MERGER & ACQUISITION FOCUS

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View from the sell-side

Which factors help determine a deal's structure?

The dynamics of doing a deal

Ask the Advisor

Breaking up is hard to do

Breakup fees can keep deals alive

PLUS! Glossary

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View from the sell-side

Which factors help determine a deal's structure?

A seller owns a business and wants to divest it. A buyer wants to acquire the business. That scenario seems straightforward enough. In reality, however, the dynamics of a deal — regardless of which side of the table you're on — are exceedingly complex. Numerous alternatives exist for structuring a deal.

Sellers' concerns

Volumes have been written on this subject — certainly more information than we can impart here. So we'll home in on sellers' most common concerns, which weigh heavily into the deal structure your M&A advisors will recommend. Sellers' concerns include:

- The amount they'll be paid for the business,
- The payment medium (for example, cash or stock in the buyer's company),
- The timing and certainty of the payments,
- The tax implications of the chosen structure, and
- The risks affecting the ultimate amounts of the various payments.

In addition, a seller may have an interest in how the company will be run after the acquisition, perhaps because a portion of the payment depends on the company's ongoing performance. In addition, the seller may also feel a sense of loyalty to his or her employees and customers.

Buyers have their worries as well. Their concerns include the sources of capital for the acquisition, and risks that may affect business performance after the acquisition.

As the seller, you must clarify what is being sold. It could be the entire company with all of its assets and liabilities in the form of a stock purchase, or just specific assets and liabilities.

Often, you'll be asked to provide financial guarantees (whose size and duration are negotiable) that certain things are as stated. For example, a seller is typically required to identify all litigation against the company and to guarantee that there are no other lawsuits besides those listed. Many of the terms of a merger or acquisition relate to issues such as these.

Bridging a price gap

A seller and buyer often disagree about the company's future performance and its effect on price. The seller may argue that the company is poised for dramatic growth in the next several years; therefore, it's worth more. The buyer is unlikely to pay more based on promises of a brighter future. This seemingly irresolvable debate over price can kill a deal.

Fortunately, these differences can often be resolved through negotiating appropriate terms and conditions. For example, the buyer could offer to make part of the purchase price contingent on earnings growth in subsequent years.

This solution is called an earnout. With an earnout, the seller will ultimately get more for the business and the buyer will not be paying for something that might not happen.

Your company's financial statements are where due diligence will start. If they are clear, accurate and reliable, further information can be gathered around them. If there are doubts about their completeness or accuracy, the deal will grind to a halt.

Due diligence hotspots

Once the buyer understands the financials, the due diligence process can begin. Major due diligence areas include:

- **Inventory.** What does the seller really have and what is it worth?
- **Property, plant and equipment.** What is the condition of the company's long-term assets?
- **Intellectual property.** Does the company hold patents and copyrights? How defendable are they?
- **Contracts.** What agreements exist (or don't exist) that could affect the company in the future?
- **Customers.** Are they happy with the seller's goods and services? Are they likely to continue doing business? To what extent will the volume of that business likely increase or decrease?
- **Employees.** Are they satisfied with their position and compensation? Are any key employees planning to leave after the acquisition?
- **Litigation.** Are there any present or pending legal actions against the company? These could include product liability, employee issues, customer issues and environmental problems.
- **Government regulations.** Is the company complying with the law? If not, what will be the likely effect of possible compensatory or remedial actions?
- **Environmental issues.** Are there current or potential issues which the company will be responsible for?

Before due diligence is performed, the buyer will have indicated an intention to acquire the company at a given price and set of terms. This offer would assume that no additional negatives will arise during due diligence. Because issues inevitably do arise, however, you and the buyer must debate the extent to which potential negatives may affect the deal's original price and terms.

The best that you can hope for is that the original offer will not change. Often, though, the initial offer will be reduced because of information uncovered during the due diligence process. To limit this degradation in price, be as prepared and forthcoming as possible.

A seller is typically required to identify all litigation against the company and to guarantee that there are no other lawsuits besides those listed.

Deals can be further complicated when the ownership of the selling company is made up of different entities with different interests. Typically, a majority decision is not enough. Often, the needs of each owner of the selling company must be addressed.

Completing the deal

This is only a snapshot of factors that can potentially complicate M&A transactions. The M&A process requires that professionals find ways to address sellers' and buyers' myriad intricate — and often conflicting — interests. A thorough understanding of deal options and parameters is a must to get the results you want. 🗝

The dynamics of doing a deal

After the first attempt to formalize one's intent to buy or sell a company to a specific target, dealmakers sometimes enter the danger zone, when there is a good chance the deal will crater.

Though the danger zone can be rather large, it can be successfully traversed if all parties, including both the buyer's and seller's team of professionals, are committed to getting the deal done.

Some deals fail after they get to this point because the two sides focus solely on what they want to get out of the transaction. Failing to look at what the other side wants can doom the entire deal to failure.

Intermediary assistance

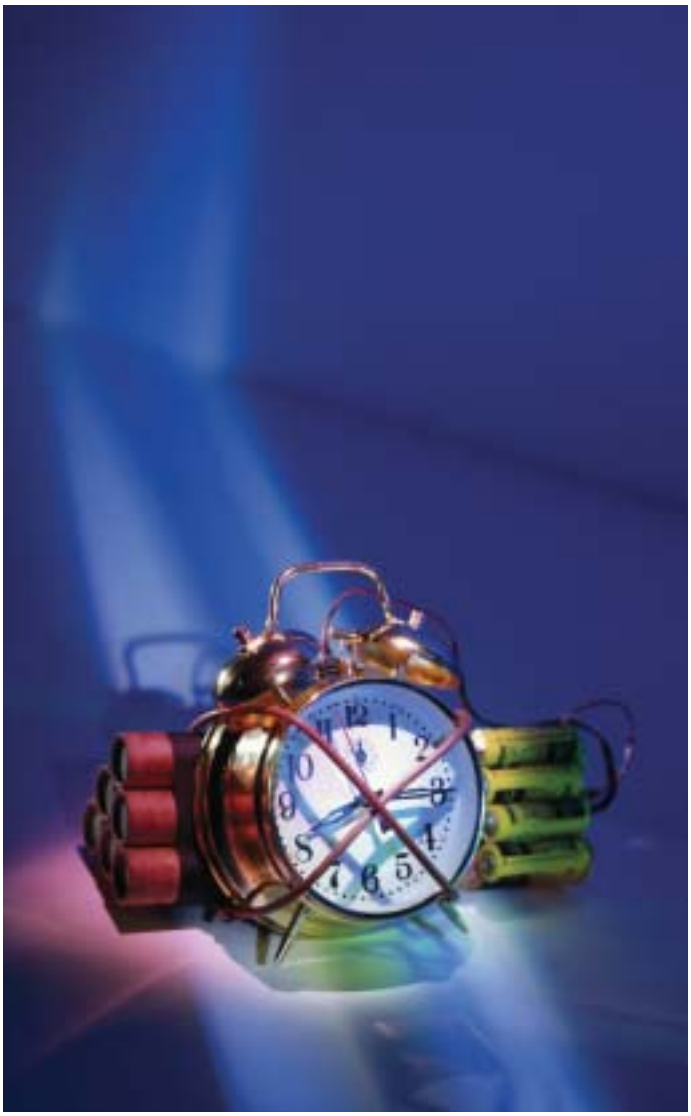
The key to successfully exiting the danger zone often lies with the intermediary, or other members of the professional team, guiding the buyer and seller through this treacherous time. Intermediaries' experience in getting deals done helps them see things in a more objective way than either the buyer or seller alone possibly can.

Sellers for the most part are in the process of parting with "their baby" for a price that is expected to provide them, at a minimum, with a degree of security for the balance of their lives. In addition, sellers negotiate to sell an enterprise that they've spent a major part of their lives developing. In a process akin to marrying off one's child, the prospective spouse is never good enough — at least at first glance.

Financial buyers, on the other hand, tend to be more objective. They are looking to acquire cash flow; it's all about how much cash the business will generate and how certain they are that it will do so.

Strategic buyers tend to look at what the potential acquisition will bring to their already existing business or businesses. The "add-on" can take one or more forms: It can be accretive to earnings, add to the product offering, increase geographic coverage, or bring in management talent to fill a void or improve current operations.

At this point, it's imperative to engage an intermediary experienced in bridging gaps and guiding clients through deal danger zones.



Avoid bombshells

Buyers tend to view surprises and negative information as tools with which to lower the company's price. Or, in the worst-case scenario, as a way to get out of the transaction.

Conversely, sellers likely would contend that their companies' value shouldn't be reduced, because the company's future value will not be negatively affected by a minor adverse adjustment.

Here's an example of the pricing process and one of its tripwires. Let's say that, thus far, a seller has been talking about the sales run rate of a new customer (that is, the customer's annual volume) as if it has been in place for a full fiscal year. The key customer's annual volume is,

or is expected to be, $3 million. When the buyer reviews the sales figures closely, he discovers that the annual volume for the key customer in question has only been $2.5 million for this fiscal year.

The buyer doesn't know, however, that the key customer didn't come on board until the middle of the second quarter of the fiscal year. The buyer seizes on this information to reduce the price he is offering the seller. Meanwhile, the seller wants compensation for the future value his business will bring to the buyer.

The earnout

With the intermediary's assistance, the buyer and seller often can resolve an issue like this by tying part of the purchase price to future performance. Many M&A professionals would recommend an earnout — a method of compensation that is contingent on future performance.

Wait, you say, how do we judge future performance? How long is the earnout time period? What are the metrics of the earnout provision? How can I be sure that the buyer won't "jimmy" the numbers? All of these are fair questions that should be addressed in the transaction's documentation. Among the professionals representing both the buyer and the seller — all of whom want to get the deal done — the details can be worked out if all of the parties to the transaction have their clients' best interests at heart.

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Admittedly, an earnout or another form of delayed, contingent payment complicates a transaction. If both sides, however, include people with requisite professional skills and a strong desire to see the deal through to fruition, the danger zone can be circumvented.

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Asset-based purchase

The buyers' purchase of assets and assumption of liabilities they deem acceptable. Those liabilities usually include accounts payable and accrued expenses. Buyers would favor this type of purchase because they can eliminate liabilities that they don't want to assume. It's less friendly to sellers because of the remaining liabilities. Sellers of a C corporation, though, benefit from tax treatment that is not as favorable to buyers.

Private equity (PE) group

An investment group usually comprises institutional investors called limited partners. A team of professional investment managers puts the PE group together. PE groups offer their investors a return on investment they anticipate will be significantly higher than either the stock market or more liquid investments can achieve. PE groups, however, are typically riskier than more liquid investments.

Stock purchase

The purchase of most or all of an acquisition target's stock. Stock purchase is a fairly common method of making an acquisition. A seller benefits from a stock purchase transaction because the gain, if any, is based on lower capital gains tax rates. In addition, all of the company's liabilities go with the company unless the purchase/sale agreement specifies the exclusion of certain liabilities.

Ask the Advisor

Question: There's a business I'd like to buy and operate, but the likely purchase price exceeds what I can afford. I believe I'm well qualified to operate a business of this size, in this industry. What are the pros and cons of getting investment capital from a private equity group? What are its criteria for evaluating operating executives?

Answer: Private equity (PE) groups are rarely interested in operating businesses. They usually look for experienced and capable management, often seeking companies with management already in place.

There are many situations, however, that require new management, either because the previous owner is leaving a big hole or because the PE group is convinced that new management is needed to improve operations.

PE groups tend to bet on proven performers. They look for executives with relevant experience in the target company's size and industry. They will want to know how your previous company performed under your leadership and whether it consistently met its financial projections.

Beyond that, they'll want to get comfortable that your interests jibe with theirs and that you will work well with them at the board level.

PE groups are always after executives who will invest alongside them in the acquisition. They generally believe that managers who invest a substantial portion of their net worth in the company will be properly motivated.

There are many positive reasons to co-invest with a PE group:

1. It can be more fulfilling to operate a bigger business, especially if the company's size aligns with your experience. It's also potentially more lucrative.

   A PE group allows you to earn additional equity for achieving yearly financial objectives. This earned equity often exceeds the equity you initially purchased, resulting in a better outcome when the company is sold.

2. The right PE group will be skilled in supporting management without excessive interference. Before co-investing, check with CEOs of the PE group's portfolio companies to gauge potential business relationship quirks.

There are a few negatives to this type of structure as well:

1. The PE group often gets its capital from a fund with a fixed end date, which you should know. The PE group may wish to sell the business as that date approaches regardless of how well the company is performing. And, frequently, the CEO as a minority shareholder won't be able to prevent it.

2. You may not work well within the structure imposed by a professional board of directors. If you don't like to answer detailed questions about your plans or regularly prepare detailed financial statements and other operational reports, a PE group may not be right for you. 🗝

Breaking up is hard to do

Breakup fees can keep deals alive

Breakup fees came into being many years ago to protect the parties to a merger or acquisition. Typically, when a party is either buying or selling a company, major transaction costs begin to accumulate after the buyer and the seller sign a letter of intent (LOI).

These costs include performing due diligence, preparing documents, conducting an audit, paying investment banking fees and conducting market research.

The charges mentioned above are not limited to either the seller or the buyer. For each of the parties involved in a middle-market deal, transaction costs can be as high as 8% to 12% of the overall cost of doing the deal — a significant sum. Hence, the advent of breakup fees.

Exiting a deal

Most LOIs provide ways to exit a deal. Parties usually exit deals when due diligence reveals significant performance weaknesses or other untenable situations that cannot be rectified by renegotiating the deal. These renegotiations, by the way, usually result in lower compensation for the sellers.

Issues that cannot be rectified by renegotiating a deal include loss of a major customer (25%+ of total revenue) or discovery during due diligence of a major undisclosed liability.

A sizable breakup fee dissuades buyers and sellers from dropping a deal for no obvious reason (for instance, if the buyer or seller has found a better transaction with another party or has simply gotten cold feet). Sellers, in particular, won't consider breaking up a deal unless a third party makes a *substantially* enhanced offer.

Breakups in action

Let's say a transaction's total value is in the $10 million range. A reasonable breakup fee would likely be in the neighborhood of $750,000 to $1.25 million. A fee of this size will compensate an aggrieved party for his or her out-of-pocket expenses.

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Because of space constraints, we've only been able to provide a brief overview of what breakup fees are all about. For additional information, consult with your professional advisors. 🗝

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.

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