

Merger & Acquisition Focus



Year End 2011

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Ask the Advisor



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Future-oriented acquisitions

BUYING WITH YOUR EYE ON THE HORIZON

Sometimes the best M&A deal is the one whose value isn't obvious. The right acquisition target may not even be on your radar. But buyers that are focused on the future — as opposed to the present — are more likely to find their best strategic match and avoid making ill-chosen acquisitions of opportunity. A future-looking approach may require a lot of research and planning, but it will also help ensure that your acquisitions make good long-term sense.

Don't be short-sighted

Many acquisitions are based on simple rationales. A buyer comes across a company that can expand its product line or help grow market share. Or a buyer spots a bargain — a company it believes is temporarily undervalued.

Unfortunately, this emphasis on short-term opportunities can have negative consequences. If you move on the first attractive target that crosses your path, your company may miss out on better — even possibly less expensive — targets elsewhere.



And while it may be tempting to take advantage of a relatively depressed M&A market, keep in mind that a bargain is only a bargain if the acquisition provides you with long-term value.

Evaluate your targets

To keep your focus on the future, draft a strategic plan that includes revenue projections and objectives related to new markets and clients. Your plan should include objectives for five-year and possibly 10-year periods.

Armed with these long-term objectives, start looking for potential acquisition targets. When you identify an appealing prospect, ask yourself the following questions to help determine its potential future value to your company:

How do the company's products fit into your strategic plans? Maybe you're planning to roll out a new product in the next few years — at considerable expense and effort. It may make more sense to buy a company already established in the marketplace that brings the development, production, sales expertise and brand recognition that could take you years to build from scratch.

Is the target company on a competitor's radar?

You may not be planning to make an acquisition right now, but consider the implications if a major competitor pulls the trigger instead. If your rivals buy a potential target, will that give them a competitive advantage? If so, you may want to buy the company yourself.

Is the target itself a potentially strong competitor?

Fast-growing smaller companies can represent a threat to your customer base and market share. An acquisition of such a company could be considered a pre-emptive strike.

Think creatively

Some of the targets you identify may seem insignificant or out of your company's purview, so it's important to think creatively and keep an open mind. Consider how potential acquisitions could enhance a slightly different product lineup or broader geographic focus. And remember that your market is always changing. If you don't change with it, you'll be left behind.

To better understand this acquisition strategy, consider the following real-life example. Over the past decade, the Arizona's Children Association (ACA) has used a future-oriented approach and series of strategic deals to expand its size and reach. It found its targets by first deciding what it wanted to be doing in the future and then identifying the companies or nonprofit organizations that already provided those services. What began as a Tucson-based service focused solely on residential treatment of patients grew via acquisitions into an Arizona-wide foster care, adoption, behavioral health and prevention agency.

Ready for the future

Even if you aren't ready to make an acquisition right now, future-oriented thinking can help you begin to identify valuable targets — and help make it easier to ignore opportunities that won't contribute to your long-term success. When you're finally in a position to consider a deal, you'll be ready. ■

What's in it for sellers?

Future-oriented M&A deals have an obvious appeal for business buyers. But what about sellers? By researching the strategic plans of other companies, you may be able to find the right buyer faster and even realize a higher sale price.

Examine your major competitors, as well as companies dominant in adjacent sectors. For example, if your company is in food distribution, look at everything from food wholesalers to retailers to freight companies and warehouseers.

To better tailor your pitch to potential buyers, classify these companies as one of the following:

- ❖ Market leaders with a history of expanding into new areas via acquisitions,
- ❖ Aspiring contenders that are hungry to grow and may be looking for opportunities to de-throne market leaders, or
- ❖ New market entrants that have never made an acquisition but could be enthusiastic first-time buyers.

Attract buyers with an “essentials” list

Getting the attention of the right business buyer isn't easy. But one way sellers can kick-start their marketing effort is to conduct a self-assessment and identify their key strengths. This “essentials” list not only helps you make the case to buyers, but it may also aid you during deal

negotiations and help the two companies integrate after the deal closes.

What's on it?

Your essentials list should contain your most valuable tangible, intangible and human assets. There



are no specific rules for inclusion, but everything on the list must have contributed to your company's positive past performance — and therefore be critical to its future growth. In addition to brand presence and core assets such as facilities, machinery and equipment, typical items include:

Key employees. Whether it's the salesperson who single-handedly generated half of last year's revenues or a manager who kept a division outperforming others while coming in under budget, these MVPs belong on the list. Be sure to identify key players by name and provide salary, contract and other relevant information.

Core products. List the products and services that are the most profitable and popular, have the greatest growth potential, are proprietary or unique, and are considered "core" to your company's brand.

Valuable subsidiaries. If there's a subsidiary, division or segment that generates the lion's share of your company's revenues, single it out.

Critical customers. Which customer or client relationships are most important to your company? Think in terms of longevity, percentage of revenue and potential for increasing your business in the future. Also consider listing customers who have given you additional business through referrals and testimonials.

Which employees participate?

Consider developing an internal team of employees from various divisions and levels to perform a candid, unbiased assessment of your company. Make sure the team isn't made up only of executives — lower-level managers and rank-and-file employees often can identify strengths that escape the notice of their bosses.

When relying on an internal team, watch out for personal bias and self-interest. A manager might, for example, try to include on the list an employee who's a friend but not a particularly good worker, or a unit or customer for which he or she feels responsible, even if they haven't contributed much to your company's bottom line.

One way to get around this issue is to have team members randomly assigned to parts of the organization to review, but bar them from assessing their own departments. Or, ask each member to submit a list of strengths anonymously, and then review and vote on it as a group.

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When are experts necessary?

If you don't think it's possible to assess your strengths without ruffling feathers or risking bias, or if your company lacks the time to do a proper assessment, consider bringing in a third party. An M&A advisor or independent consultant can review

your financial statements, operations and assets and conduct interviews with your staff to gather the essential information.

Having a professional assess your company may have the added benefit of reassuring potential buyers that the list is objective and accurate. Although buyers perform their own research and due diligence when they're serious about an acquisition, your list should provide an accurate snapshot of your company. Exaggeration or misstatements will only come back to haunt you.

Several uses

In the end, your essentials list is an informal document that can help you attract a qualified buyer. Even if it's only a small piece of your larger sale strategy, the process of assessing strengths is invaluable.

Buyers, too, will find the list useful. They can use it to supplement their own due diligence efforts and sharpen their internal analysis of the target company's strengths. The list also can help buyers remain focused on preserving their acquisition's most valuable assets after the transaction closes. ■

Distress symptoms

WHY SELLING CAN CURE YOUR FINANCIALLY TROUBLED COMPANY

Many businesses have gone under during this long recession — and more are likely to fail before the economy returns to robust growth. Even if your company has remained afloat, you may be having a hard time paying your bills and qualifying for financing. With little new revenue, things may only get worse.

Believe it or not, now may be a good time to sell all or a portion of your company. There's a market for financially distressed companies, and with the right perspective and professional advice you can possibly get a fair price for yours.

The first step

Deciding to sell your company won't be easy. You've invested significant time and emotional energy in it. But if you tried but can't seem to right the ship, your best option may be to get what you can for it now — before your only choice is bankruptcy.

Begin the sale process by making a hard-line assessment of your company's worth. Hiring a



financial professional to value your business will provide you a basis for negotiating the sale price and terms with potential buyers.

Depending on your company's financial condition, a valuator may estimate liquidation values for assets

such as real estate and equipment. For healthier companies, a valuator assesses financial statements and pays particular attention to earnings and sales volume. Your intangible assets, such as people, knowledge and intellectual property, may also be attractive to potential buyers. Keep in mind, however, that values placed on intangible property are likely to be scrutinized closely.

Selling a fixer-upper

Once you understand your company's market value, you'll have some idea of what you can expect from a sale. Generally, distressed company sales are different from those of healthier companies. 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.

Buyers look for opportunities to maximize human resources by restructuring job roles and placing people in the right positions.

One of the qualities buyers seek is 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 automotive mufflers and a potential buyer is in the business of servicing and repairing exhaust systems, acquiring your line of merchandise could help them strengthen existing customer relationships and cut out competition.

Buyers also look for companies with good 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.



Another major draw is talent. Buyers look for opportunities to maximize human resources by restructuring job roles and placing people 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 is critical. It won't necessarily garner a higher sales price, but it will make the difference when it comes to buyer interest.

Advice and guidance

Because selling a distressed company can be a complex and delicate operation, you should get professional advice as soon as possible. Allowing advisors to handle the difficult work of selling also frees up your time to continue managing your company's day-to-day operations.

Advisors experienced in selling financially troubled companies can help you improve your competitive position and your final sales price. They're also 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.

Potential win

No business owner wants to admit defeat. But selling your distressed company can be a win when you find a buyer interested in your company's strengths and willing to overlook its weaknesses. ■

Ask the Advisor

Q. How long should my M&A deal take?



A. When it comes to M&A transactions, there's no such thing as an ideal timeframe. Each deal is different and many factors come into play. Most transactions take six to 18 months from start to conclusion. But, based on the nature and complexity of the deal, as well as the planning and organization of the company's management, it could take even longer.

That said, it's never a good idea to drag a deal out — especially if delays are caused by internal issues such as inadequate due diligence or poor communication between the parties.

Pinpointing delays

Once deal negotiations begin, buyers and sellers must work together to map out a loose timeframe. Flexibility is essential because you're unlikely to hit every date, including the closing target. Add in extra time and specific methods of resolution for unexpected events such as an additional round of due diligence, financing problems and price negotiation stalemates.

To estimate the kinds of issues that might cause out-of-the-ordinary delays, consider:

The type of deal. Is your deal a fairly straightforward merger of equals, or is it a more intricate transaction that involves, for example, the sale of divisions to more than one buyer? The more "moving parts," the longer a deal is likely to take.

Financing method. Will the deal be an all-cash purchase — usually the easiest type — or will it require debt financing from bank lenders or be a stock sale that requires the parties to negotiate a

fair exchange rate? Deals financed by the seller or via earnouts also might take longer.

Regulatory interest. If the buyer and seller operate in the same industry and have substantial market shares, the government may initiate an antitrust review — which can cause major delays. The Department of Justice's recent decision to challenge the T-Mobile/AT&T merger, for example, has added months to the deal, if it doesn't derail it entirely.

These are only a few factors that can knock you off schedule. Depending on the type of business, you may also need to worry about such things as labor union or local government resistance, or serious legal liabilities involving, for example, contaminated property, disputed trademarks or employee discrimination lawsuits.

Focus on the controllable

M&A parties should keep to their timeframe as much as possible, knowing that they'll inevitably encounter unexpected roadblocks. So try to concentrate on the variables you can control, such as due diligence preparation, communications with stakeholders and employee integration. ■





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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