Merger & Acquisition Focus

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The key to capital

Understand how lenders and investors evaluate your company's financial ratios

Avoid conflicts with a shareholder agreement

Not-so-extreme makeover

Normalizing makes your company more attractive to potential buyers

Ask the Advisor

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The key to capital

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Without capital — whether it's profits from internal operations, a bank loan or equity financing — most businesses find it impossible to develop products, hire additional employees or invest in new equipment. As the old adage claims, you have to spend money to make money. But before you seek capital, it's important to understand what qualities lenders and investors look for in a company, including key financial ratios.

Capital sources

There are three basic sources of capital for a business: internal operations, debt and equity. Most companies prefer funds generated from internal operations, or the net profit that results from subtracting expenses — including taxes, interest and depreciation — from sales. This form of funding doesn't involve obligations to anyone outside the company or increased outlays for interest payments or dividends.

Unfortunately, most businesses don't generate enough internally to pay for their growth. When increasing sales or cutting expenses isn't enough, you must decide whether to borrow money or sell partial ownership in your company. Each method has advantages and disadvantages.

Debt vs. equity financing

Debt financing, or a loan, can be an expensive source of funds, but it allows your business to remain in the hands of existing shareholders. Most lenders are primarily interested in earning interest and receiving the balance according to the loan's terms. As long as these conditions are met, lenders have little reason to exert control over your business.

Your other option is equity financing, which means selling shares in your company to investors. These could be angel investors — individuals who invest directly in small businesses, often taking a mentoring role. Or they could be investment organizations such as private equity firms or venture capital funds. By selling shares in your company, you get the capital you need, but also surrender partial

control of your business. And if you're required to pay dividends to shareholders, that reduces the amount of capital left to grow your business.

Unlike interest payments, corporate dividends paid to shareholders are not tax deductible, but dividends boast certain advantages compared to interest payments. Dividends are generally lower than interest payments, and they're paid out on a more discretionary basis than interest payments. This payment flexibility can be useful if your company experiences a downturn and you need to reduce or discontinue dividends until conditions improve.

What key financial ratios say

When evaluating your company for a loan or investment, lenders and investors look at several financial ratios. It's important, therefore, to understand what these ratios tell a prospective decision maker.

The **quick ratio** represents cash plus accounts receivable, divided by current liabilities. It shows whether your short-term assets are capable of covering your short-term debts if you need to repay funds in a crunch. The higher this "liquidity ratio," the more likely a lender will approve your loan request.

The **times-interest-earned ratio** expresses earnings before interest and tax expenses, divided by interest owed on borrowed funds. It tells lenders how much of your company's cash flow is available to cover interest payments. The higher this "coverage ratio," the more creditworthy your company is considered.

The **debt-to-equity ratio** compares total liabilities to shareholder equity. The resulting number measures a company's leverage — the degree to which assets are financed through debt or earnings and stock sales. The lower the ratio, the more moderate a company's debt is considered and the more favorably a lender will look upon your application.

Unlike the previous three ratios, which are primarily of interest to lenders, the **return-on-equity** (ROE) ratio is most relevant to investors. This ratio represents after-tax net income, divided by average net worth; it indicates the percentage shareholders are earning on their investment. The higher the ROE, the better the shareholder return and the more attractive your business will appear to equity investors.

Another test of a company's profitability is the **return-on-assets** (ROA) ratio. This compares earnings to total assets, rather than to just equity as ROE does. A broader measure of profitability, ROA is of interest to lenders and investors alike. The higher the ratio, the more profitable the business.

Avoid window dressing

Whether you decide to seek debt or equity financing, remember that ratios for your company will probably be compared to average ratios for your industry. If your business's ratios are out of line with those of your peers or if they show recent changes, be prepared to explain them.

If you have the time and resources, consider improving your company's ratios before seeking capital. Boosting sales and cutting overhead expenses are common methods of doing this, but they may require six months or more to accomplish.

At the same time, avoid extreme measures that could harm the long-term prospects of your business. Cutting maintenance on valuable production equipment, pressuring valued customers by aggressively collecting accounts receivable or stonewalling vendors by delaying accounts payable may improve your ratios temporarily, but when taken to extremes can backfire. Sacrificing long-term growth for temporary financial window dressing can be self-defeating.

Anticipate scrutiny

Whichever route you decide to take — debt or equity financing — be prepared for intense scrutiny of your financial statements. Understanding key ratios and doing what you can to improve their appearance may mean the difference between getting or not getting the money you need to grow your business.

Avoid conflicts with a shareholder agreement

Mike was vice-president of a very successful fan manufacturing company started by his father 30 years ago. He and his two brothers had inherited the company from their father, and it grew steadily under their management until two years ago. That's when Mike went through a contentious divorce.

Unexpected events

Under the divorce settlement, Mike's wife was awarded a portion of his shares in the company. Problems began when his former wife's new husband — who also owned a manufacturing business — started acting like an owner of Mike's company. When the new husband's demands for control over budgeting and other functions were not met, he and Mike's former wife resorted to litigation.

During the discovery process, Mike's company was asked to provide information on customers, receivables, employees and even manufacturing patents. This threat to the company's intellectual property, not to mention the legal expenses and time preparing paperwork, nearly destroyed the business.

While it's not always possible to anticipate events that might shake up a family-run or small business, a shareholder agreement could have saved Mike and his company a lot of money and grief.

Shareholder agreements are made among company owners to define procedures for handling business issues, including stock ownership and management.

When shareholder disagreements go public

Rare is the company whose owners or managing partners don't have differences of opinion. Opposing points of view are to be expected, which is why a well-drafted shareholder agreement that sets explicit ground rules about how firms are to be managed can keep ordinary disagreements from becoming divisive, public battles.

Disagreements that end up in court can cost co-owners much more than legal expenses and lost time. Decision-making among company leaders is a frequent casualty, as sides form, positions harden and gridlock sets in. Employee morale and productivity also suffer, as the rank and file respond to turmoil among senior ranks.

Disputes also make great headlines, especially when money is involved and the media has access to public court filings and testimony. The resulting bad publicity can severely damage a company's reputation in the eyes of its customers, vendors and lenders, no matter who has the legal high ground.

A well-written shareholder agreement can provide guidance and limit actions when business partners disagree or in the event of the retirement, death, disability or divorce of a major shareholder.

Protecting interests

Whether you're starting a new business or running an established company, discuss with business advisors the best way to structure your company to protect everyone's interests fairly.

A comprehensive shareholder agreement can cover stock ownership provisions that discuss to whom company stock can be sold and at what price. (For example, stock ownership might be limited to blood relatives of a family.) Not only can these procedures be useful when life events affect an owner's participation in the company, they can also reduce taxes. A company might redeem shares of an owner who has died so that her estate can pay estate taxes. Carefully worded buy-sell language in the shareholder agreement can eliminate the tax consequences of this redemption.

An agreement might also include:

- Management and employment provisions that define an owner's compensation, benefits, job responsibilities and retirement benefits,
- Dispute resolution mechanisms that provide a framework to resolve shareholder disagreements, including provisions for the departure of a shareholder and procedures for an enforced share sale,
- Definitions of what percentage of shareholder votes is required to approve key decisions such as electing directors, issuing new shares, declaring dividends, borrowing money or making large capital expenditures, and
- Shareholders' obligations to lend the company money if it cannot obtain conventional financing.

When discussing and drafting the shareholder agreement, remember to include all the key players, including legal counsel, your accountant and business insurance agent, and any spouses or others nonactive in the business who own company shares. Once you have a shareholder agreement in place, review and modify it periodically to reflect changes in personal and business circumstances.

Agreement in action

Not only can shareholder agreements help when there's a risk that shares may pass to an undesirable shareholder, as

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in Mike's case, but they often simplify retirement and management succession. Five years ago, James, president of a family-run architectural firm, announced he wanted to start reducing his workload and transitioning his responsibilities and shares to his niece, Sandra.

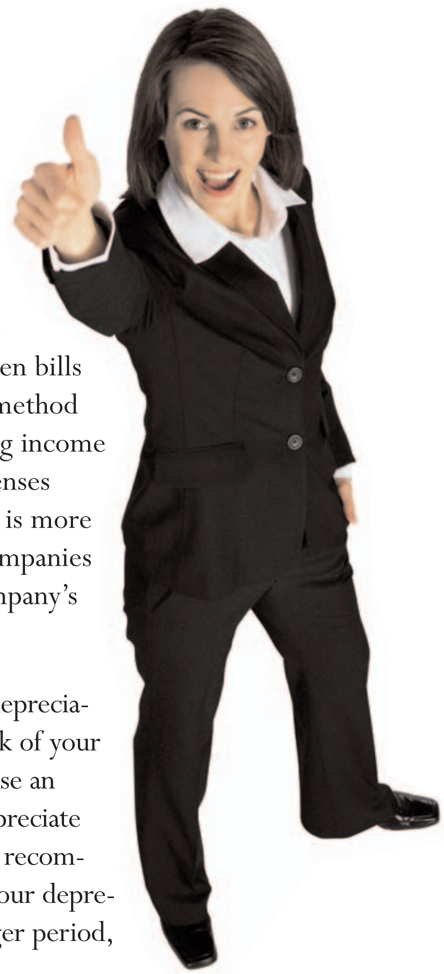
Fortunately, a shareholder agreement provided for "salary continuation," outlining the terms and conditions — including the time period and amount of compensation — under which James could ease into retirement. Though two of Sandra's cousins initially objected to her succeeding James, a buy-sell provision in the agreement also stated clearly to whom he could sell his shares (in this case, Sandra) and the method that would be used for valuing the shares. This effectively prevented family members from obstructing his plans.

Good shareholder agreements are never finished

Understand that your company will evolve over time as you grow older, new employees will join, and business conditions will change. If the time and expense associated with drafting or updating a shareholder agreement give you pause, remember the benefits of a good agreement and the long-term costs that an out-of-date or nonexistent agreement can impose.

Not-so-extreme makeover

Normalizing makes your company more attractive to potential buyers



Playwright Oscar Wilde observed that "only shallow people don't judge by appearance." This facetious remark is actually quite valid when it comes to the sale of a business. The appearance of your company — particularly the presentation of your financial statements — can very well determine whether you receive a fair market price.

Often, the financial statements of small and midsize businesses misrepresent a company's profitability because various accounting methods are used to reduce income and minimize taxes. Also, owners and family members may receive compensation and other perks that cut into reported profitability. It's usually necessary, therefore, to normalize or adjust financials when you prepare your business for sale.

Accounting for differences

Normalizing entails changing the level of expenses and revenues your business has been reporting to what a buyer might expect after acquiring your business. Many small businesses employ the cash method of accounting, which recognizes income when cash is received and expenses when bills are paid. But the accrual method of accounting — reporting income when it's earned and expenses when they're incurred — is more common among larger companies and may present your company's financials in a better light.

Your system of reporting depreciation may also harm the look of your business. If you currently use an accelerated schedule to depreciate assets, your advisors might recommend you instead spread your depreciation expense over a longer period, as potential buyers would.

Compensation and perks

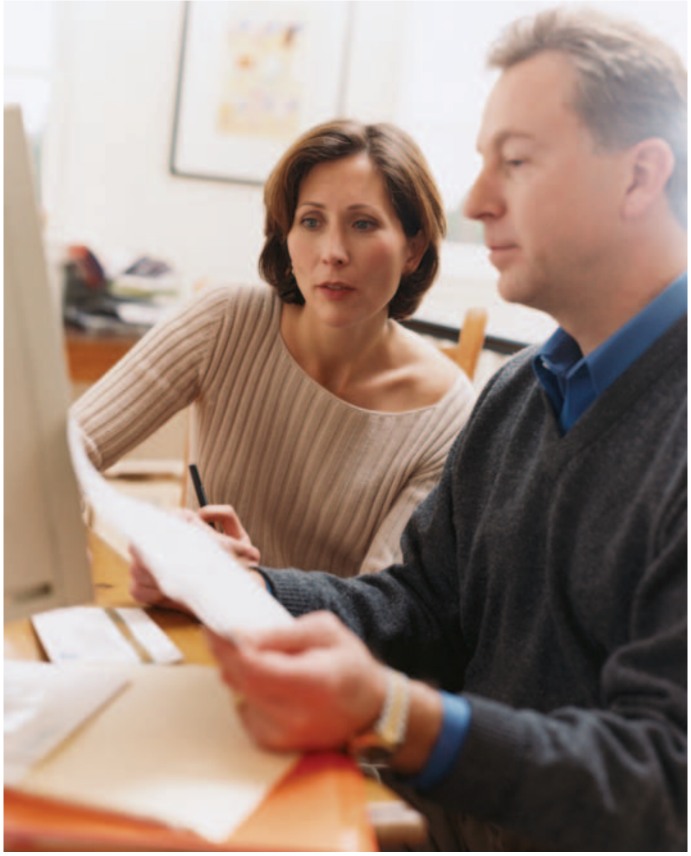
Owner-operated businesses often compensate owners and other family members at higher levels than other companies pay their key executives. Buyers who no longer need to compensate an owner or may not wish to pay executives as generously would, therefore, expect lower expenses allocated to salaries and bonuses. And because the company's normalized payroll would be lower under different ownership, the firm's assumed payroll tax would be adjusted as well.

Perks enjoyed by business owners — including company cars, club memberships, entertainment, luxury hotels and dinners — may also need to be eliminated on normalized statements. Financial advisors adjust these expenses by eliminating anything a new owner might regard as excessive or unnecessary and place them in line with industry norms.

Some business owners include their spouses and other family members under their company insurance policy coverage. Because a buyer presumably wouldn't maintain this generous coverage, insurance costs would be normalized into a less comprehensive, standard coverage plan.

Other adjustments

Other items that might merit the attention of your financial advisors during the normalization process include:



Inventory. Businesses often record inventory sales using the last in, first out (LIFO) accounting method. Given that the cost of inventory usually increases over time, the LIFO method more quickly reflects these recent increases as cost of goods sold, resulting in lower reported profits and lower taxes. Restating earnings with the first in, first out (FIFO) method makes for more robust profits and is generally recommended if you are trying to sell your business.

If you currently use an accelerated schedule to depreciate assets, your advisors might instead spread your depreciation expense over a longer period.

Interest expenses. If your business has bank loans or bonds outstanding with varying interest rates, a new buyer might be able to consolidate this debt with a lower overall rate. A normalized income statement would reflect potentially lower interest expenses.

Real estate leases. If your company leases real estate from another business you own, the lease may be set at an above-market rate to maximize your real estate earnings. Advisors normalize the cost of the lease to reflect the fact that a new owner would likely pay only a fair-market rate to lease the property.

Related-party transactions. Similarly, your business may be overpaying certain vendors or undercharging particular customers because of personal and family relationships that would not apply under different ownership. These items would also be adjusted to going market rates.

Realistic and appealing

As a business owner interested in selling your company, be prepared to work with your advisors to reshape your company's financials into a format that's useful to buyers. When you successfully normalize your financial statements, not only is a more realistic picture of your company likely to emerge, but a more appealing one as well.

Q. What are the benefits of moving real estate into a limited partnership?

A. You can gain several advantages: A real estate limited partnership both protects property from adverse lawsuits and reduces the capital gains tax impact of selling property before a deal, or as part of a deal.

Corporations often purchase the real estate they require for their business assuming that owning it outright is the best way to ensure long-term control of the property and benefit from future capital appreciation. Yet many owners are unaware of the legal risk of owning property through a corporation.

If someone is injured on your company's property, that person may sue the business. Your company's general liability insurance may settle the claim, but if you lose the case and the claim exceeds the dollar amount of your insurance coverage, the injured party can potentially come after your company's assets and company stock. A winning plaintiff who is awarded a majority of your company's shares can then gain control of the business and liquidate all of its assets, including real estate.

A limited partnership can protect you from this kind of situation. Limited partnerships are business entities with at least one limited partner and at least one general partner. Limited partners typically maintain rights to distributions — including profits — of the entity, but have limited liability equal to their contribution of company assets to the partnership. The general partner has decision-making responsibility for the partnership, and can be anyone you wish, including the property management company that oversees the real estate.

When you own real estate in a limited partnership, a successful plaintiff can seek damages from the partnership but is entitled only to distributions and allocations of income and loss that would otherwise go to you as a limited partner. The litigant has no enforceable claim on the limited partnership's real estate.

There are also important tax advantages to owning company real estate in a limited partnership. When a corporation sells real estate that it owns directly, the transaction is considered a taxable capital gain on the appreciated value of the property over and above its original cost, or tax basis.

But, when you hold real estate in a limited partnership, the tax basis of the property is increased by any mortgages or other debts on the property. This reduces your tax bill because the higher the property's tax base, the lower the taxable capital gain allocated to its partners. A limited partnership can also refinance property, and, depending on the amount borrowed, can make tax-free cash distributions to limited partners.

Limited partnerships aren't difficult to create when you work with legal counsel. You'll likely need to make a state filing to establish the partnership, and it's advisable to have a written partnership agreement specifying the roles and responsibilities of the general and limited partners.

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. Additionally, Mr. Herrera served on the Commission of 125, *Planning for the Future of the University of Texas at Austin*.

He currently serves on the board of directors of the Harris County Housing Finance Corporation, the Houston Hispanic Chamber of Commerce and the CHRISTUS Gulf Coast finance committee. He is the immediate past President of the Turnaround Management Association, Houston chapter the leading education and advocacy group dedicated to the corporate renewal industry.

Previously, Mr. Herrera was appointed by Governor Rick Perry in 2001 to serve as Chair of the General Services Commission through its transition to the Texas Building and Procurement Commission. He was also 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 public member of the Commission for Lawyer Discipline from 1993 to 1999 and Chaired the Budget committee.

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