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Ask the Advisor



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Lock in your financial interests

Key person insurance protects owners, buyers, other stakeholders

Though it's unpleasant to consider the possibility that you or one of your critical employees will die unexpectedly, it's important to anticipate and prepare for every variable that might affect your business's future. Key person life insurance can help you do just that. This versatile product can protect your company's financial interests, as well as those of other stakeholders, including investors, lenders and potential buyers.

Who's covered?

When you purchase a key person policy on the life of an employee, your company pays the premiums and becomes the owner and beneficiary. Should the employee die, your company receives all death benefits — not the employee's family.

Why a buy-sell agreement?

Buy-sell agreements have two fundamental purposes: to provide for an orderly business transition should an owner die, become incapacitated or leave the company, and to help ensure a fair price for ownership interests. This type of agreement is often considered essential to a company's business continuation plan or an owner's estate plan.

A buy-sell agreement can help prevent situations your business would rather avoid, such as the deceased partner's family squabbling with remaining shareholders over, for example, who has the right to buy shares or at what price. It might also include covenants that prevent a terminating shareholder from competing with your company by soliciting its customers or employees.



Companies typically buy key person policies for owners, senior executives, partners and other employees whose death could cause significant disruption in business operations or trigger financial losses. This could include, for example, top salespeople and intellectual property developers.

When identifying individuals to be covered, you should consider the:

- ✦ Opportunity cost of forgone sales, product development, customer relationships or other key functions for which the employee is responsible,
- ✦ Expense of hiring and training a suitable replacement for the employee, and
- ✦ Contractual obligations to the employee's family, such as deferred compensation or salary continuation.

The policy payout can help you meet these obligations while your business works to recover financially from its loss.

Buy-sell agreements and other uses

Key person insurance can also be used to fund buy-sell agreements. This might be done in one of two ways:

- 1. Cross-purchase agreement.** Each shareholder buys a policy and names him- or herself beneficiary on each of the other shareholders' lives. When a shareholder dies, each shareholder uses the proceeds to buy some of the deceased shareholder's shares.
- 2. Redemption agreement.** The business buys a policy on each shareholder's life and names itself beneficiary. When a shareholder dies, the business uses the proceeds to buy the deceased shareholder's shares.

If you're considering using key person insurance as part of a buy-sell agreement, you'll need to appraise the value of each ownership stake to determine the amount of coverage that's needed. This generally requires you to hire a business valuation professional.

Key person insurance might also be used by investors and lenders to protect their financial interests. They might, as a loan covenant or investment condition, require an owner to take out a policy naming them as beneficiary.

Role in the M&A process

Key person insurance can also be reassuring to prospective buyers of a company who base their offering price on the value that certain executives, salespeople or product developers bring to the business. Buyers who don't believe this kind of coverage necessary or who wish to cut expenses always have the option of reducing or discontinuing key person coverage when they assume control.



Sellers in a transaction might also protect their interests with key person insurance. If your transaction is owner-financed, you might require the buyer to continue key person coverage already in force and ask the new owner to take out a policy on him- or herself, making you the beneficiary.

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Cost of coverage

The amount of key person coverage necessary can depend on many variables, including the insured employee's role in the business, the type of company and its profitability. One calculation method multiplies an employee's annual contribution to profits by the number of years your business is likely to need to find and train a replacement. Another method multiplies the individual's total annual compensation by a multiple — commonly two or three times the employee's annual salary.

Annual key person insurance premiums typically cost 2% to 3% of the policy's face value. The age and physical condition of insured employees influence cost, with younger, healthier employees generally receiving better rates. You might reduce costs when buying coverage for a group of key employees by using a "first to die" policy, under which only the first death qualifies for benefits. In that scenario, the remaining employees are then eligible to apply for new coverage without having to prove insurability.

The type of key person policy you take out will also determine cost. Term insurance, which remains in force for a specific period of time, for example 10 or 20 years, is the lowest-cost form. Permanent insurance is more expensive because it builds a cash value and extends for an employee's life, as long as your company continues to pay premiums. While permanent policies are more expensive, they offer an advantage term coverage doesn't: The policy's cash value can be used to pay retirement benefits to employees who survive to retirement.

Getting the best value

There are plenty of reasons to consider key person insurance. Whether you want to protect your company from potential financial distress, ensure that funds to carry out the terms of a buy-sell agreement will be available, or preserve your financial interests during and following a business sale, this type of policy is a relatively inexpensive way to do so. ➔

After the sale: Retirement and estate plan considerations

When business owners retire and sell their business or transfer it to family members, they typically face two major challenges: 1. to manage assets adequately to support themselves through retirement, and 2. to pass wealth efficiently to heirs. To meet your retirement and estate objectives, it's essential to begin the planning process well before you sell your business.

Getting started

This process begins with a good succession plan that outlines how your business is to be sold or transferred. You might, for example, begin grooming your children as successors and transferring partial ownership to them while you're still at the helm. Then, when you're ready to relinquish control and turn your long years of hard work into a steady source of income, the transition is more likely to be smooth.

You may also want to consider establishing a trust, an excellent way to transfer wealth to future generations.

You shouldn't attempt to make your retirement and estate plans without assistance, and business owners have many special considerations that require the expertise of financial and legal professionals. Assemble a team that includes — at the very least — an investment advisor, attorney and tax expert. In addition, you may require the assistance of an insurance agent, and you'll need to appoint a trustee if you decide to make a trust a component of your estate plan.

Retirement finances

One of the first things an investment advisor will help you do is ensure your assets are diversified. A high concentration in any one asset — such as shares in your business — can make for an extremely precarious



financial situation. If that large asset were to decline in value, your retirement income and security could be compromised.

Another major component of retirement planning is determining your income stream — or where your income will come from and in what order you should tap your assets. In addition to Social Security benefits, you're likely to have retirement accounts such as an IRA, SEP, Keogh or 401(k).

When tapping accounts for retirement income, you'll want to be careful to avoid actions that could have negative tax consequences. You'll need to keep an eye on minimum distribution rules governing tax-deferred retirement accounts. With certain accounts, such as traditional IRAs, your choices may be limited because you must begin taking distributions at age 70½ or face significant penalties.

How much income you'll require depends on many factors, including your lifestyle and health. Some business owners stay on as paid consultants to their former companies or even as salaried employees. If you work at least part time after your official retirement, you may be able to put off tapping your investments and have the opportunity to continue to contribute to tax-advantaged retirement plans.

Planning your estate

Your first estate planning objective should be to write a will — if you don't have one already — and to appoint an executor or personal representative to oversee the distribution of assets following your death. You may also want to consider establishing a trust, an excellent way to transfer wealth to future generations and help them avoid the costs and inconvenience of probate.

Trusts are legal agreements in which a trustee, such as a trusted advisor or a financial institution, manages property for the benefit of beneficiaries. These legal forms are varied and flexible. Trusts also can protect assets from creditors and provide professional investment management services.

Your circumstances, including the size of your assets, their allocation, and your beneficiaries, will determine the credit and tax calculations that recommend your ideal trust. Trusts can be designed with many provisions, such as to accommodate wealth management through fiduciaries for living family members, create credit shelters and provide tax shelters.

A customized solution

No two retirement and estate plans are alike, so you should work closely with your advisors to ensure all of your and your family's objectives are met. While selling your business may seem like an ending, it's also hopefully the beginning of a long and prosperous retirement. ➔

Counting cash (flow)

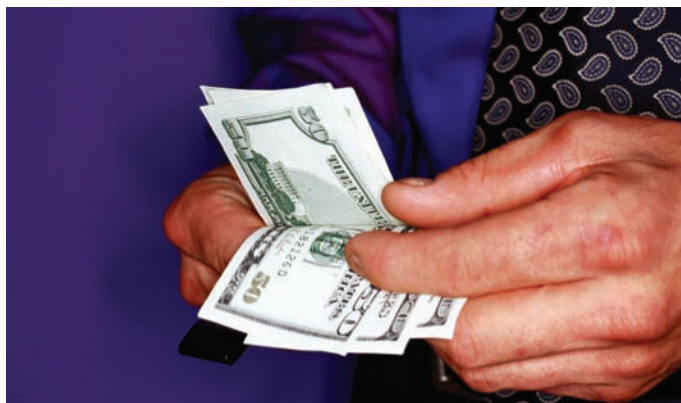
How buyers and sellers can arrive at different valuations

Given the centrality of cash flow to business operations, it's no surprise that it also plays a fundamental role in valuing private companies. Understanding how cash flow determines your business's value — or that of the company you're trying to acquire — will help you make knowledgeable decisions when negotiating a sale.

Role in valuation

There are many definitions of cash flow. But it is commonly thought of as a company's net income (sales minus expenses and income taxes), plus noncash expenses (primarily depreciation and amortization) minus principal liabilities, working capital, and capital expenditures, such as new equipment. The resulting figure, known as free cash flow, is the amount a business's owner could remove each year without compromising the company's ability to function and grow.

Most acquirers will want to receive cash amounts over the next five years equal to their original investment, plus interest. Therefore, if you can forecast the next five years' cash flow, you can reduce the total amount by the interest the investor expects to receive and determine a present cash value for the operating company. This may be referred to as discounting future cash flows to find the present value.



To calculate the value of a company from the cash flow it generates, a valuation professional performs a discounted cash flow analysis (DCFA). The valuator uses a variety of methods to estimate the company's future cash flow over a period of years, and then discounts the combined flows to determine the present value. The "discounted" portion reflects the risk of actually receiving the full amount.

In theory, a DCFA consists of two seemingly simple steps: 1. estimating future cash flows, and 2. choosing the appropriate discount rate. But in practice it can be a complicated calculation involving many assumptions and choices. The larger and more complex the company being analyzed, the more elaborate a DCFA is likely to be.



Running the numbers

The first step in the analysis — estimating future cash flows — begins with determining how many years of cash flow to include. Valuation experts commonly make five-year projections, with estimates based on more than 10 years being rare. Some larger acquirers expect three years' returns. The further out estimates project, the more work that's required and the less accurate the resulting DCFA figure is likely to be.

Once the time period is set, assumptions about future sales, operating expenses, tax rates and capital expenditures are factored in to arrive at free cash flow for each year in the analysis. To the sum of these cash flows, some experts add an estimated value of the company's net assets at the end of the period being analyzed.

Estimating future business results can be tricky because many factors can cause actual results to differ from assumptions. Some are particular to a company itself, such as labor disputes, management turnover, or problems with plant and equipment. Others are unforeseen developments outside a company including changes in the economy, the company's industry, its competitors, government regulations, taxes and interest rates.

Quantifying uncertainty

The second major step in a DCFA — choosing the appropriate discount rate to apply against estimated future cash flows — is how valuation experts try to account for

the uncertainty of projected results. While cash flow estimates attempt to quantify *returns*, discount rates try to quantify *risk*. If the discount rate is set too high, a valuation is likely to undervalue the business. Conversely, if it's set too low, the resulting market value will be too high.

Some discount rates used by valuers are based on complex mathematical models, while others rely on industry averages that have been tracked over time. It's not uncommon for buyers analyzing a business for potential acquisition to use a "weighted" discount rate, which factors the buyer's borrowing cost into the calculation. Two prospective buyers with similar cash flow assumptions about a business could, in fact, arrive at different valuations because their borrowing strategies had them using different discount rates.

Testing conclusions

Because so many variables enter into DCFA calculations, valuation professionals often perform "stress tests" to assess the validity of their conclusions. By varying assumptions — say, the assumed growth rate of sales or expenses, or the discount rate — they can generate a range of possible values for a business.

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Ten years of \$100,000 in free cash flow discounted at 8.5%, for example, suggests a market value of \$604,730. But assuming a higher discount rate of 10% reduces the market value to \$558,600. This kind of disparity suggests that businesses compare DCFA results against market values generated by several methods, such as multiples of after-tax profits or percentages of annual sales. The party across the sale negotiation table is certainly likely to do so.

Subjective value

When preparing you for sale negotiations, your valuator will likely provide a range of possible business values. These variations reflect how subjective a business's value can be and will enable you to respond authoritatively to your buyer's or seller's proposals during the negotiation process. ➔



Q. How does the Sarbanes-Oxley Act affect my privately owned business?

A. As an owner of a private company, you might think that the widely publicized Sarbanes-Oxley Act (SOX) to regulate public company financial accounting and reporting doesn't affect you, but you could be wrong. If you've thought about an initial public offering or selling your business to a public company, or you just want to improve your reputation in the eyes of lenders and investors, you should consider implementing some SOX provisions.

SOX, which became law July 30, 2002, involves several financial accountability measures. CEOs and CFOs must vouch in writing for the accuracy of financial statements and can be subject to criminal penalties for serious violations of accounting and reporting standards. Directors must form an audit committee to work independently with external auditors and must establish procedures for financial records retention and protection of employees who report accounting abuses. In addition, internal accounting controls must be documented and reported to the Securities and Exchange Commission annually. Finally, accounting firms that audit the books of public companies are encouraged to act independently of their clients.

Higher costs associated with additional paperwork and more stringent audits are the major objection many public companies have to SOX. They believe SOX to be an imposition worse than the corporate misdeeds it's intended to prevent. And the smaller the company, the more burdensome the fixed costs associated with compliance.

Despite these costs, however, some private companies can benefit from implementing SOX provisions. Companies

planning to go public, for example, should get an early start on compliance, since the learning curve can be steep. Allow at least a full year of SOX implementation before considering initiating an IPO.

What's more, businesses that provide financial and database services to public companies and those wanting to attract acquisition interest from public companies can benefit from being able to prove they have effective internal controls and procedures for financial accounting. Such proof may also prove useful in attracting new board members and private equity investors and help a business more easily qualify for loans and competitive commercial insurance rates.

To implement SOX-friendly measures without paying the high costs of full compliance, consider the following:

- ✚ Adding independent (not owners or managers) directors to your board,
- ✚ Forming a board audit committee,
- ✚ Hiring an accounting firm to recommend audit improvements,
- ✚ Strengthening accounting procedures and record-keeping, and
- ✚ Establishing a policy to protect whistleblowers.

These measures may not bring your business up to full SOX compliance, but they can yield improved process controls and enhance your company's image. Potential acquirers are likely to be reassured that your financial records accurately reflect your business's true profitability. In fact, a company with reliable accounting will command a higher price than one with questionable financials. ➡



Gilbert A. Herrera, founder of Herrera Partners, LP was previously the Director of Coopers & Lybrand's Southwest region corporate finance group, responsible for building a new practice consisting of private placements, merger and acquisition advisory services 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, the Longhorn Foundation for Intercollegiate Athletics, the Littlefield Society and the Executive Committee of the Chancellor's Council of the University of Texas System. By appointment of the Texas

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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 a past President of the Turnaround Management Association, Houston Chapter, the leading education and advocacy group dedicated to the corporate renewal industry.



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