

Merger & Acquisition Focus



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or break — your M&A plans

International acquisitions

Circling the globe for deals

Partial sales: Have
your cake and eat it too

Ask the Advisor



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Major investors can make — or break — your M&A plans

If your company has one or more major investors, you need to ensure these investors support your M&A deal well before the transaction's close.

When investors with a substantial stake in a company oppose any part of a deal, they're capable of delaying it — or even derailing it.

Real dangers

Both sellers and buyers need to consider their major stakeholders. A public company seller, for example, could alienate private equity investors by accepting an offer the investors consider too low. Buyers' stakeholders might object to an acquisition on the grounds that it's a poor strategic fit.

Often, stakeholder resistance to a deal has its roots in resentment over being ignored or neglected.

Unhappy shareholders can easily get in the way of deal proceedings. Even if a major investor is only lukewarm about your proposed deal, he or she can influence other stakeholders until discontent is widespread. And a strongly opposed investor in a public company could lobby other shareholders to push for a proxy vote to reject the transaction.

Worse, investors could file a lawsuit claiming the deal damages the value of their holdings. According to a recent study by the Securities Class Action Services, deal-related shareholder lawsuits increased by 500% in 2010 from 2008 and 700% since 2006.



interests into consideration. For example, are you dealing with a strategic investor who concentrates on companies in a single market sector? Such an investor might object to a merger with a widely diversified, multi-industry company.

Aside from concerns specific to the investor, consider other common objections:

Theoretical synergies. Merger participants often expect their deal to produce significant — and sometimes unrealistic — cost synergies. Risk-averse investors may be skeptical. Provide them with a list of your deal's objectives, including projected growth rates, increased cash flows from existing assets, and expanded market shares. The more detailed your case, the more likely stakeholders are to support you.

What investors (don't) want

To avoid conflicts with major investors over a planned M&A deal, start by taking their specific

Added costs. M&A deals can be expensive for buyers, and their major investors are likely to keep a wary eye on the bottom line. If you're buying a company, be prepared to provide specific examples of how the deal will reduce costs or increase revenues — and ultimately boost profits — and how long it will take to repay any new debt you'll be assuming.

Unfair valuation. Investors, particularly private equity investors, are always concerned about valuation. Simply put, investors don't want to sell their holdings too cheaply. Or, if they own a portion of the buying company, they don't want their stake devalued when the buyer issues stock for a potentially overvalued acquisition. Work with your M&A advisors to estimate a current, supportable market value.

Communication is critical

Another way to reduce investor objections? Keep the lines of communication wide open, particularly with those prone to cause trouble. If major stakeholders have a history of contentious management relationships, meet with them personally to explain your plans and how you arrived at certain decisions.

Even mild-mannered investors require care. Often, stakeholder resistance to a deal has its roots in resentment over being ignored or neglected. Investors who supported your company in its early stages are likely to be especially sensitive. So be sure to regularly debrief and solicit feedback from all of your major investors both through formal communications and informal meetings about important decisions, such as those on price or deal structure.

Expectation management

Despite your best efforts, it may not always be possible to get every major player on board. But if you anticipate your investors' objections and keep the lines of communication open, you should be able to rely on most of your major stakeholders during this make-or-break period. ■

Prevention is the best medicine

Suppose you plan to go ahead with a deal despite the objections of a major investor. There are several things you should do to protect yourself from costly legal action that could block the transaction.

First, organize all records that discuss management's consideration of alternatives to the deal. This includes offers from other buyers and why they ultimately were rejected, or other acquisitions that were under consideration. The more detailed these records, the better.

Other protective measures you might want to consider include:

- ❖ Involving legal counsel in every major decision related to the deal,
- ❖ Assuming that all informal communications, including personal e-mails sent via the company's account, could potentially be used as evidence,
- ❖ Obtaining a fairness opinion about the deal's financial viability from an objective, outside expert, and
- ❖ Vetting company directors and executives who are involved in the deal process for potential conflicts of interest, including stock ownership in the proposed merger partner's company or personal relationships with its owners.



INTERNATIONAL ACQUISITIONS

Circling the globe for deals

Although the U.S. economy remains sluggish, other regions of the world currently are experiencing rapid growth. If your company is considering making an acquisition, you might want to check out overseas opportunities. Business at some Chinese, Indian and South American companies, for example, is booming — and these companies may be less expensive to buy than similar domestic businesses. But before you make a cross-border deal, consider the risks as well as the rewards.

Count the ways

There are plenty of good reasons to consider an international deal, including:

- ❖ An enhanced competitive position,
- ❖ Access to new customers and product markets,
- ❖ Lower production costs,
- ❖ Local market expertise and established distribution systems, and
- ❖ Better access to debt.

Also, you may be able to tap an existing competitive advantage and benefit from instant customer goodwill, which wouldn't necessarily be the case if you simply opened a new division of your U.S.-based company in a foreign market. Finally, there may be more companies that fit your acquisition criteria in other countries than there are in the United States.

Cross-border potholes

As with all expansion strategies, international acquisitions can be risky. When considering a cross-border deal, you must extend your due diligence beyond the standard review of financials, assets and internal operations. You also need to investigate how business gets done in your



target company's country. Consider the country's political stability, taxes, regulations, unions and government support of businesses.

Ask whether any of these factors would require major changes in your operational structure and what those changes would cost. Also, be sure you understand how you'd tax-efficiently move profits out of the acquisition company's country.

Cultural understanding

One of the biggest challenges of a foreign acquisition is integrating the two corporate — and national — cultures. Get off on the right foot by treating your target company's culture with respect during the deal process, particularly in the negotiation stage where price disagreements can cause nerves to fray. Chemistry between the two companies' executives is also important, so be sure to meet privately and get to know the selling company's owner or CEO on a personal level.

Once the deal closes and you begin the integration process, offer the acquired company a good amount of autonomy. The business will likely want to keep its name and systems — unless you can show the benefits of adopting yours. Also recognize the skills of your international management team. If you recognize their worth,

these managers will want to stay on after the acquisition and will encourage employees and customers to do the same.

And as with all acquisitions — domestic and cross-border — keep the lines of communication open. Expose leadership teams at both operations to each other, and add representatives from the acquired company to your board of directors or executive team.

Don't travel alone

Whether you're eyeing an acquisition in Canada, Croatia or China, remember that international mergers involve real risks. So be sure to work with American M&A advisors with cross-border experience and consider enlisting the help of advisors in your target company's country for help with local financial, tax and cultural issues. ■

South America's M&A hotspot

For global investors, the developing markets of South America represent some of the best acquisition opportunities right now. Brazil, in particular, is on fire thanks to its political stability, strong and steady economic growth, ample natural resources and burgeoning middle class.

According to mergermarket and Merrill DataSite, Brazil saw 142 M&A deals worth \$41 billion in the first half of 2011. This represents a 15% increase in volume and a 24% increase in value over 2010. Sectors with the greatest activity include infrastructure, energy, construction and consumer goods.

Partial sales: Have your cake and eat it too

Business owners frequently are torn between the desire to sell their company to realize liquidity and reluctance to lose what's been their life's work. Unfortunately, conflicted feelings can lead owners to delay or decline a good offer. However, with a partial sale it's possible both to raise cash and retain control over your company.



Minority stakes

There are several ways to achieve a partial sale. Usually the easiest route is to find one or more institutional or individual investors interested in acquiring a minority stake in your company. You receive a quick cash infusion to reinvest in your business or use for other purposes and hold on to majority ownership.

In most cases, you continue to have the final word on your company's strategic decisions. However, minority investors may ask for considerations such as the option to acquire a majority stake at a specified time in the future or for certain decision-making rights until their investment is recouped.



Recapitalization methods

Another partial sale option is a recapitalization. In this type of transaction, your company replaces its current sources of financing with new ones — for example, issuing debt to buy back stock.

In one popular recapitalization method, the owner sells his or her equity in the company to a financial sponsor such as a private-equity fund. Financial sponsors typically push for a 50% or greater stake in the company, which gives them voting control. Sponsors also generally require the company's owner and original management team to remain in place to run day-to-day operations. This is particularly common when a sponsor is unfamiliar with the industry or product niche.

Potential benefits

If you're not sure whether you should make a partial sale, consider some benefits. Partial sales can:

Increase company value. New capital from a partial sale can help your company expand and increase market share. This in turn boosts its value and can lead to a larger payoff when you eventually sell your remaining stake.

Improve merger opportunities. By accepting new investors, you're likely to gain business partners

with M&A deal experience. These partial owners can be a good resource if you're interested in expanding via acquisitions. And if you want to sell your full stake in the company at some point, your partners can help you prepare the business for sale — including enhancing its value — and advise you on potential buyers.

Aid succession plans. A partial sale can help your company identify the best candidates for future succession and enable your exit strategy. Sponsors, for example, typically encourage top performers and promising managers to invest in the company.

Mitigating risks

Naturally, selling a portion of your company isn't without risks. For example, a poor relationship with a financial sponsor could wreak havoc on your business. If the sponsor is unhappy with the relationship and has a majority stake, it even could try to sell your company without your input or approval.

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That's why it's important to carefully screen potential partners. Private-equity and other financial investors typically intend to own a company for five to seven years before selling it. So you should assume you'll be working with your partial owner for at least that long. Because these types of investors usually specialize, it's important to partner with people who've worked successfully with other companies in your sector.

An easy transition

Aside from the other benefits, a partial sale can help ease you out of your owner role. It gives you time to make plans for the future — whether that's retirement or a new business venture — and removes a lot of the anxiety that often prevents owners from selling outright. ■

Ask the Advisor

Q. Should my company ask for a cash or a stock deal?



A. One of the many issues sellers must consider is the type of deal they prefer — cash, stock or a combination of the two. Of course, buyers usually have their own preference, and deal structure can become a sticking point during sale negotiations. But next to price, deal structure is probably the most important facet of a business sale. Knowing the pros and cons of each will help you decide whether you should compromise or stand your ground.

Deals a la carte

Some companies are purchased with cash, which, not surprisingly, most sellers prefer. An all-cash deal is simple and doesn't depend on the buyer's future performance. All-cash is particularly appealing for owners who are planning to retire or start a new company and need liquidity.

But all-cash transactions are less common than more complex structures such as:

Partial cash/partial stock offers. Buyers that are publicly traded might offer a quantity of their stock

as part of the purchase price. This gives the seller a stake in the future success — or failure — of the merged company. If your buyer's stock has generally appreciated in the past and you have confidence in its management and strategic plan, a partial stock deal could make sense.

Partial cash/debt assumption. When sellers have substantial outstanding debt, their buyers might assume it as part of the final price. This releases the seller from debt obligations, but it also reduces the amount of cash it receives.

Share exchange. Here, buyers and sellers exchange stock with one another at a fixed ratio. As with partial stock offers, sellers could benefit from an appreciation of their buyer's stock price.

Delayed compensation (earnouts). Sellers might agree to a lower cash payment at closing in exchange for further compensation if the merged company achieves a set of mutually agreed upon goals (typically financial) over a certain period. This type of deal can be risky for sellers, but it also can be helpful in breaking a price deadlock, especially if you need to sell quickly. In this recovering economy, many buyers don't have access to adequate bank financing.

An informed choice

As a seller, you must weigh the immediate reward of cash against the potentially greater value — and greater risk — of other deal structures. Tax consequences are another important consideration. The bottom line is that flexibility and compromise continue to be key to getting many deals done. ■





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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