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# Loose lips sink deals

**D**uring World War II, posters showed Uncle Sam with a finger to his lips superimposed over a freight ship. The caption read “Loose Lips Sink Ships.” It was a clever way to remind troops never to discuss confidential information, lest they unintentionally disclose secrets to the enemy that could cause disaster. Though ramifications of breaching a business deal are not as dire, maintaining strict silence is still critical.

## Preplug potential holes

Before receiving detailed information regarding a potential acquiree or merger prospect, the buyer is normally required to execute a confidentiality agreement (CA) or a non-disclosure agreement (NDA). In essence, the two agreements are synonymous and used interchangeably. Occasionally, less-than-upstanding competitors pose as potential buyers to access privileged financial and operational information regarding competitive businesses.

The CA or NDA is a seller’s first line of defense, so requesting one is not just reasonable, but prudent. Maintaining confidentiality throughout the entire deal process also is in a legitimate prospective buyer’s

or merger partner’s best interest. This doesn’t mean, however, that the potential partner’s professional advisors, banks and other financing sources must be kept in the dark about the impending transaction. (For more information, see “Other potential impediments” below.)

## Shore up the details

What information should a CA or NDA contain? Here are some of the more common confidentiality provisions you may encounter in these agreements:

**Disclosure terms.** Usually, the CA or NDA specifies that information released pursuant to the document be used only to explore the transaction. Both agreements enjoin the signers from using the data for another purpose.

Most CAs and NDAs contain provisions for disclosure of information to the buyer’s advisors and potential financing sources. The buyer is responsible for informing these people of the CA’s or NDA’s existence.

Whoever becomes privy to the confidential information must abide by the agreement’s requirements. In fact, it’s an excellent idea for a buyer to require his or her advisors and financing sources to complete a CA or NDA, ensuring their cooperation in keeping the confidential information private.

**Exemptions.** Some CAs and NDAs exempt facts that are in the public domain or that a court document such as a subpoena demands. In these cases, the affected party is entitled to notice before information is released. CAs and NDAs commonly state that there is no liability to the buyer for disclosing information under those circumstances.

These agreements may also require that the buyer obtain the seller’s approval before revealing anything pertaining to discussions about the potential merger or acquisition.

**Expiration date.** The potential buyer can expect that the CA’s or NDA’s requirements will expire within a specified period. In fact, virtually every agreement of this nature contains an expiration date. (Two years is typically considered reasonable, though one year is more common.)

## Other potential impediments

A buyer often must reveal details about the target company to his or her advisors or bankers. In certain circumstances, these parties also should be asked to sign a confidentiality agreement (CA) or non-disclosure agreement (NDA) incorporating that fact. For example, if there’s a likelihood that another part of the buyer’s lending institution is one of the seller’s customers or prospects, the buyer may ask his or her banker to execute a CA or an NDA.

Confidentiality doesn’t end with the CA or NDA. At some point, usually after both parties have signed a letter of intent, the buyer will interview the target company’s key personnel to judge whether to retain them after the deal closes. Under normal conditions, the buyer retains at least some, if not all, of the target company’s key managers. To help ensure an orderly transition, the content of these conversations should also be kept confidential.

**Breach of confidentiality.** The CA or NDA usually contains a provision that details the harm a prospective buyer will suffer if it breaches the agreement. Applicable state laws regarding mergers and acquisitions also are included.

**Canceled deal.** Most of these agreements require that the potential buyer either return or destroy all documents and other materials involved in the transaction if either of the parties should decide to break off negotiations for any reason.



## Nondisclosure is golden

The less said about impending deals the better. Even when speaking with members of your team, consider any public place a bad place to have a conversation about confidential information. It's in the best interests of both parties to be reticent when they are involved in a deal.

A going business is akin to a living thing, so significant changes can take place in the company, the marketplace or both within a relatively short period. Make sure to discuss confidentiality agreement contingencies with your M&A professional. ➤

## Erring on the side of silence

This is the story of a successful acquisition made more than 25 years ago. The seller was the third or fourth largest manufacturer in its industry, with a 12% market share. The buyer and the seller's owners were so paranoid that information about the impending purchase might get out, they went to what some may consider extreme measures. But there's nothing wrong with a bit of paranoia when it comes to M&A.

The story starts with a blind ad placed by the seller in *The Wall Street Journal*. The potential buyer sent a letter to the post office box and shortly received a phone call from the M&A firm retained to sell the company.

The prospective buyer asked for specifics. "What kind of a manufacturer is for sale?" Response: "A metal products company." Next question: "What kind of metal products?" Response: "I have to get the seller's permission before I can reveal that." If that level of caution seems excessive, it isn't. (See "Loose lips sink deals" on p. 2.) After securing authorization, the seller's representative called back and described the products.

Eventually, the buyer and seller reached an agreement in principle and the due diligence process began. The administrative staff had to be informed, for instance, because the buyer had to spend significant time on the premises conducting due diligence. Also, to learn more about the market, the buyer arranged with the seller to appear at the industry's next trade association meeting — the seller was a member — in the guise of a consultant to the selling firm.

Because the seller's product was a consumer commodity, the buyer arranged through the seller to speak (again, cloaked as a consultant) with three key customers about the market's perception of the seller's product line vis-à-vis its competitors. To maintain confidentiality, the savvy buyer disguised the visit's real goal by asking questions not completely germane to the potential purchase of the target company.

Because of his assiduous preparation, vigilant silence and strict adherence to agreements between the parties, the buyer suffered no surprises after taking control of the company. In the case of M&A, the old saying holds particularly true: "Silence never betrays you." ➤



# Employee purgatory

## *Sweating out the due diligence period*

Employees are the drivers that either speed a new owner's assimilation into a business or cause the transition to falter. Yet during all the detailed work of the due diligence process, employees are frequently uninformed, undervalued assets.

Due diligence often takes up to 90 days to complete. If left on their own to fill in information gaps, employees might presume the new owner will terminate all of them. Even if this is the business strategy, the company needs to continue operating effectively through the transition period. Let's look at what to do to ease employees' concerns.

### Employees feel the heat

This tentative period for employees may be equally uncertain for the company's buyer and seller. The seller doesn't want to communicate too much — or incorrect — information about employees' future with the new ownership. The buyer doesn't know what the final organizational structure will look like and, because the seller is still the owner, isn't in a position to communicate with the target's workers.

While the due diligence process steams ahead, employee performance can roil as vital people leave and the remainder worry about their security. The result: lost productivity, diminished customer service, reduced customer retention and overall underwhelming operating results.

### Dousing the flames

What can be done to minimize employee uncertainty without making misleading statements or tenuous commitments? The following actions can expedite a successful assimilation:

**1. Communicate early, candidly, sincerely and frequently as much information as possible without breaching confidentiality.** Employees today see business transactions occur regularly. If bulletins about the deal's progress — even those that say there's no further information — are given to employees regularly, it will help reduce employee anxiety and thus keep operations running smoothly throughout the due diligence process.

### **2. Define and share details about severance.**

Distribute this information, in writing, to employees — particularly those whose positions may be affected after the transaction closes. Let workers know if the severance policy includes severance pay and outplacement services.

Clearly state whether the severance policy applies only if the transaction is consummated.

The severance pay and outplacement services should be considered part of the sale's costs by both parties and negotiated as such. Though comparatively small expenses, they're frequently not discussed until the 11<sup>th</sup> hour, if at all.

### **3. Provide employees with a hotline or other avenue for answers.**

This can be done using internal resources or outside consultants. Keeping employees informed will likely satisfy the appetite for information and keep the rumor mill in check. Many times these questions include the sale's effect on health benefits, scheduled vacations, tuition reimbursement, seniority, and other terms and conditions of employment.

### **4. Make sure due diligence includes an assessment of in-house talent.**

If the buyers take time to meet with the target's most significant personnel, they can better assess the culture and how entrenched employees may be in the status quo. Buyers typically meet only the senior company leaders, but interviews with leaders' direct reports and first-line supervisors can offer invaluable insight into business practices.



This knowledge can give the buyer a head start finding candidates to fill identified voids. If the distribution manager, for example, seems averse to changing current vendors and processes, the buyer may either consider an internal candidate for promotion or begin recruiting a replacement.

This talent assessment will also provide a basis for determining how much the organizational structure must be changed to gain efficiencies or increase productivity as soon as possible after the transition.

## Back to business

By the time a deal makes it to the due diligence process, there is at least an agreement in principle. Unlike a business's bricks and mortar, machinery and inventory, employees aren't stationary.

By giving employee satisfaction considerable weight during your next transaction, you will help ensure you retain the best talent and improve first-year business results. ➡

# *glos · sa · ry*

## *Add-backs*

Owners of privately held businesses often pass through expenses (such as cars, travel and club memberships) that might not be justifiable if the business were publicly held. These expenses reduce the business's profitability, resulting in less tax paid.

When trying to sell a business, the owner wants to show off its profitability, so "adding back" personal expenses is desirable. The owner prepares a list of add-backs, which result in adjusted earnings before interest, taxes, depreciation and amortization (EBITDA).

## *Earn-out*

A variation of seller paper, earn-out means a portion of the purchase price is calculated based on the performance of the company after the sale. The earn-out period is usually one to three years. An earn-out (typically based on top-line revenue or bottom-line earnings) is often used to bridge a price gap between a buyer and a seller.

This may occur when a seller wants to justify a higher price by arguing that the company has great growth potential, or the seller wants an ongoing role in the company after the sale (or the buyer wants to ensure the seller's commitment).

## *No-shop*

When a prospective buyer issues a letter of intent, it often includes a "no-shop" clause. This commits the seller not to negotiate with other prospective buyers for a specified period to allow the buyer time to complete due diligence and close the deal. The length of time and specific terms of a no-shop vary.

## *Seller paper*

This is when a buyer and seller agree that the buyer can make part of the payment for the company over a specified time (typically one to five years). In effect, the seller is lending the buyer part of the purchase price. This debt is typically junior to bank debt. Sellers sometimes are willing to take a portion of the price this way because it's the only method that gets them close to the price they want for their business.



**Question:** I'm considering selling my business sometime in the next few years. How can I find out what it might sell for today?

**Answer:** Numerous variables affect the sale price of a particular company. Learn about comparable sales from an investment banker who is familiar with your industry. Your accountant or lawyer may also know this information. Use several actual deals as your company's value benchmark. What was the multiple of earnings before interest, taxes, depreciation and amortization? Who were the buyers?

One valuation approach is definitely not recommended: putting your company on the market when you don't intend to sell. It creates ill will with prospective buyers and other parties who will feel that you've wasted their time. It also may cause unneeded employee unrest when the inevitable rumors start percolating.

**Question:** I have used the same small accounting firm for more than 10 years to keep my books and file my taxes. I'm thinking of selling the business. How important is it to have audited financials?

**Answer:** Generally, it's important to have audited financials, preferably three years' worth when you want to sell your business. If audited numbers aren't available, reviewed numbers help, especially if the most recent year is audited.

Buyers base their offers on financial statements, and they need to have confidence that those statements are correct. A reputable accounting firm's seal of approval is precisely the sort of assurance they're looking for. (The size of that accounting firm isn't an issue, unless you're a public company.)

The absence of clear and reliable financial information is often the reason sales don't go through or that companies sell for less than they otherwise might have.

**Question:** It's been awhile now since the Sarbanes-Oxley Act went into effect. My company is private, but we're considering merging with a public company. How will Sarbanes-Oxley affect our potential merger?

**Answer:** First, kudos for planning ahead. Many deals wither because potential contingencies weren't examined.

Second, you're right to be concerned. When negotiation time comes, the public entity will scrutinize your private company to ensure it complies with the new regulations. The public company will also want to ensure that getting your company in compliance will be a relatively straightforward process.

The more you can demonstrate to a potential acquirer that your business can comply with Sarbanes-Oxley, the more likely your merger discussions will be surprise-free.

Conversely, failing to comply with the new law may make you a far less attractive merger partner. A potential acquirer may decide that the effort, expense and legal risk involved with ensuring your compliance isn't worth the trouble. Even if the public company decides to go ahead with the transaction, you might wind up receiving less for your business than you had hoped.

If these answers have generated questions — or you need information about another facet of mergers and acquisitions — call us. ➔



# Measuring performance after a merger

**M**uch of the talk surrounding mergers focuses on their “how to.” While pre-merger issues deserve all of the attention they receive, post merger matters sometimes get short shrift. And that can cause problems.

What happens, for example, after a merger if the new entity’s performance and merger goals fall short of management and shareholder expectations? Pinpointing the problem can be difficult and successes might be missed. One way to quell potential pitfalls is to quickly define the new merged company’s key performance indicators (KPIs) and merger-related goals along with implementing a merger team.

Defining the new KPIs and merger goals allows a company to track achievements as well as failures. The buyer’s and seller’s companies likely have different KPIs they focus on. For example, one company may focus on customer service, while another focuses on low costs. Determining the KPIs for the merged company is critical in defining the priority and details of the specific merger goals.

As soon as possible after a merger, define specific merger-related goals. Ongoing business KPIs may include top line revenue growth and margin improvement. Among other things, merger-related goals would be:

- ✚ Reducing the two existing management information systems to a single system servicing the entire company,
- ✚ Merging together certain (or all) departments within the two companies,
- ✚ Transitioning into a single location, and
- ✚ Transitioning fruitful customer relationships.

Whatever approach you take, make certain to clarify and disseminate the new company’s performance metrics and merger-related goals to your employees.



## Staying on track

Once you’ve selected the new KPIs and merger-related goals, gather a merger team to implement, track, report on and be responsible for achieving the goals. The merger team needs to be cross-functional and include senior management, ensuring that they have the authority to drive projects forward.

This team needs to keep in mind the corporate KPIs while pursuing the merger-related goals as quickly as possible. Balancing the two is a formidable challenge.

Achieving the merger-related goals without regard to the KPIs can have dire long- and short-term consequences to the company. Conversely, focusing too heavily on achieving KPIs in the short term may slow down the merger-

related activities, making it impossible to hit merger goals and long-term improved KPIs due to the merger.

Having mentioned both concerns, a good rule of thumb is to complete merger-related items as quickly as possible, while avoiding as many negative consequences to customers as possible. The quicker you achieve the merger, the sooner you can turn all of your attention back to the ongoing KPIs.

Remember, communicate your merger goals and new company KPIs and don’t forget to measure and manage them. In the end, employees will be happier, and the merged company can prosper and properly measure its success. ➡



## **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 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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