

# Merger & Acquisition Focus



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Ask the Advisor



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# Middle-market M&A has wind in its sails

If you own a middle market business, 2010 could be a good year for a merger. M&A activity dropped precipitously across the board in 2008 and 2009, but as the economy recovers, buyers are beginning to look for acquisition targets again. Strategically positioned middle-market companies are likely to be the big winners in a resurgent M&A market.

## Surviving the storm

Finding adequate deal financing remains an issue for many business buyers, and some, such as private-equity investors, have remained on the sidelines. (See “New buyers, old buyers” on page 3.) However, M&A market watchers began observing increased optimism and deal activity at the end of 2009. December alone saw a 14% increase in the number of announced deals and a 54% increase in deal values, according to R.W. Baird.

Deals launched by middle-market companies in the last months of 2009 include Danaher’s purchase of Applied Biosystems (\$450 million) and Teva Pharmaceuticals’ \$430 million purchase

of OncoGenex Pharmaceuticals. And in 2010, deal announcements include Service Corp. International’s \$200 million acquisition of Keystone North America and Marsh & McLennan Agency LLC’s acquisition of Thomas Rutherford Inc. (The deal terms haven’t been disclosed, but Rutherford’s annual revenue is \$171 million.) So although the recovery is likely to be slow, middle-market sellers have the best chance in several years of making a good deal.

*Sellers may need to make the case that they weathered the storm better than their peers or that their long-term performance over the larger economic cycle remains competitive.*

## The valuation question

The middle-market sector is hot for several reasons. Primary among them is that, after years of volatility,

midsize company valuations are finally stabilizing — making it easier for buyers and sellers to agree on an acceptable price. Sellers should note, however, that the market values of most companies have remained lower than their prerecession highs.

A survey by the Association for Corporate Growth and Thomson Reuters found that middle-market companies averaged multiples of 8.4 times EBITDA (earnings before interest, taxes, depreciation and amortization) in





early 2010, as compared to a high of 10.1 times EBITDA in 2007. (Still, that's an improvement over the 7.5 times EBITDA average in 2009.) And sellers should expect buyers to try to negotiate even lower prices. The survey, conducted in late 2009, found that 80% of respondents expected to pay no more than five times EBITDA for targets in the short term.

### Not quite smooth sailing

Middle-market sellers also should expect buyers to perform more thorough due diligence. Many buyers remain wary about the economic recovery and cautious about their targets' ability to emerge from the difficult environment of the past few years. Buyers may request extensive historical data and frequent financial updates as numbers become available.

Sellers, therefore, need to devote extra care to the due diligence stage. They should assemble an internal due diligence team or enlist the help of outside experts to handle data requests quickly and efficiently.

Sellers also must consider the "story" they'll tell about their near-term financial performance. Most

## New buyers, old buyers

If you're putting a middle-market company on the market this year, what kind of attention should you expect? Most experts believe the buyer pool will contain more strategic buyers (typically corporate buyers seeking "synergies") and fewer financial buyers (often private-equity (PE) funds seeking a financial return on their investment). PE funds once were major players in the middle market. But that changed in mid-2008, as they experienced big losses and were unable to find bank financing to back their often-risky ventures.

PE funds almost certainly will become middle-market players again, though. In fact, in 2009's fourth quarter, PE activity in middle-market deals increased by 12.4% quarter-over-quarter, according to Deloitte Corporate Finance.

Still, middle-market sellers probably can get more lucrative offers from strategic buyers these days — for example, from a competitor that wants to expand its product lines, geographic scope or market share. Such buyers typically are less concerned with getting a rock-bottom price as they are with realizing their long-term strategic goals. That's good news for sellers that have what strategic buyers want.

U.S. companies experienced declining revenues and asset values during the recent market downturn. So sellers may need to make the case that they weathered the storm better than their peers or that their long-term performance over the larger economic cycle remains competitive.

### Stable ground

The artificially high prices of the M&A boom in the mid-2000s are long gone, but so are the dirt-cheap valuations of the recent economic downturn. Indeed, the middle market looks to be relatively stable in 2010, and thus a good place for both buyers and sellers to make a satisfactory deal. ■



# Seller's endgame

## IT'S NOT OVER 'TIL IT'S OVER

Once a business seller has found a buyer and negotiated a fair price, and is in the process of completing any regulatory or legal requirements, the deal's essentially done, right? Not quite. Sellers have several final goals they must accomplish before they hand off the company for good. The last stages of an M&A deal are more critical than you might realize.

### Integration tasks

One of a seller's major tasks as a transaction nears its close is to prepare the company for integration. Depending on your buyer and the deal you've negotiated, such preparation could be as simple as general housekeeping or as involved as working with the buyer on its long-term strategic plan. Most deals, however, require you to:

**Perform last-minute paperwork.** This covers everything from transferring employee and vendor contracts to negotiating the end, or transfer, of mortgages and leases to your buyer.

*No matter how formidable an 11th hour obstacle appears, remain calm and composed.*

**Initiate long-term planning.** Sellers typically meet with buyers to discuss their plans for the acquired company. For example, you and the buyer might talk about future roles for your company's key employees based on your knowledge of their strengths and weaknesses, or you might discuss how a particular division would fit into the merged organization.

**Prepare employees.** You also should prepare employees for the transition and possible layoffs



or relocation. Work with your HR department to communicate your buyer's plans and provide support to your understandably nervous staff.

### Ready to go

Typically, business owners discuss future involvement with the company they're selling during the negotiation stage of the deal. In many M&As, buyers ask selling owners to stay on for months or even years to assist with the integration process, and often offer lucrative compensation as an incentive.

You might, however, want to prepare for an earlier exit, because the buyer's plans might change. For example, your buyer could decide to reduce staff, close facilities or reassign managers. Moreover, having your old regime around may only confuse employees and prevent them from accepting the new owner's authority.

It's important, therefore, to expedite your departure. Just be sure your personal financial and estate plans are in order so that you can retire or pursue a new venture on relatively short notice.

## Final hurdles

Even if your M&A deal has proceeded smoothly and the end's in sight, a last-minute issue could delay or even derail the transaction. For example, the merger of your two companies potentially could lead to anticompetitive claims. If your buyer will be required to sell off a segment to meet regulatory compliance, you'll need to renegotiate deal terms. In another scenario, your buyer's board of directors could reject a tentative compensation agreement. Or the buyer could decide that it wants to sell a division of your company that it had verbally promised to keep, meaning that longtime employees will lose their jobs.

No matter how formidable an 11th hour obstacle appears, remain calm and composed. Let your legal and M&A advisors handle the problem and try not to get personally involved in further negotiations. Keep in mind that your buyer most likely wants to close the deal as much as you do.

## Be confident, not complacent

The last stages of an M&A deal can be an exciting — even triumphant — time for a selling owner. But be careful not to pop the champagne cork prematurely. The deal's not done until you've signed every last document and fulfilled all of your obligations to your buyer, the buyer's financiers and your employees. ■

# The other part of the due diligence story

When you hear the words “due diligence,” you likely picture experts poring over earnings statements and customer contracts to verify representations made by a prospective business seller. But while financial and legal documents are central to understanding any company's story, they only tell part of it.

Buyers also must investigate their target's operations — employees, customer and vendor relationships, facilities, production processes, company policies — to uncover potential deal-breaking issues. What you learn during operational due diligence not only affects deal negotiations, but also your ability to successfully integrate your acquisition.

## Lines of inquiry

Generally, buyers perform operational due diligence after they've signed a letter of intent (LOI). LOIs indicate a serious interest in buying the business and a promise to keep information revealed during the

due diligence stage confidential. They typically stipulate that you have the right to cancel the deal if due diligence reveals negative issues or the target's performance deteriorates before the deal closes.

Operational due diligence can encompass many activities, but tasks generally can be divided among three key areas:

**1. Marketing and sales.** Start by interviewing marketing managers and salespeople to learn about their backgrounds, skills, motivations and compensation. You need to know that these employees will be willing to support a new owner and new objectives.

Also review your target's largest accounts and talk to key customers. If the seller objects, propose distributing a satisfaction survey. The survey might ask customers to rank the company on product quality, price competitiveness, customer service and overall satisfaction. You might also ask what factors enter into their purchasing decisions.



**2. Production.** Look carefully at how the company produces its goods or services. Generally this means auditing vendors to ensure they provide quality supplies in a timely manner and at a competitive price. Look out for overreliance on any one supply source, and ensure that vendor terms will remain constant (or even improve) under new ownership.

Also consider the company's production capacity. Too much may signal sloppy management, while too little may suggest the need for significant capital expenditures. Look at the efficiency and skills of production employees and examine production equipment for signs of aging or obsolescence.

Although inventory turns are calculated during the financial due diligence process, you should look at turns by major products and product lines and test the actual condition of inventory on hand. Make sure the company isn't keeping old inventory on its books to bolster value, and pay particular attention to excess and obsolete items.

**3. Administration.** Review your target company's policies, procedures and organizational charts for insight into what currently does — and doesn't — work. These documents also will help you identify potential integration challenges such as incompatible business cultures.

Analyze employee compensation and benefits and determine how they align with your own company's. And review personnel records for discrimination, harassment or on-the-job injury claims that could

later lead to litigation. Finally, assess the company's IT system for compatibility with your own.

## Volumes of paperwork

Much of your operational due diligence will involve document review. Some of the more important documents to request from the seller include:

- ❖ Tax returns,
- ❖ Strategic plans,
- ❖ Organization and business processes flowcharts,
- ❖ Standard process reports,
- ❖ Equipment and inventory lists,
- ❖ Marketing plans, collateral materials and customer satisfaction surveys,
- ❖ Benefit plan documents,
- ❖ Key employees' performance reviews,
- ❖ Company contracts, including vendor agreements, and
- ❖ IT systems manuals.

You may not feel qualified to evaluate all of your acquisition target's operations documents, so make sure your due diligence team includes an M&A professional and, possibly, experts in such areas as marketing, employee benefits and IT.

*Interview marketing managers and salespeople to learn about their backgrounds, skills, motivations and compensation.*

## Happily ever after

The scope of your operational due diligence will be determined by your target, the industry and your reasons for making the acquisition. Whether it will be a major undertaking spanning weeks or a one-day review, make a detailed plan, schedule interviews and request documents as early as possible. The more you know about your target, the more likely your acquisition will have a happy ending. ■

# Ask the Advisor

*Q. What is a reverse merger and when is it appropriate?*



**A.** In a reverse merger, a privately owned company merges with an existing (but typically dormant) public company, known as a “shell.” This shell company officially and legally purchases the private company by issuing new stock. The private company then acquires a majority stake and gains control of the public shell, which enables it to issue publicly traded stock on behalf of the merged entity.

## Reverse mergers begin to recover

Since the U.S. economy nosedived in late 2008, reverse mergers have declined in popularity by percentages similar to declining numbers for traditional mergers. According to sector trade publication *Reverse Merger Report*, only 187 reverse merger deals were completed in 2009 compared with 211 in 2008. And 2009 deals were smaller in volume — \$1.9 billion compared with \$9 billion in 2008.

That said, as with the M&A market in general, reverse merger numbers and deal sizes began climbing again in the fourth quarter of 2009. Some industry observers believe that a revival of this type of transaction could be underway.

For the right companies, reverse mergers offer several benefits. For starters, they’re usually much cheaper than IPOs. A typical reverse merger’s total cost (including fees and expenses) can be as low as \$200,000. (Of course, costs rise with the increased size and complexity of a transaction.) Reverse mergers also can be completed in less than a month — compared with the six-to-12-month IPO process.

They further offer strategic advantages, allowing, for example, companies to incentivize key employees

with stock compensation packages and helping investors to gain liquidity. And they enable companies to raise money for expensive initiatives such as business acquisitions.

## How to do it

The reverse merger process follows a straightforward timeline:



**Find and purchase a public shell corporation.** These must be free of assets and liabilities, but registered with the SEC. Typically, shells sell for \$600,000 to \$1 million.

**Raise additional capital.** If your company is pursuing a reverse merger to avoid having to borrow from banks, consider offering private placement securities to investors redeemable for stock in the new public company.

**Handle the documents.** Merging with a public shell requires your company to file a bevy of legal and tax forms. Plus, it puts your company under the SEC’s jurisdiction and you must become compliant with all of their requirements, including the Sarbanes-Oxley Act.

## Best candidates

Companies that want to go public but are put off by the cost of an IPO, or have been shut out of the tight credit market but require new capital, might consider a reverse merger. These transactions may have fallen out of style recently, but this could actually work in your favor. You may, for example, be able to buy a shell company at a discount price. ■



**Gilbert A. Herrera** founded Herrera Partners in 1992, a private investment banking firm that provides acquisition advisory services including allocation of purchase price and fairness opinions, SEC and FASB compliance services, impairment studies and valuations to our corporate clients; damage, proximate cause and expert testimony services to our legal clientele and restructuring services including the sale/disposition of non-core assets as part of debt restructuring and pre-packaged plans. He formerly served as director of Coopers & Lybrand's Southwest region corporate finance group. Previously, he was the senior investment banker for Underwood, Neuhaus & Co.

Mr. Herrera graduated from the University of Texas at Austin in 1978, where he is a member of the Dean's Council for the McCombs School of Business, MBA Investment Fund, Ex-Students' Association Advisory Council, Littlefield Society and 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 and Chaired their Budget Committee. 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 as Chair-elect of the Houston Hispanic Chamber of Commerce and CHRISTUS Health Gulf Coast, Vice Chair of Business and Financial Affairs for UTMB's Development Board and on the board of directors of Neighborhood Centers, Inc. 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.

In 1995, he received the Outstanding Young Texas-Ex award from the Ex-Students' Association and previously served on the University of Texas at Austin's Commission of 125, *Planning for the Future*. In 2008, he received the Chairman's Award for Distinguished Service to the Houston Hispanic Chamber of Commerce.



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