

Merger & Acquisition Focus



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Ask the Advisor



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STRATEGIC ALLIANCES

When two is better than one

A strategic alliance may be an option for growing companies when a sale or acquisition isn't feasible. In fact, carefully chosen and executed alliances can yield many of the benefits of a successful merger — including increased revenue and market share and the acquisition of key employees — but without the time, cost or hassle.

Venturing out

Say you need to raise capital to effectively compete in your market, but also want to retain ownership and full control of your company. A joint venture — a common, but complex type of strategic alliance — may be the

solution. Joint ventures require participating companies to create a separate legal entity (generally a corporation, limited liability company or partnership), of which all participating companies are partners and through which the new business will be conducted under strict operating agreements.

Help ensure a successful partnership by choosing a company that shares similar values and business philosophies.



Though joint ventures can face many of the same integration challenges of standard mergers — plus the additional challenges involved in jointly managing a company — they allow you to share some of the risk. They can also potentially generate valuable synergies that, for example, yield more robust product lines, greater geographical reach and cost reductions related to scale while enabling participating companies to manage their own core competencies.

In addition, pooling your resources in a joint venture may enable you to:

- ❖ Take on projects that are larger than you would normally accept,
- ❖ Boost your bidding power and bonding capacity,
- ❖ Tap the unique skills and ideas of a different organization — possibly revitalizing your own, and
- ❖ Increase your ability to raise capital.

A joint venture maintains its own accounting records and produces financial statements that are independent of each participating company's financial records (though the joint venture is noted in those companies' financial statements). Your percentage of ownership and level of control in the joint venture dictate the accounting method — cost,

equity or full consolidation — used to report joint venture activity. Most joint ventures are limited in scope to a single project or product, but they can also operate indefinitely.

Contractual arrangements

Contractual arrangements offer a simpler form of strategic alliance. These short-term collaborations may be appropriate when you don't require a formal management structure. The contract's specific provisions will depend on the complexity of the business arrangement, but it should discuss the duties and responsibilities of each party, confidentiality and non-competition, payment terms, and intellectual property. Also be sure you enter a contractual arrangement with an exit strategy in mind.

A contractual alliance might be formed when two businesses partner to distribute products, but share few financial resources. (See “Looking for less commitment?”) On a larger scale, two companies might both make significant financial contributions to fund capital-intensive investments such as those in facilities and equipment.



Many contractual alliances grow into more significant businesses for their participants. So regardless of the type of alliance you choose, seek expert advice to assess your initial legal, financial and operating risks and benefits as well as those that potentially come into play down the road.

A perfect match

You should never enter into a strategic alliance without carefully considering the risks. These include corporate culture clashes and loss of control over operations and proprietary information and technology. You might

Looking for less commitment?

Contractual alliances may allow companies to partner with one another without making major legal or financial commitments. By no means a one-size-fits-all business model, contractual alliances run the spectrum to include cooperative:

- ❖ Marketing efforts,
- ❖ Licensing,
- ❖ Product design,
- ❖ Sales or distribution,
- ❖ Manufacturing,
- ❖ Technology development,
- ❖ Research and development,
- ❖ Intellectual property, and
- ❖ Service agreements.

also miss out on future business opportunities with your strategic partner's competitors.

Help ensure a successful partnership by choosing a company that shares similar values and business philosophies. For example, if you have an entrepreneurial spirit and believe in taking calculated risks, partnering with a company that follows a more conservative, risk-averse approach is likely to lead to conflict.

During the screening process, investigate your potential partner's financial and labor resources, strengths and weaknesses, bonding capacity and production output. Request copies of the company's financial records for the past five years, interview its clients, and research records for litigation and other legal proceedings in which the company may be involved. You may also want to check legal records for civil actions such as a divorce. An ex-spouse or creditor could attempt to claim your joint business revenue.

Bearing fruit

A strategic alliance can provide growth prospects for its participants when cash is tight and a merger isn't possible. These alliances always harbor risks — particularly if the partners aren't financial equals. But if you carefully enter an arrangement and put plenty of forethought into what you hope to achieve strategically and financially, it can be an extremely fruitful relationship. ■

Snake in the grass

EMPLOYEE-RELATED LIABILITIES CAN POISON YOUR DEAL

Overpaying and poor integration planning are frequently cited as major reasons mergers go awry. Discussed less often — but still potentially devastating — is a buyer's failure to consider the seller's employee benefits. For example, who will be liable for the target's employee pension plan? Make sure you consider such issues well before your transaction closes.

Biggest balance sheet liability

Even the most thorough due diligence process won't ferret out every acquisition risk and liability. But involving your human resources team in the process can help you spot and assess employee benefit-related issues that might otherwise elude you.

At the top of your priority list should be employee pensions. They can be the most onerous liability on a company's balance sheet — often amounting to as much as 200% of the company's value. Determining the size of a potential target's pension deficit and corresponding annual contributions with the help of a professional valuator can help prevent you from overpaying, or worse, buying a long-term financial burden.

A healthy company

Next, consider health and welfare benefits. Will your transaction make any of the target company's employees eligible for COBRA (which guarantees employees the right to continue coverage after they lose their job)? Some could be COBRA-eligible independent of the transaction (for example, divorced former spouses), and continue to be so after the deal closes. In these cases, determine whether coverage will be provided under the seller's or your health plan. Although COBRA rules assign responsibility to provide coverage in merger situations, parties are free to change them by mutual agreement.

Also look at any health or other welfare benefits your target offers its retirees and determine what type of postdeal responsibility you'll have for them. If you intend to provide them, be sure you perform thorough due diligence by reviewing all plan documents, including summaries and participant communications. Determine whether these benefits can be modified or terminated, or whether participants are vested and have the right to receive them for life.



Risky vacation policies

If your deal is structured so that the seller must terminate all employees and you immediately hire most or all of them back (which is true in many asset-purchase deals), both parties must decide how to handle employee accrued vacation or paid time off. Because their employment will technically be terminated by the seller, employees may be entitled to payment for accrued vacation, even though they still have a job.

This potential liability can be dealt with in one of several ways:

- ❖ You may choose to accept existing vacation balances under your own policy,
- ❖ The seller may pay out the full vacation balance in cash, or
- ❖ You might assume some or all of the cash-out cost.

In some cases, you might want to ask employees to consent to the transfer of vacation balances or to waive rights to vacation pay.

If you're making a stock purchase deal, pay attention to potential risk in vacation policies that may create contractual liability, or that make it difficult or impossible for you to implement your own policies. Some companies, for example, make written promises in policies that buyers find difficult to keep, such as vacation day accrual policies and expense approvals.

Employment claims

Also obtain information about any pending employee claims or outstanding litigation. Review the target's history of employment-related litigation, searching for trends that suggest habitual noncompliance in areas such as discrimination, harassment and safety violations. Ensure that your purchase agreement includes seller representations regarding compliance with federal and state employment laws.

If you must reduce the workforce you're acquiring, scrutinize your target's severance policies and plans to determine the content of severance packages and whether you or the seller will be responsible for them. Further decide whether the transaction will

trigger change-in-control or other severance that's payable to your target's executives. If payment of such benefits significantly reduces the company's net worth, be sure to include it in the formula you use to determine a starting bid.

Taking responsibility

In any acquisition, buyers must review employment issues and uncover related risks and liabilities, as well as determine how benefit program changes are likely to affect employees and the integration process. Be as knowledgeable about your target's liabilities as you are of its assets and you'll help prevent unpleasant postdeal surprises. ■

M&A insurance can shield your deal from risk

Most M&A transactions come with a clear and present danger: risk. From hidden liabilities, negative tax treatment and valuation issues, to legal and environmental obstacles, many unforeseen risks could hinder your deal or halt it altogether. M&A insurance, however, may be able to protect you from these deal breakers.

R&W heads off surprises

Parties on both sides of the table can benefit from M&A insurance coverage. Representations and warranties (R&W) insurance protects buyers from postclosing "surprises" such as revenue declines and misrepresentations regarding intellectual property, major contracts or titles to assets.

It may also enable buyers to:

- ❖ Set their bids apart from competitors in an auction scenario by providing protection beyond the customary level of indemnification,
- ❖ Protect relationships with key employees by removing buyers from potential future claims against them, or
- ❖ Purchase a bankrupt company when they have no other source of risk protection.

R&W coverage also protects sellers from problems that buyers fail to fully disclose or disclose at all,

such as contingent liabilities. This type of policy typically provides coverage for three to seven years. And the noncancelable policy goes into effect when a "breach of a representation and warranty" is discovered.

Some standard business insurance policies may adequately address the risks attending smaller transactions.

Environmental risks

Uncertainties surrounding potential environmental liability — such as the extent of soil or water contamination at a manufacturing site — can stall an M&A transaction. Four types of environmental insurance are available to help protect buyers and sellers, including:

1. Environmental site liability. This type of policy protects sellers and buyers from costs related to cleanup, bodily injury or property damage. It can be structured to cover an entire company or specific work sites.

2. Remediation cost cap. This policy covers the new owner in the event of cost overruns associated with a toxic site cleanup. Helpful in guaranteeing the extent of a buyer's total liability, remediation cost coverage often facilitates transactions in which the parties can't agree on the amount of known and unknown liabilities.

3. Blended risk. This coverage protects buyers when they know they'll be assuming a seller's environmental liabilities but need an asset to offset liabilities on their financial statements. These funds could cover costs should the government shut down a facility in the future.

4. Secured creditors. This policy covers financial institutions and real estate investors against environmental risks when they back real estate transactions. Benefits are paid out when a buyer defaults on a loan because pollution cleanup that the buyer can't afford is required.

Tax liabilities and breakup fees

Tax liability insurance can reduce or eliminate contingent tax exposure when a transaction fails to qualify for an expected federal income tax treatment. This coverage can be useful if you're involved in a tax-free merger or spinoff, tax-exempt financing, or a deal that involves tax credits. Coverage, which typically is available in noncancelable terms of four to seven years, also can be extended to state and foreign taxes.

Breakup fees — paid by the party that terminates a deal against the other party's wishes — pose another risk. Insurance can cover a potential buyer if the seller walks away during takeover negotiations. Reverse breakup fee insurance protects sellers from buyers that back out.

Regulatory qualification insurance can protect both parties when a deal is terminated by neither of them. For example, a regulatory agency might refuse to approve the merger because it would violate antitrust laws. Or it could fail to meet federal, state or statutory requirements, or regulatory or accounting rules.

Legal claims

Finally, litigation buyout insurance assumes the risk of known or pending lawsuits. It can cover a broad range of legal actions — including securities, antitrust, product liability, construction, tax and intellectual property litigation.

Typically, this type of policy is purchased to protect against unfavorable rulings and to transfer litigation from the liability column of the defendant's financial statements. At times, it's also obtained to hedge against the reversal of a favorable verdict upon appeal.

Getting started

To determine how M&A insurance might affect your proposed deal and long-term business strategy, review your existing general business insurance policies for gaps that could become gaping holes during the merger process. Look in particular at your policies' limits and deductibles and determine whether you may need to combine or segregate coverage.

Because M&A insurance can be expensive, traditional forms of business insurance may — depending on the size and scope of your deal — provide a more cost-effective solution. Some standard business insurance policies may adequately address the risks attending smaller transactions.

Is it right for you?

Whether you're on the buying or selling end of a deal, M&A insurance may be able to shield you from deal-damaging risks — known and unknown — and protect your investment down the line. Talk with your M&A advisors to determine if this coverage can help mitigate the chances that something will go wrong with your next deal. ■



Ask the Advisor

Q. How can a business valuation help me plan my exit strategy?



A: Whether your decision to move on is motivated by a planned event such as retirement or a new professional challenge, or by unforeseen circumstances such as a health crisis or financial trouble, an accurate business valuation is essential.

Naturally, you want to get a fair price for your company. A professional valuation provides insight into its financial state, market position, and overall strengths and weaknesses — enabling you to set a base price and make improvements that could help maximize your profit.

Primed for sale

When you enlist the help of a valuation expert, he or she will prepare your financial statements for buyer scrutiny by making various adjustments to earnings — a process called “normalizing.” Your valuator, for example, might remove one-time or discretionary items from your balance sheet and income statements, such as owner-specific and nonrecurring capital expenditures. This will provide the buyers with a more accurate picture of the business’s potential performance when it comes under their control.

To enhance your company’s perceived value, a valuator might also advise you to pay down debt, beef up your internal controls and ensure that legal documents, such as contracts, are in order. Sometimes, experts suggest more drastic measures, such as cutting staff, freezing expenditures to reduce overhead, implementing accounting practices that increase inventory turnover, or divesting businesses of a poorly performing unit.

Order to business affairs

Even if a sale isn’t in your immediate future, a valuator can provide you with the information necessary to draft a buy-sell agreement. This agreement provides a plan to follow in the event you or a business partner unexpectedly dies, becomes disabled or otherwise withdraws from the company. A valuator will help name and define your agreement’s standard of value

and determine a formula for calculating it, so that ownership can be transferred at fair market value.

And because the value of your company will affect the tax-related costs of gifting or bequeathing business interests, if you choose to pass the business to your family or loved ones, a valuation can prevent you from improperly estimating value. Otherwise your heirs could end up with a sizable estate tax bill that could force them to sell your company after your death.



Valuators use a variety of methods, most of which use some variation of market multiple — operating cash flow, revenue or book value — as a benchmark to assess a business’s purchase price. Your valuator will likely perform a complex analysis using several methods that suit your company, balancing quantitative financial techniques with qualitative analysis of general business performance, economic conditions and your industry’s specific circumstances.

Your role in the process

To help your valuator make a fair and accurate appraisal and get the most from the engagement, gather all pertinent data and contractual agreements relating to financials; marketing and sales; operations; and products and services. Also be prepared to provide this expert with information related to the value of intangible assets — something many business owners forget to consider, but which could be a major contributor to your company’s worth. ■



Gilbert A. Herrera, founder of Herrera Partners 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 Authority, the Houston Hispanic Chamber of Commerce and CHRISTUS Health Gulf Coast. He is a past President of the Houston Chapter of the Turnaround Management Association, the leading education and advocacy group dedicated to the corporate renewal industry.



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