

# Merger & Acquisition Focus



April/May 2011

Don't let the economic  
chill freeze your M&A deal

When a debt purchase is  
your best — or only — option

Lean, mean,  
competitive machine

Spinoffs can fast-track  
your acquisition's future

Ask the Advisor



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# Don't let the economic chill freeze your M&A deal

**A**lthough the frozen economy appears to be thawing, a full recovery probably is still a long way off. Indeed, some sectors, including manufacturing and home construction, are recovering at a glacial pace, if at all. Regardless of industry, owners hoping to sell their companies in 2011 need to work to keep proposed M&A deals on track.

Outside factors, such as the availability of acquisition financing from banks and buyer appetite for risk, are likely to affect the number of deals that close this coming year. However, sellers can take steps to boost their appeal for potential buyers

and ensure that a proposed deal remains on track and actually crosses the finish line.

## Positive signs

Most analysts agree that, after several years of sluggish activity, M&A activity is finally growing. M&A global dollar volume rose 23% in 2010 over 2009, according to Thomson Reuters, with U.S. merger volume up 14.2% last year.

But such activity is still much less than during the M&A boom years of 2006 and 2007, and some industries remain in the doldrums. The hottest sectors for mergers in 2010 were energy (about 28% of all deals) and health care, while other industries enjoyed only minimal activity.

## Likely buyers

If you're in the energy or health care industry or you have unique products or in-demand intellectual property, you may have a relatively easy time finding a buyer. However, keep in mind that, even if a buyer has expressed strong interest and has already begun the transaction process, many issues can derail a deal — especially in a fragile economy. To reduce the chance of that happening, be sure to seek and consider serious buyers with:

**1. Sufficient cash.** The credit market remains relatively tight, so most buyers are unlikely to find a bank willing to give them the full acquisition amount. Prospective buyers need their own cash



reserve. Fortunately, many companies have been waiting out the recession and are sitting on piles of cash. Look for those companies that are eager to put their cash back to work as quickly as possible.

## 2. The right strategy.

Depending on the seller, either a strategic or financial buyer could be the right fit. But sellers need to understand their prospective buyers' strategic goals, determine whether they match their own and then market themselves accordingly.

*Financial* buyers generally seek sellers with low debt and a streamlined business model. *Strategic* buyers — which are most common in the current environment — prefer sellers with good or exclusive market share and strong growth prospects. Although such buyers hope to make a financially sound acquisition, they may be more willing to overlook short-term problems than financial buyers.

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## Don't get bogged down

M&A deals can get bogged down — sometimes permanently — at various stages. For example, irreconcilable differences over price frequently kill deals at the negotiation stage. Sellers hoping to

## Don't neglect the final steps

You may be tempted to exhale when the end of your M&A transaction is finally in sight. But be careful: The deal isn't over till the ink on the sale document is dry.

As you approach the finish line, focus on how you can help facilitate an easy and efficient integration so your buyer doesn't get cold feet thinking about that monumental undertaking. Also be prepared for end-of-journey challenges, including:

- ❖ Time-consuming but essential tasks such as transferring employee contracts and negotiating with health care providers,
- ❖ Customer service issues that could lead to negative word-of-mouth,
- ❖ The concerns of community leaders and local authorities if, for example, jobs will be eliminated,
- ❖ Rumors that could cause employee defections or damaging gossip, and
- ❖ Economic or political changes that might affect business.

avoid such a fate must remember that concepts such as value and risk are relative to the economic environment. If you need to sell in 2011 (when sellers still far outnumber buyers and buyers remain risk-averse), try to be flexible regarding price and deal terms, and consider seller-financing part of the deal.

Due diligence also can be a deal killer. Consider letting your M&A advisor handle this stage of the deal. He or she is likely better equipped to address difficult financial questions and recognize which issues are critical to a buyer's decision, given the current M&A market and competition in your sector.

## Be vigilant

Ambitious big-ticket mergers, such as HP's recent acquisition of 3PAR after a bidding war with Dell, suggest that 2011 could be a good year to sell — even among middle-market companies. But remember that the economic recovery is fragile and you must closely monitor every stage of the deal if you hope to start a new chapter in 2012. ■



# When a debt purchase is your best — or only — option

**F**inancial institutions that have managed to ride out the recession understandably want to remove distressed loans, particularly those that appear to be heading for bankruptcy, from their balance sheet. One of the ways they do this is to sell the debt to corporate buyers. Buyers, in turn, can use such purchases to gain majority control of distressed businesses — essentially making “backdoor” acquisitions.

This can be a good scenario for owners of distressed companies. Corporate debt buyers may want to restructure the company, inject cash into it or take other steps to revitalize it — which is more than a bank that’s written off the bad debt is likely to do.

## Everyone wins?

In an effort to slough off underperforming loans, lending institutions often are willing to sell them at a discount and absorb the financial loss. In the long run, such losses can be less costly and time-consuming than servicing distressed debt.

## *A collaborative effort between debt buyers and distressed company owners is more likely to succeed.*

It’s easy to understand how distressed debt might appeal to potential business buyers. Although some companies probably are unsalvageable, there are plenty of fundamentally solid businesses that have fallen on hard times but still have turn-around potential. As the economy recovers, buyers are likely to look for such diamonds in the rough.

## Make it work

Acquisitions via debt purchase can be tricky for all parties and generally involve several stages.



First, a potential buyer purchases the distressed debt obligations from the lender through a private arrangement or auction. The buyer then considers whether it wants to make an offer to buy the rest of the company by purchasing assets not owned by the lender.

Buyers must understand the distressed company’s current financial — and possibly legal — challenges and be able to accurately project future opportunities and growth rates. This involves researching issues external to the company, such as competition within the sector, regulatory actions and economic cycles. Buyers can remove certain obstacles and improve their chances of success by limiting their purchases to companies in their own industry.

## Sell the plan

Distressed companies may not be pleased when they first learn that a company wants to buy back debt from their lender. Banks too, can make the buyback process difficult by refusing to negotiate on price. So buyers need to be prepared to back up their offers with hard numbers and persistence.

Although lenders make the ultimate decision about the disposition of the debt, buyers should sell their acquisition plan to the distressed company’s owners,

too. A collaborative effort between debt buyers and distressed company owners is more likely to succeed than a transaction opposed by owners.

### Success story

Penn National Gaming's 2010 acquisition of M Resort Spa Casino, which had defaulted on \$860 million to the Bank of Scotland, illustrates how buyers can successfully make this type of purchase. Penn "sold" the bank on the deal by emphasizing speed: The transaction took about five days to complete, compared with the anticipated three-to-six-month timeframe had Penn bought the company's equity.

Penn also touted the ease of the buyback transaction. A traditional acquisition of M Resort would have required Penn to obtain antitrust clearance

and approval from gaming regulators. The regulatory red tape would have left Bank of Scotland holding the debt for months after the deal had been struck.

### Keep an open mind

Owners struggling to regain control of their distressed companies may not initially welcome the idea of a backdoor acquisition via debt purchase. But in some cases, it may be the best chance they have of surviving. If you're in this situation, discuss your options with your financial and legal advisors.

For their part, debt buyers must be ready to make a case to lenders and owners. The clearer your objective and ability to communicate it, the better the odds are of securing a satisfactory debt discount with minimal resistance from all parties. ■

# Lean, mean, competitive machine

## SPINOFFS CAN FAST-TRACK YOUR ACQUISITION'S FUTURE

**Y**ou just bought a business, so selling it is likely the last thing on your mind. But even if you're satisfied with the price you paid and your acquisition's growth prospects, you may be able to increase its value to your company with a strategic divestiture or spinoff.

Among other reasons, companies spin off units to raise cash, eliminate underperforming segments, streamline operations and focus management's attention on more profitable parts of the company. Chances are that your acquisition has product lines or subsidiaries that could hold back your merged organization rather than propel it forward.



Keep in mind, however, that these transactions can be challenging and time-consuming if you're unfamiliar with the process. If you're considering a spinoff, be sure to work with experienced M&A professionals.

## Good candidates

Business buyers often learn about their target's weaknesses during the due diligence stage of an acquisition, so you may already have an underperforming or noncore business unit in mind for divestiture. But before you start looking for a buyer, consider whether a spinoff will actually boost your bottom line.

Financial models that evaluate the impact of the divestiture on your company's revenue, product mix, gross profit margins, selling costs and overhead can help you make the decision. But while it's easy to identify the forgone sales and direct cost reductions that will result from your planned divestiture, it may be more difficult to fully calculate the amount of overhead the unit has been absorbing. Its sale could affect other business units by increasing overhead.

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Spinning off the unit might also create operational problems. So be sure to ask whether the acquisition's remaining units' manufacturing, research and production processes are independent. Also consider how a spinoff might affect employee benefits, intellectual property and public disclosure issues.

## Bumps in the road

Because a divestiture can change the nature of a company, you'll likely need the consent of your lenders before selling a unit. Lenders also may restrict how you use the sale proceeds, requiring you, for example, to reduce your outstanding debt to a level that can be supported by your cash flow.

Carve-out statements can cause additional headaches. This is a discrete set of financial statements you must create for the division you're divesting

when that division has no separate historical financial statements. While identifying sales and direct costs is usually easy, allocating shared costs that involve marketing, accounting, information services and human resources requires some judgment calls. Carve-out statements are necessary, however, because buyers need them to value the unit for sale.

You may also encounter problems if the spinoff isn't just underperforming, but is financially "troubled" or "distressed." To mitigate risk, a buyer may require you to retain an equity stake in the unit or provide financing for the deal. There's an upside to this: If your underperforming operation produces better results for a more efficient owner, you get to participate in its success.

## After the sale

Typically, sellers have no significant continuing involvement with a completed spinoff transaction. However, depending on the type of deal and buyer, you may retain some involvement in the divested business through complex sublease arrangements, seller financing, retained equity stakes, royalties due from licensing or service commitments.

Even if some issues remain, now's the time to review your company's strategic plan and determine whether your recent acquisition and subsequent spinoff have enabled you to reach important goals. Also plan how you'll use the cash from the divestiture — whether it's to pay down debt or expand into new markets.

## Streamlining as a business practice

The period following an acquisition is always a good time to consider a spinoff, but it's not the only time. For example, companies considering a sale may be able to increase overall value by divesting underperforming units *before* going on the market.

The bottom line: To remain focused and competitive, all companies should periodically evaluate their segments for outliers and underperformers. Divestitures can be time-consuming, but if they're thoughtfully considered and well executed they're likely to be profitable in the long run. ■

# Ask the Advisor

*Q. How can my HR department help facilitate a merger?*



**A.** Whether you're a buyer or seller, your HR department can play a vital role in the M&A process. Poor communication between sellers and buyers, as well as within each organization, can slow down or even derail a merger. Enlisting HR's help during almost every stage of the transaction ensures that accurate and timely information will reach critical stakeholders.

## Deal's data center

HR departments handle a significant amount of information essential to an M&A, such as employee performance records and contracts and benefits information. If you're a seller, ask your HR staff to prepare detailed breakdowns of employee compensation by position and department and summarize the company's current medical, retirement savings and other benefits. Also discuss any discrimination or harassment complaints or disciplinary actions that could become legal issues in the future.

All of this will help your buyer determine whether compensation or benefits need to change. For example, the buyer may decide to equalize compensation levels so employees in both companies are making similar salaries. Because this decision could be controversial, sellers need to provide accurate salary and benefits numbers to buyers as early as possible. And although you may be reluctant to reveal the possibility of employee-related litigation, it's best to be honest.

## In-house effort

Of course, HR's traditional role is to act as liaison between management and employees. So it's also the best place from which to disseminate merger news

to staff, address their concerns and generally "sell" them on the deal.

Although the initial announcement generally should come from an owner or CEO, HR can provide updates on the deal's progress and explain to employees how their jobs are likely to change. Whether it's the seller's employees who need to relocate or the buyer's employees who are getting new managers, HR professionals know how to deliver news in a way that reduces employee distress and prevents rumors and premature departures. Finally, HR provides postmerger integration management to ensure a harmonious merger of assets — and employees.

## All about people

Obviously, your deal doesn't hinge on your HR manager's approval, and HR won't negotiate price or deal structure. But it's important to remember that companies are nothing without their employees, and, as your company's most people-centric department, HR must be involved if your deal is to have any chance of being successful. ■







**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 board of directors, 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 public 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 on the executive committee and board of directors of Neighborhood Centers, Inc., Chairman of CHRISTUS Health Gulf Coast, Chair-elect of the Houston Hispanic Chamber of Commerce, Vice Chair of Business and Financial Affairs for UTMB's Development Board and Chairman of the Investment Committee of the Texas Exes Scholarship Foundation. 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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