MERGER & ACQUISITION FOCUS

Year End 2004

Your board is your best friend

Boards of directors and advisors provide objective advice on M&As

Buyer beware

Know the risks before making an acquisition

Beat the odds and make your strategic alliance succeed

Ask the Advisor

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Because of the risks involved, making decisions about mergers and acquisitions places enormous pressure on company owners and executives. But management can mitigate some of this pressure by relying on the wisdom and advice of its company's board of directors or board of advisors.

Board responsibilities

The official responsibilities of each board are different. A board of directors represents the interests of a public company's shareholders and must adhere to an official set of duties that include establishing corporate objectives, approving annual budgets and monitoring CEO performance. Ultimately, a board of directors will base its decisions and opinions on what it believes to be best for shareholders — not necessarily company management.

A board of advisors, on the other hand, is a more informal group that provides independent advice to management when required. Advisors' roles might include serving as sounding boards for CEOs or providing objective opinions on business proposals — including mergers and acquisitions.

Their differences aside, both directors and advisors can be extremely useful to companies trying to make difficult decisions about their future. Both boards usually include members with extensive business experience, financial expertise and legal knowledge. Some members, for example, may have been personally involved in a merger or acquisition and can evaluate a company's proposed deal based on firsthand experience.

Boards also offer the kind of objectivity not generally found in owners and CEOs. Too often, ego and emotion, or the "thrill of the hunt," drives M&A decisions. Board involvement can help ensure that mergers and acquisitions are pursued for the right reasons and that the target company makes sense from a growth perspective.

To be truly useful, both directors and advisors should constructively review and challenge any proposed deal — not simply rubber stamp management's plan.

Tapping board resources

Management can best take advantage of board resources by involving them in the merger or acquisition process as early as possible and by providing members with as much information as they can.

Board members, in turn, should be able to provide insight and guidance in the following areas:

Determine if the company will receive a good return on its investment. A merger or acquisition is an investment in a company's future — often a very costly investment. Before signing off on management's plans, boards should thoroughly examine the deal's cost, including an increased debt load, and reconcile it with potential growth and earnings.

Management can help its board evaluate the financial due diligence by submitting financial models of the proposed transaction. Two types of models should be built: The first considers the deal on a standalone basis, and reflects the expected revenue, earnings, assets, technology and cash flow.

The second model represents the deal on a combined basis — or with all the anticipated synergistic benefits.

These benefits include all likely cost savings from integrating the two organizations, as well as the probable revenue enhancements. This model will indicate the expected economic return your company will earn as a result of the acquisition.

Boards should also consider the less-quantifiable, opportunity costs that can make a deal less attractive. M&A activity can consume a significant amount of an organization's most precious resource: the time of its key executives. Time spent pursuing a deal, then integrating the target company, is time lost pursuing other high-value opportunities, such as organic growth initiatives.

Make sure a well-reasoned strategic rationale exists. One of the worst M&A mistakes companies make is acquiring a target because it is cheap or a "good deal." Boards should make sure management can clearly articulate a strategic rationale for any proposed deal. For example, will the merger provide access to new markets, the acquisition of new products or better economies of scale?

Whatever the specific reasons for the deal, it should dovetail with the company's stated long-term goals.

Require focused integration plans and performance accountability. Failure of postmerger integration is the most common reason for an unsuccessful deal. But the window to effectively implement a deal is a small one. A minor delay in integrating the target may limit management's ability to fully capture the strategic benefits that justified the deal in the first place.

The board can help ensure that the company coordinates the target with its new parent by requiring an integration plan. The integration plan should clearly indicate the people responsible for implementation, and hold them accountable to a realistic timeline.

Often, important issues such as information systems, accounting, marketing and personnel integration are delegated to midlevel executives instead of senior management. Consequently, the synergistic benefits of the acquisition are waylaid. Any integration plan should discuss how top executives will take an active, hands-on role during the integration period.

Objectivity and credibility

Owners and CEOs accustomed to making important company decisions may find it difficult to ask their directors or advisors for input on a merger or acquisition. But a board's objective feedback is usually what's required when contemplating a deal that is likely to have a huge impact on the company's future.

Board approval also lends credibility to management's decisions and relieves some of the pressure that comes with great responsibility.

Buyer beware

Know the risks before making an acquisition

Acquisitions can create value and significant economic return for an acquiring company's shareholders. But there's another side to acquisitions — the risk created by the knowledge gap between buyers and sellers.

Information and knowledge will never be shared symmetrically between both parties in an acquisition. No matter how much due diligence buyers perform, sellers always possess more and better knowledge about their own company.

Expert opinions

While buyers can never completely eliminate this information asymmetry, consulting with lawyers, bankers and accountants can help mitigate risk. And an increasing number of smart buyers are also adding risk management and insurance professionals to their due diligence team.

Accountants and bankers can help examine business transactions from a corporate finance perspective. They understand financial projections, high-level business risks and tax issues. CPAs, in particular, can guide you through all stages of financial due diligence. Lawyers, of course, evaluate acquisitions from a legal point of view.

These professionals, however, aren't necessarily experts in evaluating corporate risk. Risk management and insurance professionals are probably better qualified to uncover issues related to liability, environmental obligations and insurance coverage. Their additional analysis can help solve problems before they become expensive and jeopardize a proposed deal.

Liabilities may lie in wait

Many companies contemplating acquisitions may not realize it, but the form the acquisition takes may present special risks.

For example, if an acquisition is via a stock purchase, you normally acquire all of the target company's past liabilities along with its assets. Unfortunately, no contract, no matter how well written, can mitigate risks associated with your target's claims, whether disclosed or undisclosed.

How then do you protect yourself against hidden liabilities when purchasing another company? Start by examining the target's risk management program. Then obtain copies of all past insurance policies and claims for a minimum of three to five years.

This is important, because your own insurance program probably won't cover claims made against the acquired company if the incidents occurred prior to the acquisition date.

There's another risk you should know about — incurred but not reported liability. This refers to the potential liability caused by past negligent or wrongful acts that have yet to result in injuries or damages. Such acts may actually trigger claims well after the acquisition has been completed.

Because of the time lag between the negligent act and the resulting damage, it may not be clear which insurance policy must assume responsibility. Often this issue leaves much room for interpretation and judgment.

Because the issue of liability insurance is a significant complicating factor in insurance and risk analysis, it should be thoroughly vetted by risk managers before your company makes an acquisition.

Review for risk potential

An acquiring company's financial, legal and risk management advisors should examine at least three major areas before purchasing the stock or assets of another company.

Real estate and environmental concerns. Your team of experts should examine the condition of real estate of the company you are buying to ascertain whether the property is unsafe or may present a public hazard. To avoid landmines, such as the discovery of asbestos or toxic waste, review the current and previous uses of all property you are purchasing.

Owners can be held liable for part or all of any environmental cleanup and remediation costs, regardless of how long they have owned the property. For this reason, commercial lenders generally require an environmental assessment of any of the real property a company plans to acquire.

Assuming no obvious environmental problems, you need to decide how to optimize the newly acquired facilities into your existing infrastructure. Finally, you should determine the liability and insurance costs associated with the property.

Contracts. Too often, acquiring companies assume excessive risk because they don't closely scrutinize their target company's existing contracts.

When you acquire another company, it's likely you will assume existing leases and agreements. While your attorney will examine them from a legal point of view, your risk manager must understand the amount of liability being assumed. Even a small company will have a large number of contracts and quasi-contracts, including contracts with vendors, customers, financial institutions and employees.

Past and undisclosed claims. There is no easy and effective mechanism to obtain information on past claims, undisclosed claims and unusual risks. While it is easy to obtain information about certain issues, such as workers' compensation and liens, others may be more difficult to find or even predict.

For example, claims that have yet to be filed may be inherited subsequent to the deal closing. The employees of the target company are another consideration. If you plan to cut personnel, you may become subject to claims of wrongful termination, age discrimination or Americans with Disabilities Act issues. Managing employment practice risks is critical to avoiding costly problems.

It takes a team

It will be impossible to eliminate all risks from your proposed acquisition. But if you assemble a risk management team to review potentially troublesome areas, including real estate, contracts and insurance claims, you should minimize the possibility of unpleasant surprises down the road.

Beat the odds and make your strategic alliance succeed

According to the Institute for Collaborative Alliances, more than half of all strategic alliances either fail or fall short of expectations after just a few years. Despite a failure rate that is even more disconcerting than U.S. divorce statistics, many companies still pursue this traditional path to corporate growth.

Understanding your company's role in a strategic alliance and anticipating risks and conflicts will help improve its chances of success.

Strategic alliances don't have to fail. The key to their success is for both parties to understand that the relationship will require a substantial commitment of time and resources. Companies also need to recognize the risks involved. This is particularly true for smaller companies entering deals with larger ones.

Types of alliances

Strategic alliances are by no means a "one size fits all" business model, but they generally have the following characteristics: Both parties typically share a common business strategy, are willing to exchange specific knowledge or strengths with their partner, and are willing to pool resources for mutual gain.

Strategic alliances commonly include joint marketing, sales or distribution deals. In certain industries, such as technology or pharmaceuticals, collaboration on design, manufacturing, technology, research and development, and even back-office activities is common.

One framework for evaluating strategic alliances is along a business integration continuum. This framework compares the financial, managerial and operational commitment by both parties of an alliance. It permits the parties to visualize the resulting governance and economic benefits that might be realized between the two partners.

As two companies commit greater and greater financial resources, research budgets, managerial talent, and manufacturing and distribution resources, the relationship becomes more integrated.

For example, an informal alliance might be formed when two companies with little shared financial resources join to distribute products. On the other end of the continuum, two firms might both make significant financial contributions to fund a very capital-intensive investment.

Alliances can be flexible business models. Many informal alliances, after a period of increasing collaboration and trust between the two companies, can grow into more significant businesses for both organizations.

Understand risks and benefits

Regardless of the type of alliance, you should seek expert advice to assess all of the legal, financial and operating risks and benefits that might be involved. This will help ensure that both parties enter into the agreement with an accurate understanding of their commitments and obligations.

Smaller companies, in particular, need to anticipate special business risks. Often, these firms end up giving up more than their pro-rata share of the investment in their quest to obtain what they believe are substantial resources of their alliance partner.

Only later might smaller companies realize their larger partners do not share the same passion or commitment to take combined businesses to the next level. Small companies that are rich in intellectual capital need to carefully evaluate the knowledge they intend to share.

Plan for success

Drawing up a rigorous business plan and financial model can help protect both parties' financial interests. The business plan should outline the expectations of the venture, including business objectives.

The financial plan, in turn, should include the parties' investment of cash, intellectual property, licenses, personnel and distribution access, among other investments. The financial plan should also articulate a dividend policy, how

costs will be shared and how value will be determined when the alliance is terminated.

Unfortunately, while strategic alliances are wonderfully flexible business operation models, they can become legally complicated. Alliance contracts must cover current and future capital requirements, ownership and governance structures, a wide range of human resource issues and access to future intellectual property creations.

A "divorce arrangement" should also be planned in advance. Strategic alliances usually end at some point — either because the term of the alliance has expired, the alliance has failed to meet financial objectives or there are substantial disputes between the parties. It is necessary, therefore, to put a dispute resolution mechanism and buyout process in place before entering the original agreement.

Prioritize implementation

Many strategic alliances appear successful on paper, but fail to actually produce results over time. Understanding your company's role in the partnership and anticipating risks and conflicts will help improve its chances. But ultimately, the success of the alliance may come down to how well you implement your plans. So whatever form your alliance takes, be sure your company makes it a priority.

Ask the Advisor

Q. I'm considering requesting investment capital from a private equity group. What are the pros and cons of going this financing route?

A. Expanding companies are frequently faced with a major problem: The financial requirements created by their high-growth prospects are greater than their available capital. Indeed, growth creates a myriad of management challenges — not the least of which is ensuring sufficient capital to support the requirements for increased receivables, inventory and fixed assets.

In certain situations, private equity is a viable financing option — for example, when you no longer have access to senior debt or bank loans. But, as with any type of financing option, you must consider all of the advantages and disadvantages before approaching a private equity investment firm.

Several advantages

A private equity infusion can have several significant benefits. For example, it can improve a company's balance sheet. As equity increases, leverage decreases and the fixed expense of debt service payments is reduced or eliminated.

An equity infusion also enhances financial flexibility. The new equity capital can be redeployed into inventory and fixed assets. As the company gains additional collateral, banks are more likely to increase their funding commitment, thus leading to better cash flow. Equity can also be provided to expand marketing programs or fund product development when bank financing is unavailable.

Some disadvantages

One disadvantage of private equity is its cost. Without high growth and high margins, it may be difficult to make the math work. In other words, because private equity investors require a higher rate of return than senior lenders, the value of your company must grow at a rapid rate to meet their growth expectations.

Even with a rapidly growing firm, selling shareholders will likely face dilution of their holdings as they make room for the private equity holders' ownership interests.

Private equity also involves many governance and control issues. Even if a company is only selling a minority interest, the private equity investor will request a board seat as well as some control over significant corporate decisions in the future.

What's more, the perspectives between selling shareholders and private equity investors may differ. Private equity investors often have an intermediate-term outlook and intend to exit the investment after five years. Shareholders, on the other hand, generally have much longer investment horizons.

While evaluating this complex decision, you will find there are many competing interests and conflicting opinions. The best approach may be to seek a team of financial and legal experts with experience evaluating financing options. Assembling the correct expertise and resources should result in a better corporate decision.

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.