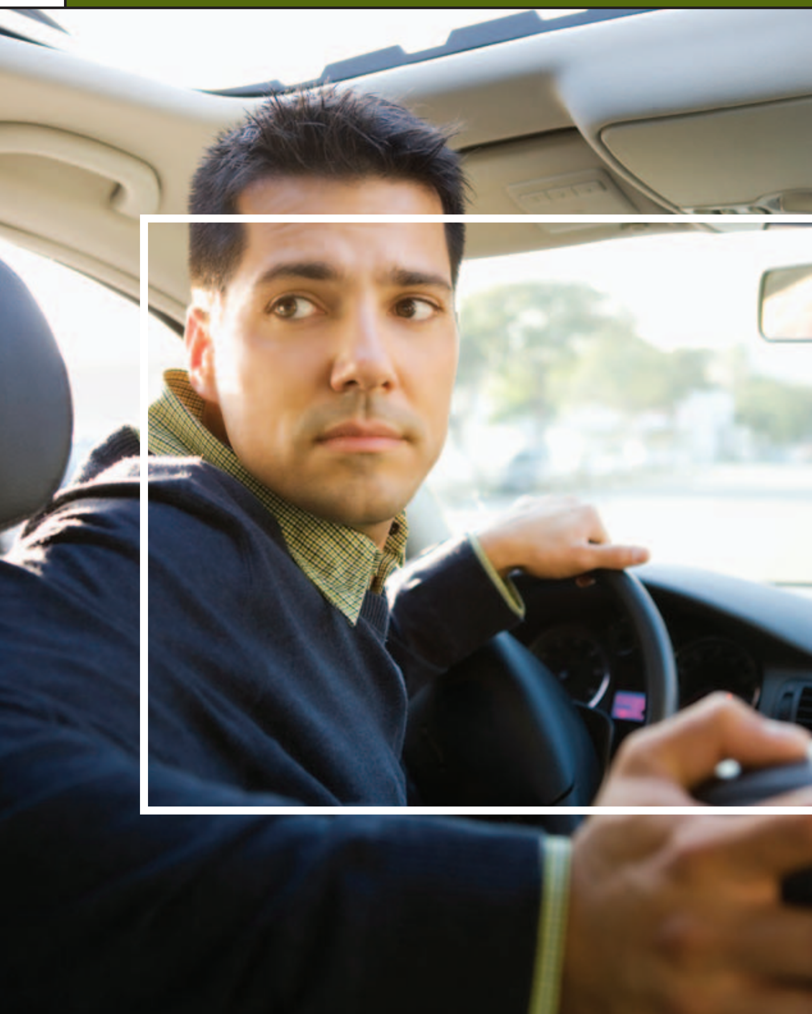
Merger & Acquisition Focus



April/May 2012

Reverse mergers
New rules could mean new obstacles

Be careful not to overvalue your target's customers

Getting your small-scale deal right

Ask the Advisor

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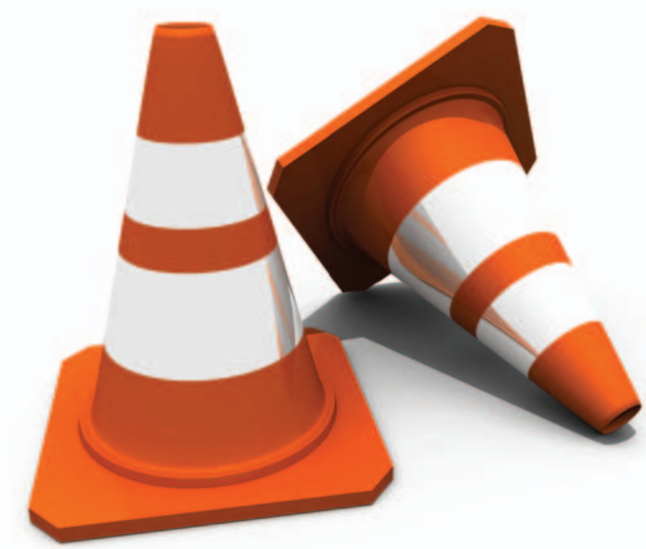
REVERSE MERGERS

New rules could mean new obstacles

If your company has considered a reverse merger as a quicker and cheaper way to go public, know that new rules could make such a transaction more difficult. The SEC recently applied the brakes to companies pursuing reverse mergers as a backdoor method of getting listed on major public stock exchanges. Although these rules won't necessarily affect your plans, you should be aware of the potential obstacles.



Public by way of private

A reverse merger is a financial transaction in which a privately owned company merges with an existing public, but presently dormant, company called a "shell." The shell legally purchases the private company by issuing new stock and using it to acquire a majority stake. Once the two entities are merged, the former private company becomes the majority owner of what's essentially a new public company and is able to issue shares to the public.

The rules could reduce the appeal of reverse mergers, which already have declined since 2008 due to market volatility.

Though these transactions are complex, they can be an appealing way for business owners to circumvent the initial public offering (IPO) process. Along with being expensive and time-consuming, going public can be risky. Bloomberg analyzed 333 IPOs between January 2010 and November 2011 and found an average decline of 11.1% from the initial offer price.

Game changers

Unfortunately, companies that intend to use a reverse merger to land a New York Stock Exchange (NYSE) or Nasdaq listing may find that the path to going public has gotten a lot longer. In November 2011, the SEC approved reverse merger regulations designed to promote greater transparency by increasing the amount of information available on newly listed companies. The SEC's actions are intended to help investors, regulators and auditors make better decisions.

Now, a reverse-merged company must complete a one-year "seasoning period" before being listed on a major exchange. During that period, it must trade in the U.S. over-the-counter market or on another regulated exchange while reporting audited financial statements to the SEC.

The reverse-merged company also must maintain a minimum share price for a period mandated by the

SEC. For example, for 60 days prior to its listing application for the NYSE, a company's stock price should never sink below $10 per share.

However, there are exceptions to those rules. If the reverse merger occurred long enough ago that the company has filed four annual reports with audited financial statements, the seasoning period and minimum share price rules generally won't apply.

Potential implications

It's still too soon to know how the SEC's rules will affect companies and financial markets. But some analysts have speculated that these new prohibitions could increase the allure of alternative exchanges such as Kansas City–based BATS. Now the third-largest U.S. exchange, BATS offers faster trades and lower commissions — and it doesn't have seasoning requirements. Moreover, the rules could reduce the appeal of reverse mergers, which already have declined since 2008 due to market volatility. Faced with having to spend a year seasoning its shares, a company may decide to take the IPO route.

That said, reverse mergers still have a lot going for them. Where many IPOs cost upwards of $1 million, a reverse merger transaction can cost as little as $200,000. And, compared with the six- to 12-month IPO process, reverse mergers can be completed fairly fast — typically in just one to two months. However, it's uncertain how much longer that will remain an advantage.

Time is of the essence

If you're thinking about a reverse merger to expedite your company's path to a major stock exchange, think again. Even if your transaction takes a month to complete, you may be required to spend another year in the "minor leagues." However, if you're open to a longer seasoning period and the chance to stabilize your stock price before being thrown headfirst into a volatile public market, the SEC's rules could be welcome news. ■

Shift into reverse in 3 steps

With the help of experienced financial advisors, a reverse merger can be fairly straightforward. Generally, there are three major steps to setting one up:

1. Secure a public shell corporation. The linchpin of a reverse merger is to find a public, SEC-registered company that has no assets or liabilities on its balance sheet. On average, buyers pay from $600,000 to $1 million for this shell, although it's possible to buy a shell for as little as $100,000.

2. Raise any required additional capital. Companies that don't have the cash to buy a shell may need to tap a combination of sources. For example, they might offer private placement stock in the newly merged company, line up outside investors such as private equity funds and borrow from banks.

3. Ensure compliance. A reverse merger entails filing a host of legal and tax forms. And once it's under the SEC's jurisdiction, the company must begin to comply with all of the government's reporting and auditing requirements, including those related to Sarbanes-Oxley. Such costs should be included in any budget projections.

Be careful not to overvalue your target's customers

Depending on your strategic objectives, obtaining access to a target company's customer base can be an excellent reason to make an acquisition. By expanding the number and quality of customers, you may instantly increase demand for your products or services.

But be careful. If customer access is your primary motivation for buying, you'll need to ensure those customers really are as valuable to your business as they seem. If not, you could be making a very expensive mistake.

Account for receivables

The due diligence stage of an M&A deal is where you have the best opportunity to evaluate the target's customers. Start with the most recent financial statements and focus specifically on the company's accounts receivable. Make sure the balance sheet's receivables are collectible and not simply "paper" assets. Note whether large and long-running receivables are on the books and, if so, find out why the company has had trouble obtaining payment.

Also review collection documents to determine how quickly the company has been able to collect on customer charges. If you discover that it has had a history of problems turning receivables into hard cash, find out why — as well as whether the problem is endemic or only an occasional issue.

Go to the source

Talking directly to customers is also important. How loyal do they seem? Loyal customers are more likely to retain their relationships with the company after it's acquired. If, on the other hand, they seem dissatisfied with their current business relationship, they may use a change in ownership as an excuse to find a new vendor.

Your acquisition target's management practices can tell you a lot about the value of its customer relationships.

Also note which customers are in sound financial shape and meet their obligations. Financially distressed or late-paying customers will be of little value, no matter how big their orders. But if they're financially healthy, your target's largest customers should be your primary focus. Consider how revenues would fare if the target company lost one or more of these sources. Would you still want to buy the business — or pay as much as you originally intended?

Even with the best deals, it's not unusual to lose a handful of customers during the integration process. If that handful includes the company's most valuable revenue sources, a deal that looked good at closing will almost immediately lose significant value. So, in general, the larger and more diversified your target's customer base, the better.

Consider management

Your target's management practices also can tell you a lot about the value of its customer relationships. For example, do managers seem to spend an inordinate amount of time on collections? If so, it could suggest a number of potential problems — that the company uses resources inefficiently, is experiencing financial difficulties or has low standards when it comes to customers (and, potentially, other types of relationships).

Also ask how much time managers devote to identifying and winning new business. Has the company tried but failed to generate new sales recently? If so, determine why, and pay particular attention to what this says about the company's ability to grow.

For example, if sales are falling off because your target's customers are flocking to a new competitor with superior products, your entire deal could be misguided. On the other hand, if sales are falling because your target company's sales department is understaffed, you could have a big growth opportunity. With greater financial resources, you may be able to turn a neglected customer database into gold.

Beyond face value

If you're pursuing an acquisition to gain new customers, be sure to use the due diligence stage wisely. What looks dazzling on paper might just be window dressing, and you could end up paying too much for too little. ■

Getting your small-scale deal right

Size does matter. Mergers between small-capitalized, privately held companies are different animals from larger-cap and public company combinations. Small deals can run more smoothly than large ones, but they also can get bogged down in issues that neither party to the transaction could ever foresee.

The key to success is preparation, particularly if you're a business seller with no prior M&A experience. Because small, private companies have fewer reporting requirements and dedicated staffpeople than their larger public counterparts, financial and operating information — and the quality of that information — can become a major stumbling block.

Will small get bigger?

The small-cap M&A market has been relatively sluggish over the past couple of years due to weak economic conditions. According to Thomson Reuters, small-cap (up to $50 million) M&A transactions for the first three quarters of 2011 equaled $95.5 billion. That's a 1.0% decrease over the same period in 2010.

However, many observers expect small-cap M&A volume to increase in 2012. Middle-market companies hoping to wait out the recession are now in their fourth year on the sidelines. They're sitting on substantial cash piles, and, at some point, will have to start spending to grow. Their strategies are likely to include acquisitions.

Too little information

For many companies, getting bank financing is the biggest obstacle to buying a business. So buyers with adequate cash have a big advantage. Instead, the problem for companies ready to buy may be finding quality information about potential acquisition targets.

This is especially true when buyers approach small businesses that aren't on the market and may not have considered selling. Even if potential sellers are interested in making a deal, they might not have the historical financial data and other documentation that buyers need to make a reasonable offer.

Companies that want to sell, therefore, need to prepare financials with the help of experienced advisors, fill in any record-keeping gaps and reduce risks. In particular, sellers should:

- Verify and double-check all reported income — especially if revenue has been deferred or expenses pushed forward to reduce annual tax liabilities.
- Shore up weak or missing documentation regarding key intangible assets, including patents, licenses, employee contracts and proprietary software.
- Review and strengthen internal controls, and standardize any operations that have formerly been ad hoc.

Even if a business is selling to a private company buyer, that buyer is likely to scrutinize the seller during the due diligence stage to avoid potential postdeal surprises.

Preparing financial statements also enables a seller to spot opportunities for improvement — potentially increasing the company's sale price. For example, owners might want to sell some noncore assets and use the cash to reduce debt.

Buyers need help, too

Small-cap sellers aren't the only ones that need help getting in shape. Buyers, particularly first-time buyers, are vulnerable to rookie errors and it's possible they won't recognize danger signs when they see them.

Every company making an acquisition should work with M&A advisors — especially during due diligence. Aside from reviewing financial statements, they can help buyers assess the value of tangible and intangible assets, including whether the seller owns the intellectual property it claims it does. Advisors also can spot hidden costs. For example, many inexperienced buyers don't realize how difficult it can be to dispose of real estate holdings, or how costly it can be to train newly merged employees or integrate IT systems.

The key to success is preparation, particularly if you're a seller with no prior M&A experience.

While the greatest risk for buyers is to *over*estimate the value of a deal and pay too much, *under*estimating its value also can have negative consequences. If the selling owners believe they're being lowballed, they may simply look for other suitors with a more realistic understanding of their company's value.

Ignorance may be bliss

Ironically, private, small-company deals tend to be most successful when both buyers and sellers admit their relative ignorance. M&A transactions are complicated and require expertise that most business owners simply don't have. Even with small companies, details can fall through the cracks. Pull in a professional advisor to help you spot them. ■

Ask the Advisor

Q. How should I manage employee resistance to our merger?

A. No matter how thoroughly you explain an M&A deal's benefits to your employees, there's still a chance they'll dislike the idea. If enough of them — particularly managers and other opinion leaders — are dead-set against it, your postmerger integration could be in serious trouble. You may even have difficulty closing the deal.

There are several ways to minimize strong and potentially disruptive resistance. But the bottom line is: You need to manage employee expectations.

Reasonable fears

It's not unusual for employees of a smaller company selling to a larger one to greet a merger announcement negatively. Most employees fear change and the unknown. For them, the sale of the company could mean new managers, pay reductions, office relocations or layoffs.

With this in mind, craft a counternarrative — one that recognizes employee reservations but that also emphasizes deal *advantages* such as greater financial resources and potential new career paths.

Meet with employees in small groups and allow them to voice their concerns. Then develop actionable responses to alleviate their concerns.

Ground-level meetings also enable you to spot areas of resistance. If all members of a particular department appear to be skeptical about the merger, find out whether their supervisor is responsible for their attitude and devise a plan to bring him or her on board.

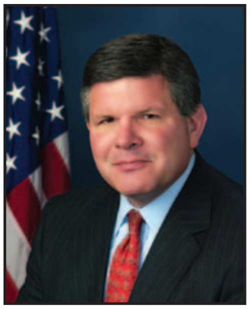
Get past the worst

One of the best ways to boost — or at least stabilize — morale is to be honest. If the deal is likely to lead to headcount reductions or restructuring, tell your employees immediately. Make layoff decisions as soon as feasible and then help discharged workers find new jobs.

Tell those employees you retain that their jobs are secure, so they won't be tempted to jump ship. And be prepared to offer incentives to the employees that your buyer or you consider essential. Modest raises, small annual bonuses or benefits such as a better health care plan or stock option program can improve morale companywide and possibly win over employees who might otherwise seek greener pastures.

Keeping perspective

Remember that you may only be able to manage, not eliminate, employee discontent. Remain positive, focus on winning the majority of opinions and don't worry about a few naysayers. Some employees will become convinced of the deal's merits when they see them for themselves.



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, 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 of the Houston Hispanic Chamber of Commerce, Chair of the Greater Houston Health Information Exchange and on the board of directors of CHRISTUS Health Gulf Coast and Community Health Choice, Inc. a Medicaid HMO serving the Southeast Texas market. 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. He has authored numerous articles and publications (http://www.herrera.com/newsletter.html) on the financial industry and has spoken at numerous conferences and forums on various topics including debt restructuring, operational turnarounds, bankruptcy and financing alternatives.