract's terms and conditions governing the sale of the business.

It's to your benefit to reveal all meaningful items of interest — both good and bad — to the buyer early in the sales process. Companies that try to hide something usually pay for it later.

After all, a serious buyer thoroughly evaluates the potential purchase and may view anything left out of the due diligence package as an intentional oversight. Then the buyer can use that omission as a lever to lower the price or attach more stringent terms and conditions to the sale.

Strike *before* the iron gets hot

Even if you're just thinking about selling your business, now is the time to act. Reinforce with your employees the need to operate cleanly and efficiently so you can present a "neat package" to prospective buyers. It helps enormously to think as potential buyers will; that way, you can anticipate what they'll want to know before committing a significant portion of their net worth to the acquisition.

glos • sa • ry

Due diligence

This is a prospective acquirer's investigation of a seller's company. The due diligence process usually comprises two parts. The first is informal and less stringent and takes place before a letter of intent is prepared. The second is the detailed process that takes place after the parties agree with the letter of intent but before the final contract is executed and the deal closes. The latter process is detailed and time-consuming and can be expensive, resulting in a lower price or perhaps in the transaction falling apart.

Letter of intent

This document outlines the intent of two parties to enter into a transaction of buying and selling a business. This letter usually contains pricing, general terms of the transaction, the estimated closing date and an exclusivity clause. The letter provides the basis for the balance of the transaction, including drafting of the contract and due diligence.

Net cash flow

Net cash flow is net earnings after taxes plus depreciation, + or – working capital required for growth, + or – capital expenditures, + or – long-term debt. To assess a company's value, most experts use earnings before interest, taxes, depreciation and amortization (EBITDA). Because it presents a more accurate picture, however, buyers increasingly use net cash flow to measure value.

The science behind selling an IT company

Many factors buyers look for are the same whether buying an information technology (IT) company or a business in another industry. Those common categories include profitability, continuity, growth potential and good financial records. But what differentiates an IT company sale from one in a more traditional industry?

4 industry distinctions

At least four variables set IT companies apart from their more conventional counterparts. These distinctions include:

1. The common — though sometimes erroneous — belief that IT companies have more upside potential,

2. The difficulty many experts, including those in the IT industry, encounter when determining the potential of new product offerings,

3. The complexity of objectively valuing IT companies' intangible assets, which largely fall in the intellectual property category, and

4. The extraordinarily high risk that another company's latest innovation can rapidly render the seller's product or service obsolete.

Because of these distinctions, hire M&A professionals with experience in the IT arena where possible.

Sales value factors

Many steps can be taken to increase an IT company's sales value. These include:

Reaching and maintaining positive cash flow. Frequently, IT companies believe that they have tremendous upside. While that can be true, many are derailed by the large research and development (R&D) costs required to get a product to market. Once the R&D fixed costs are paid, however, incremental sales can be quite profitable.

One of an IT company's primary attractions is its relatively low variable costs. That means if you can make a little bit of profit, you can often increase profitability substantially. On the other hand, innumerable IT offerings never achieve profitability because of the dearth of customers willing to pay for them.

Your ability to convince prospective buyers of your company's upside exponentially increases when you can show even a small profit.

Focusing on specific industries. Being all things to all people is an expensive way to grow an IT business. Analyze which industries and company types are likely to get the most value from your offering. Test your assumption by working with M&A professionals to try landing business with those companies.

Once you ascertain who your ideal customers are, focus your sales and marketing accordingly. Be prepared to change your product to make it an even better fit for the chosen market.

Ensuring your intellectual property rights are in good order. Ensure that all of your property's ownership rights are properly handled. All employees and subcontractors should have signed agreements giving the company explicit rights to what they develop.

Perhaps you have licensed other people's technology to use within your own. Make sure you have the unlimited

right to use and distribute that technology, and that the right is assignable to a new owner of your business.

These provisions are usually easy to negotiate when you first license the technology, but can be extremely costly if you must go back and ask for them when you're trying to sell the business.

Finding a strategic buyer. The IT industry is filled with success stories about extraordinarily high prices being paid for companies. Even in post-bubble reality, IT companies are being sold for multiples of revenue while more traditional companies are sold for multiples of earnings before interest, taxes, depreciation and amortization (EBITDA).

In virtually every such case, the buyer purchased the company for strategic reasons (that is, the seller's product fills a gap in the buyer's product strategy). Typically, the purchaser is a large software company that plans to lead the market in a particular technology area.

In addition, the buyer probably has a well-developed sales channel that reaches thousands of companies. As a result, the buyer can likely derive more value from the product than the seller currently does.

Add one more ingredient to this scenario and watch your sales price sharply increase: a second large company that also wants to buy your business. Competition, in this case, is to your benefit as the seller.

Potential buyer traits

So what's a small company to do? Analyze your product and see whether you can identify some potential strategic buyers. Start by looking at the major players in the niche your company occupies.

Try to understand how your product might round out big industry-players' strategies and then get on their radar screens. An M&A expert can help you do that subtly, without announcing what you're doing.

You also might examine potential strategic alliances. For instance, perhaps one of your customers uses your prospective buyer's product. You could arrange for an industry analyst or other third party to suggest "independently" to potential strategic buyers that your product is synergistic.

What constitutes information technology?

Beneath the broad umbrella of information technology (IT) reside numerous types of companies, including:

- Hardware manufacturers,
- Software developers,
- IT services,
- IT consultants, and
- IT hardware or software distributors.

Within each of these broad categories, there are numerous subcategories. Your analyst can research and then pinpoint the likeliest prospective buyers.

As in other areas of business, the highest rewards tend to carry the highest risks. Few IT companies achieve extremely successful outcomes, so just having a great battle plan isn't enough. You and your sales team must do everything possible to maximize the likelihood of a winning result.

Ask the Advisor

Question: As a long-time entrepreneur operating a profitable manufacturing business, I have begun to think about both my future and that of the business. I'm thinking about scaling back my business activities and creating some liquidity for my changing lifestyle. Therefore, I'm considering the sale of my company.

In contemplating the use of outside advisors, I know that I'll need to use a CPA and an attorney during the course of the sale of the business. But I'm not sure that I need to hire an investment banker. Why should I consider retaining an investment banker?

Answer: The short answer to your question is: When you are attempting to sell something, you hire a good salesperson, and an investment banker can fill this role.

The long answer is somewhat more complicated. The sale of your business is in all likelihood the most important sale you will ever make. So it's wise to retain and use people who are specialists in all phases of the transaction.

That means your legal counsel should be familiar with how to get a deal done, your accountant should understand the sales process and your investment banker should know how to facilitate marketing, qualifying, presenting and negotiating the sale of manufacturing companies (in your case).

A good investment banker will assist you in identifying the most logical potential buyers, from your industry and others. He or she will screen these prospects, freeing you from the time-consuming responsibility of dealing with a multitude of "tire kickers."

Your investment banker will advise you about the expected sale price, types of deal structures, and the pros and cons of the sale's various terms and conditions. He or she will also show you how to enhance your after-tax return and will facilitate the showings and the development of the letter of intent.

Most investment bankers are compensated by a modest upfront fee and with a "success fee," which is based on the selling price of the business being sold. The selling price (for the purpose of calculating the success fee) normally includes the money received for the stock or assets sold and delayed compensation, such as employment contracts, deferred compensation for the stock/assets, debt assumption, earnouts and non-compete agreements.

> *When you are attempting to sell something, you hire a good salesperson, and an investment banker can fill this role.*

In addition, if real estate is held under a different name or entity and is bought by, or leased to, the new owners as part of the transaction, the value of this part of the sale is also commissionable. Note, however, that a significant payout to your investment banker only takes place if he or she succeeds in executing the assignment.

Good luck with the sale of your business and remember: Investment bankers are known for enhancing the value sellers get for their most prized possession.

Raising your company's sale price with a controlled auction

A company's prospective buyer will usually explain to the seller how he or she calculated its valuation; however, the seller's ability to persuade the buyer that the purchase price should be higher is typically limited.

One of the most effective ways to get a buyer to pay more is demonstrating that other firms want to buy your company too.

When a buyer says, "We've valued your business at $30 million," he or she usually means that $30 million is the low end of the range of feasible prices. Without competition, there's little reason for the buyer to offer to pay more than the range's bottom figure.

Without competition, there's little reason for the buyer to offer to pay more than the range's bottom figure.

Getting the maximum

One way to generate competition is via a controlled auction. It is one of the best ways to find the buyer who is willing to pay the highest maximum price.

A controlled auction involves getting a number of interested and qualified parties to compete for the right to purchase your company. To create a controlled auction, you must:

- Identify at least two qualified buyers who want the company.
- Establish as many terms of the acquisition as possible so that the M&A experts on your team can compare buyers' bids. It's not necessary, though, that everything but price be standard, and competing bids may have different terms.

Define the auction procedure — you could put all of the buyers in one room, calling out their bids; or keep prospects in different rooms and move from one to another; or buyers could submit their bids electronically. Alternatively, prospective buyers can submit bids through your investment banker, who then will negotiate with each of the bidders.

Making it work

To ensure a controlled auction's success, don't impose too many terms on prospective buyers before you're sure they're hooked. Let them get interested and then let competition bring the price up.

In addition, make sure buyers are qualified. Nothing is worse than finding out that the winning bidder doesn't really have the financing to back up the bid.

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 firm's 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 President of the Turnaround Management Association, Houston chapter the leading education and advocacy group dedicated to the corporate renewal industry. Additionally, Mr. Herrera serves on 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 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.

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