

April/May 2007

Protecting your proprietary information

How a clean team can help

Will your business be ready when a buyer comes knocking?

Distressed companies
Increase your chance of getting a fair market price

Ask the Advisor



HERRERA PARTNERS

Investment Bankers, Financial Consultants

www.herrera.com

600 Jefferson, Suite 1080 ♦ Houston, Texas 77002-7363
(713) 978-6590 ♦ Fax (713) 978-6599

Protecting your proprietary information

How a clean team can help

Even early M&A discussions can make buyers and sellers feel vulnerable. Conflicts of interest, confidentiality breaches and the overstepping of legal boundaries are potential risks of any transaction.

Deal participants need to walk a fine line between getting and disseminating essential information and protecting financial data, trade secrets and other proprietary information. If this information is handled improperly, today's potential partner could become tomorrow's better-informed competitor. But a clean team, which, depending on the scope of the transaction, may involve an intermediary or a team of intermediaries, can help offset some of the complexities of M&A discussions.

Prevent contamination

In medical and computer sciences, a "clean room" is sealed off to prevent contamination. M&A transactions also harbor the threat of potential contamination — the disclosure of confidential information that could affect competition between the parties during the preclosing period or, in the event of a transaction failure, down the road.

To prevent this from happening, an M&A clean team can conduct a feasibility analysis on competitive and other confidential data to assess the benefits of the transaction. The team then presents information and analysis to the parties in an agreed format on an OK-to-know basis, usually involving summarized and aggregated data.

A clean team can add value in several types of M&A transactions, including mergers of equals, alliances and joint ventures in industries with close regulatory scrutiny.

To establish a framework for how the clean team will operate, the team's governance structure — typically composed of executives from the involved companies and a few M&A intermediaries — should outline instructions and protocols for handling sensitive data before any work begins.

Team at work

Combining companies enlist clean teams during the predeal period when such a group can serve as an objective resource for both parties. Once a deal is under way, the team is used in an advisory capacity and supports and facilitates due diligence and integration planning, such as the merging of finances, operations, benefits and corporate cultures.

Because of its unrestricted access to everyone's confidential information, the team can conduct an early and thorough assessment that might otherwise be difficult or impossible for any one transaction participant. Based on the information it gathers, the team can provide advice on whether a consolidation



appears to be prudent. Because companies share information only with the clean team, the fear of divulging too much or rushing into formal negotiations can be alleviated.

Clean teams can be employed at any stage of a transaction to help:

- ✦ Eliminate unproductive exploratory talks by refining and formalizing the process,
- ✦ Verify integrated business plans,
- ✦ Assess synergies,
- ✦ Identify significant legal and other issues surrounding competition approvals, refinancing, or contracts,
- ✦ Resolve price and other conflicts during negotiations, and
- ✦ Develop business and integration plans for the merged entity.

A clean team can add value in several types of M&A transactions, including mergers of equals, alliances and joint ventures in industries with close regulatory scrutiny, and deals involving more than two parties.

Rules of engagement

A clean team might include CPAs, attorneys, business and management consultants, and industry specialists. Its scope can be as wide or limited as the parties determine. It's important, however, that all participants clearly outline their goals and provide a clear framework for the team.

Because of the sensitive nature of the information, all parties must be willing to accept a confidentiality and indemnification agreement that outlines the expected levels of disclosure. Parties also need to decide how transaction-related information will be handled should the transaction fall apart.

Not unlike other M&As that involve data rooms with confidential information, parties must agree on clean room guidelines. For example, you may allow only clean team members in the room where documents are stored and require a log detailing which individuals

Three types of teams

When the time between the announcement and the close of a deal is expected to be as short as one or two months, a smaller and more targeted clean team might make sense. This team can be employed to gather, organize and harmonize data in preparation for the merger. Generally, there are three types:

Librarian. This most basic type of team can be up and running quickly. In addition, its records will provide regulators with precise answers to questions about divestitures or grandfathered products and services.



Facilitator. If the period between the announcement and the close of the deal is expected to be longer, it's useful to have a larger team. A facilitator team takes a more active role in facilitating, and even designing and planning, the integration of the merging companies and how synergies will occur. The team supports both companies as they develop recommendations and draft action plans.



Designer-planner. This team usually requires greater resources, a larger budget and more participation by members of both organizations. The team can plan the integration of two companies by valuing assets and modeling scenarios to support negotiations with regulators. It also might analyze budgets and financial plans to confirm and further develop the merger's synergy and growth targets. Other designer-planner roles include identifying key short-term issues that must be resolved urgently after the merger wins regulatory approval and developing postmerger strategies in sensitive areas such as pricing and channels.



have viewed specific documents. If questions arise about what information can or can't be shared, the clean team might be required to inform both parties or their legal representatives.

Right for you?

Before assembling and implementing a clean team, significant planning and preparation are required. But as long as both parties to the transaction fully agree to the conditions under which the clean team will function, this is likely to be an effective way of protecting your confidential information. ➔

Will your business be ready when a buyer comes knocking?

Selling a business can be one of the most important events in a business owner's career. This high-stakes transaction has the potential to yield great rewards — both financial and emotional.

But selling a business also can be a complex and mentally draining proposition. Even the most successful and experienced business owners may find themselves unprepared and unequipped. Before you begin the process of selling your company, make sure you're ready. Being prepared can mean the difference between a smooth sale and a bumpy — not to mention costly — ride.

Preparing for the sale

Before your business goes on the market, attend to the following checklist of items:

Normalize your financials. To present your financials in the most favorable light to potential buyers, you may want to consider switching from a cash method of accounting to an accrual method. An accrual method reports income when it's earned and expenses when they're incurred. Converting to this method can present buyers with a more appropriate financial image of your company.

Potential buyers use the numbers you provide to calculate their potential future cash flows and working capital.

Next, think about shifting from an accelerated system of reporting depreciation to one that shows depreciation spread over a longer period of time. Also, eliminate any expenses from your financial statements that could be deemed excessive by a potential buyer. These may include



items from owner perks — expensive club memberships and luxury hotels — to paying premium prices to vendors because of family or other personal relationships.

Payroll also should be adjusted, particularly in cases where family businesses employ family members at salaries that are higher than industry norms. Accordingly, extensive insurance coverage for family members should be normalized into a less comprehensive, standard plan.

An accounting professional can help adjust your financial statements to ensure that they're on par with normal business practices and improve your overall financial picture. Clean, professionally audited statements also suggest to buyers that your business is professionally and ethically run.

Ensure contracts and leases are up to date. The terms and conditions of your customer and vendor contracts and equipment leases should be current. If your company assets include real estate, you might want to separate or sell the property before your business goes on the market because it has more favorable tax and liability implications for both you and your company's buyer.

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. The cost of the lease should be normalized to show that a new owner would likely lease the property at a fair market rate.

Get debtors and creditors in line. Potential buyers use the numbers you provide to calculate their potential future cash flows and working capital. For this reason, a history of slow pays may discourage them from looking seriously at your business. Consider taking payoff settlements on open credit accounts or eliminate open accounts.

Update facilities and equipment. Make sure your workspace is running at optimum efficiency and that you've made necessary repairs in offices, warehouses and factories. A neat, well-maintained appearance — which also includes landscaping around facilities — tells potential buyers that yours is a successful company. Now is also the time to give internal systems a tune-up and invest in technology and other upgrades.

Document your company's policies and procedures. This will help facilitate a smooth transition in day-to-day operations when the sale is complete.

If necessary, create a procedure manual that describes best practices in running the business.

Retain key employees. Losing critical employees during a sale can be a deal breaker because they often are integral to the new owner's success. Keep them in place by maintaining the confidentiality of a potential sale until the deal is complete or near completion. This will help to deter panic and sudden turnover. Keep in mind, however, that key employees need to feel they are trusted and in the know.

Increase value now

The process of selling your business can be complex and arduous. But taking these steps can help increase the value of your business to potential buyers and even translate into improved profits while you're waiting to sell your company. ➔

Distressed companies

Increase your chance of getting a fair market price

Business owners face myriad challenges on a daily basis. One challenge no owner wants to grapple with is financial distress. But if you've struggled with declining profits, rising costs, fierce competition and other overwhelming problems for some time, and the situation doesn't seem to be improving, selling may be the best solution. And there are steps you can take to help maximize your business's value and get a relatively fair sale price.

Assessing value

Deciding to sell your company probably won't be easy. You've invested significant time and emotional energy in your business. But once you determine that selling is your best option, begin the process by making a hard-line assessment.

First, find out what your business is worth. A professional valuation gives you a basis for negotiating the sale price



and terms with potential buyers. A valuator will review your financial statements and determine liquidation values for assets such as real estate and equipment.

The valuator also can assess the value of your sales volume and determine whether it might be attractive to another company. Your intangible assets, such as people, knowledge



and intellectual property, can be just as important as tangible property; recognized brands, copyrights, trademarks, proprietary customer or client mailing lists, and long-term contracts all can have significant value. Values placed on intangible property, however, are likely to be scrutinized closely by potential buyers.

Once you understand your company's market position, financial status, and strengths and weaknesses, you'll have some idea of what you can expect from a sale.

Give buyers what they want

What's valued in the sale of a distressed company is usually different from what's considered in the sale of a stronger, more profitable company. If they're not simply looking to liquidate assets, buyers generally want to see potential for improvement and signs that internal problems can be fixed relatively easily.

Typically, buyers look for the following three qualities:

1. Sales volume potential. A loyal customer base and complementary products and services are major draws. Buyers often seek opportunities to cross-sell with their current product lineup. If, for example, your company manufactures heating and cooling systems and a potential buyer is in the business of selling, installing and servicing these types of systems, acquiring your line of merchandise could help them strengthen existing customer relationships and cut out competition.

2. Facilities. A transferable long-term lease in a good location can be valuable to potential buyers because it can mitigate rent inflation risk. Buyers also are interested in acquiring unused facilities and equipment that can be repaired or upgraded and used to increase productivity and generate new business.

3. People. Buyers look for opportunities to maximize underused talent by restructuring job roles and placing them in the right positions. Existing management and company operators, however, must be amenable to a change in ownership. In their efforts to increase productivity, potential buyers might also eliminate marginal performers or replace overcompensated employees.

Finally, growth potential won't necessarily garner a higher sales price with a distressed company, but it will make the difference regarding whether buyers are interested.

Positioning for the sale

Because selling a distressed company can be a complex and delicate operation, it's essential to get professional advice as early in the process as possible. Advisors experienced in selling financially troubled companies can help you improve your competitive position and your final sales price. They're likely to know of buyers interested in the kind of opportunity your company offers and can help you devise a strategic plan to identify such buyers.

Allowing advisors to handle the difficult work of selling also can free up your time to continue managing your company's day-to-day operations — including maintaining regular communication with lenders and investors. Communication with major stakeholders is critical at this stage, as they are likely to be very concerned about the future of their investment. Also, their approval will be essential to selling the business.

Hope not lost

Selling your company is a difficult decision. But with adequate planning and preparation and the assistance of experienced advisors, even a company in dire financial straits may prove attractive to a buyer and sell for a fair market price. ➔



Q. What factors should my company consider before acquiring a spin-off?

A. Divesting or spinning off noncore or underperforming assets is becoming a popular strategy for businesses that wish to remain competitive. While buying a division of an established company can be less risky than starting a new business venture, understand that the potential benefits can be offset by some risk.

The parent company is divesting because it hasn't been able to leverage the unit into an efficient profit center. Before you enter into this kind of deal, be certain you understand the challenges and are better positioned to overcome them. Once the deal is finalized, you're on your own — with no support from the former parent company.

Plan for success

To increase your odds of success when acquiring a spin-off, consider the following issues before you get to the negotiating table:

Buried corporate charges. Typically, an operating division of a large corporation pays the parent company a corporate charge for use of its central services. What's included in the charge and how it's calculated isn't always well defined. It's imperative, therefore, to examine the charges carefully. In most cases, allocations of corporate expenses don't reflect the true cost of running a company outside of a large corporate environment.

Additional costs. Assess the functions being performed by the selling company's parent currently that would require replication in the standalone or newly integrated entity.

These functions might include marketing, payroll, tax compliance and planning, budgeting, information technology, risk management, purchasing, and certain accounting functions. Consider the costs and benefits of outsourcing some of these functions vs. hiring additional staff.

Historical knowledge. Once you acquire a spin-off, you may need to employ cost-reducing strategies, including employee layoffs. Evaluate the knowledge and experience of the division's staff members — regardless of their position in the company — to avoid losing important historical knowledge and information about the company's processes, systems, and customers or clients.

Experienced management. Managers charged with turning an underperforming spin-off into a well-run machine or integrating a spin-off into an existing business must be able to devise and execute a short-term profitability plan. To help ensure posttransaction success, the management team you plan to put in place should be proven industry veterans with turnaround and integration experience.

What it takes

There's no sure-fire formula to determine if investing in a spin-off will be viable. But once you've identified an opportunity, decide if you have in place what it takes to maximize your return on investment.

Just keep in mind that, once you've acquired the division, it might take awhile for the entity to reap the benefits of its new management and more focused objectives. But with your plan in place, the spin-off should be able to better concentrate on its core business, take more risks and position itself competitively. ➔



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

Supreme Court, Mr. Herrera served two terms as a member of the Commission for Lawyer Discipline from 1993 to 1999. In 2001, Mr. Herrera was appointed by Governor Rick Perry as Chairman of the General Services Commission and its transition to the Texas Building and Procurement Commission.

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 Turn-around Management Association, Houston Chapter, the leading education and advocacy group dedicated to the corporate renewal industry.



Investment Bankers, Financial Consultants

Merger and Acquisition Advisory Services



Debt and Equity Placements



SEC Compliance Services, 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.com

600 Jefferson, Suite 1080 ♦ Houston, Texas 77002-7363
(713) 978-6590 ♦ Fax (713) 978-6599