

October/November 2004

**Reverse
mergers provide
alternative to IPOs**

**Protect your transaction
with a presale audit**

Bridging the gap

*Earnouts can pave
the way to a deal*

**New choices for
shareholders of
closely held companies**

Ask the Advisor

Don't fear the "d" word

*Divestitures can
boost company value*



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

Reverse mergers provide alternative to IPOs

Shareholders in closely held businesses interested in the benefits associated with publicly traded companies may want to consider reverse mergers. These arrangements offer a way to take a company public without the headaches of an initial public offering (IPO).

In a reverse merger, a privately held business buys a publicly traded, often dormant, company known as a “shell.” The shell then issues enough stock (usually 90%) to the owners of the private company to enable them to control the public shell. Generally, the shell’s name is changed post-merger to reflect its new operating structure.

It worked for Armand Hammer and Occidental Petroleum as well as Ted Turner and Turner Broadcasting — could it work for your company?

Several advantages

Reverse mergers offer several major advantages over IPOs. For one, they dispense with the need to comply with the complex filing requirements for IPOs. Companies don’t have to retain an underwriter and can avoid

hefty investment banking fees. As such, the initial costs of a reverse merger are much lower.

In fact, the cost of a reverse merger is about 25% of the out-of-pocket costs related to an IPO, according to *Entrepreneur* magazine. Bear in mind, however, that the “cost” also includes the equity given up in the transaction.

Reverse mergers also require less time and management involvement, making them less distracting than IPOs. What’s more, they allow a company to go public without the need to raise additional capital — resulting in less stock dilution. Finally, a reverse merger avoids the risk many IPOs face of the entire deal falling apart because of unstable market conditions.

A few drawbacks

Of course, reverse mergers do carry some disadvantages. They will not raise any capital and will result in only limited stock sponsorship. This can lead to inefficient trading of stock and possibly undercapitalization. Further, if the shell company’s failure saddles it with a bad reputation, the new company may have a hard time shaking that public perception.

For these reasons, a reverse merger will prove most advantageous for a company without an immediate need for capital. The business also needs to be able to find new capital and grow substantially once the merger is complete.

Getting started

Privately held companies should consult with their attorneys and financial advisors to determine whether going public via a reverse merger is a viable option with clear benefits. Advisors can also assist in targeting an appropriate shell company.

From a private company’s perspective, the best shell is a clean shell. If you are looking into a “trading and reporting” shell — or one that once held an active business — you must conduct extensive due diligence to ensure it hides no undisclosed liabilities, legal problems or other issues.



Why go public?

Going public is a giant step for many private companies. But public companies boast several benefits that can justify the risk and expense, including:

- 🔑 Increased liquidity of ownership shares,
- 🔑 Higher share price and, thus, company value,
- 🔑 Improved access to capital, and
- 🔑 The ability to acquire other companies using its stock.

If you can't find an appropriate shell, consider a "virgin" shell — an inactive, nonreporting corporation created through reorganization that is, therefore, free of liabilities.

Worth considering

Thanks to the occasional fraudulent use of reverse mergers during market boom periods, some stigma is still attached to the process. Reverse mergers, however, are faster, cheaper and easier than IPOs, and they deserve the consideration of any private company itching to go public. ➡

Protect your transaction with a presale audit

Business owners considering selling their companies can save themselves time and money by conducting a presale audit as early as possible. With scrutiny of accounting practices showing no signs of letting up, a comprehensive audit offers multiple advantages when it comes time to sell.

Expect a thorough review

A presale audit conducts due diligence on your company, concentrating on issues likely to concern a buyer or lender. These might include contracts nearing expiration, protection of intellectual property and lease terms. And though accounting practices receive the most publicity, an effective audit will also touch on other areas.

Expect auditors to review the following:

- 🔑 Key files for completeness and proper order,
- 🔑 Participation and service contracts,
- 🔑 Insurance policies,
- 🔑 Income and property taxes,
- 🔑 Financial records, and
- 🔑 Systems data for accuracy and consistency.

In addition, auditors will update operating statements and assess the effect of any problems on the business's marketability.

Don't put it off

Owners should resist the temptation to put off a presale audit of their business or wait until a buyer requests one. Ideally, the audit should be conducted as soon as a future sale becomes likely — at least one year in advance.



Completing the audit early serves several purposes. It lets a buyer preempt deal-breaking surprises and embarrassing situations. It also identifies potential problems and issues early enough to deal with them or at least put a positive spin on them for prospective buyers.

Get a head start

At the very least, a presale audit leads to the collecting of information that will be needed later — smoothing the way for an easy due diligence stage. And, in the case of a merger, the new company will be that much closer to complying with Sarbanes-Oxley requirements for audited financial statements. ➡

Bridging the gap

Earnouts can pave the way to a deal

When disagreements over a business valuation bring negotiations to a halt, an earnout may present the answer. Earnouts can facilitate a final deal by bridging the gap between the buyer's and the seller's valuations.

Understanding earnouts

During a business sale, disagreements over its value often arise. For example, the buyer, uncertain about the business's future value, might base its offer price on historical data and similar factors. The seller, on the other hand, may counter that its business is undervalued because of market conditions and insist that future performance be factored into the price.

With an earnout, a buyer makes a partial payment up front and agrees to make an additional specified payment when the company meets certain performance-based goals. Properly structured, this arrangement allows the buyer to minimize its upfront risks and costs, while the seller gains the opportunity to benefit from the future performance of its business — possibly resulting in a higher total price.

Structuring the agreement

An earnout must address several critical issues:

Performance milestones. Selecting appropriate, objective milestones that are clearly defined and achievable is crucial. Milestones often are based on financial performance measures such as gross revenue or net profit. The parties also might opt for nonfinancial milestones, including product or account development, capacity utilization, or service improvements.

Performance evaluation. The agreement should specify the accounting methods that will be used and the treatment of specific items such as overhead. Periodic audits can ensure that systems and operations aren't manipulated to artificially boost or suppress performance measures.

Duration. Earnout agreements typically span one to five years. If the term runs too long, it can become difficult to



attribute performance solely to the acquired business, as opposed to integrated operations. A term that runs for only a short period can encourage the seller to make business decisions that will increase short-term results at the expense of the company's long-term health.

Control. A seller who agrees to an earnout retains a vested interest in the business and may wish to retain some oversight of areas related to accomplishing the milestones. The buyer, of course, wants control of management and operations.

The parties should probably enter an employment contract that specifically addresses who holds ultimate management and strategic authority. Sellers may want to require that their consent be obtained before the sale or addition of assets or before decisions regarding key personnel are made.

Buyers should consider the duration of the employment contract and ask whether a seller can be motivated as an employee after the earnout is paid.

Building in protections

Even the best-intentioned agreement can come under attack. Buyers and sellers, therefore, should choose a mechanism to resolve disputes and avoid litigation. An earnout can certainly pave the way to completing a transaction, but it must be carefully constructed to truly benefit both parties. ➡

New choices for shareholders of closely held companies

Shareholders in closely held companies are still absorbing the far-reaching implications of the Jobs and Growth Tax Relief Reconciliation Act of 2003. One such implication — reduced taxes on dividends and long-term capital gains — makes alternatives to mergers and acquisitions, such as redeeming shares, more attractive.

Shareholders should act swiftly, however. Though still relatively new, these choices may not exist for long.

Taxes on dividends and capital gains

Although the 2003 tax package failed to fulfill President Bush's stated goal of eliminating the dividend tax altogether, the legislation did significantly reduce the tax. From 2003 to 2008, qualified dividends from domestic companies and qualified foreign companies are subject to a tax of no more than 15%.

To qualify for the slashed dividend rates, the stock must have been held for more than 60 days during the 120-day period that began 60 days before the last date on which shareholders were entitled to receive the upcoming dividend. Otherwise, dividends are taxed at the rates that apply to ordinary income, which can run as high as 38.6%.

The reduced rate may persuade majority shareholders who previously would have tried to sell their shares of a closely held business to instead seek a partial stock redemption.

The 2003 legislation also places a tax cap of 15% on long-term capital gains from sales of capital assets transacted after May 5, 2003; the previous maximum rate was 20%. Shareholders who wish to sell their stakes in a company can now do so knowing they'll be taxed at a rate of no more than 15% (assuming they've owned their shares for at least one year).

Stock redemption: Sale or dividend?

Stock redemptions generally are classified as either: 1) a sale or trade, which is subject to the capital gains tax, or

2) a dividend or other distribution, which is subject to the dividend tax. The proper classification of a stock redemption depends on the circumstances.

A redemption will be treated as a sale or trade if:

1. The redemption isn't essentially equivalent to a dividend,
2. There is a substantially disproportionate redemption of stock,
3. There is a complete redemption of all the stock of the corporation owned by the shareholder, or
4. The redemption is a distribution in partial liquidation of a corporation.

In other words, when shareholders give up a significant portion of their shares (and, therefore, control of the business), the transaction is subject to capital gains taxes. But now, the tax rate doesn't exceed 15% of the difference between the cost basis of the shares sold and the sale proceeds, whether shareholders sell their shares outright or receive a cash dividend based on the sale of assets.

Alternatively, shareholders might prefer to exchange some shares for a dividend distribution — particularly if they desire liquidity for the shares. Where the previous dividend tax rates may have made such a partial redemption of shares unappealing, shareholders now can cash out some of their shares and incur a much smaller tax liability.

Note that the dividend tax applies to the full proceeds of the transaction, as opposed to the capital gains tax, which applies to a smaller portion of the proceeds.

Fading into the sunset

Like other cuts in the 2003 tax package, the dividend and capital gains tax reductions are subject to "sunset" provisions, which will return these rates to their previous levels after 2008 unless Congress acts to extend the breaks. You should, therefore, consult your M&A advisor to determine the best time to take full advantage of the tax reductions. ➡



Ask the Advisor

Q. I've been reading about the FASB ruling on pension and postretirement benefits. How will this affect me?

A. The Financial Accounting Standards Board (FASB) issued its revised Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, at the end of 2003. It represents the FASB's response to concerns raised by investors and other users of financial statements about the need for greater transparency of pension information.

The FASB initially considered overhauling the pension accounting rules but instead settled on improving disclosure. The statement is intended to increase the reliability of financial statements by encouraging them to provide more complete and precise information about postretirement benefit resources and obligations.

The statement, which replaces the existing FASB disclosure requirements for pensions, requires companies to provide more details about their pension plan assets, benefit obligations, cash flows, benefit costs and other relevant information.

Companies now must provide in their financial statements a breakdown of plan assets by category — for example, equity, debt and real estate. For each category, businesses must describe investment policies and strategies as well as target rates of return.

Companies also must estimate and disclose pension benefits to be paid out to employees for each of the upcoming five years and an aggregate amount for the subsequent five-year period. And they must estimate contributions to

be made in the next year to fund pension and other postretirement plans.

The revised statement requires additional disclosures about the types of plan assets, investment strategies, measurement date(s), plan obligations, cash flows and components of net periodic benefit costs.

Further, companies must report the various elements of postretirement benefit costs each quarter, rather than annually. The revised statement, however, retains the reduced disclosure requirements in the previous statement for nonpublic companies.

What does this mean for your business? Will compliance with the added requirements be burdensome? The FASB points out that companies preparing their financial statements in accordance with generally accepted accounting principles (GAAP) should have already compiled and aggregated data on postretirement plans. So information about equity securities, debt securities, real estate and other assets is likely available from your asset management records.

The required reporting may necessitate some additional effort and cost. But the information is essential to comply with other FASB standards for reporting postretirement benefits and, thus, should be available to — and understood by — financial statement preparers.

The revised FASB Statement No. 132 became effective for fiscal years ending after Dec. 15, 2003, and for the quarter beginning after that date. ➔

Don't fear the "d" word

Divestitures can boost company value

High-value companies do more than just invest; they divest, too. These successful companies look at their business as a portfolio and divest strategically — shedding units unlikely to grow and sometimes even those producing steady earnings.

Could this strategy work for your company?

When to divest

Research indicates the companies that create the most shareholder value actively acquire and divest. But businesses often turn to divestiture only as a reactive measure, in response to crises such as substantial financial losses or mounting debt.

In fact, “isolation of underperformers” was the top driver behind divestitures, according to a 2003 study by benefits consultants Hewitt Associates. This suggests that many companies hold on to units for too long, allowing them to drain resources and eventually reduce sale prices.

Divestiture, however, can also be driven by more positive motivations, such as redeploying capital, improving balance sheets, increasing cash flow, funding new initiatives and paying down debt. Such divestitures allow management to focus on the core business and can lead to higher stock prices.

They also present an opportunity to change the company's message to investors, employees and others. Divestitures can reinvigorate a company that has become complacent,

encouraging the pursuit of new growth areas rather than just relying on units with predictable revenues.

How to divest

Successful divestiture calls for an established strategy and plan of attack; in other words, you should avoid reactively dumping a business unit at a slashed price. Instead, regularly evaluate units to find likely candidates for divestiture — focusing not only on underperformers but also on profitable units.

Businesses need to get past their natural resistance to divestiture and realize that it isn't necessarily a sign of failure.

To determine suitable candidates, consider several factors, including the unit's impact on the whole company, its ability to attract and retain customers, and its ability to satisfy or surpass market expectations.

After identifying a unit for divestiture, develop a business plan for it and set the unit in a direction that demonstrates your company's value to potential buyers. You must work to obtain buy-in from its employees, explaining the rationale behind the move — particularly if the unit to be divested is profitable — and the benefits. Finally, consult appropriate advisors who can assist in locating buyers, valuing the unit and dealing with tax matters.

Ensure that divestiture evaluation becomes an ongoing process and part of your overall corporate strategy.

Not a dirty word

Businesses need to get past their natural resistance to divestiture and realize that it isn't necessarily a sign of failure. Instead, divestiture should be considered a key part of any company's overall strategy for increasing value. ➔





GILBERT A. HERRERA

Founded the firm in 1992 and was previously the director of Coopers & Lybrand's South-west 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.



Merger and Acquisition Advisory Services



Debt and Equity Placements



Valuations and Fairness Opinions



Expert Testimony



Restructurings, Turnarounds and Reorganizations

*Specializing in Value-Added Distributors and Contractors
Serving the Energy, Telecommunication, Food Products and Health Care Markets.*

www.herrera-co.com

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