

# Merger & Acquisition Focus



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M&A today: Where  
opportunity meets competition

*Cost segregation studies*

New Tax Court ruling  
rewards early birds

*Success vs. failure*

It all depends on how  
you measure your merger

Ask the Advisor



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# M&A today: Where opportunity meets competition

**A**fter several years of an M&A market slump, merger activity is picking up in 2012, with proposed and completed deals up substantially in some sectors. Companies that have been waiting on the sidelines for buyers to return to the scene may at last have an opportunity to sell.

There's one wrinkle in this otherwise positive forecast — many more owners will likely put their businesses up for sale, particularly as members of the baby boom generation reach retirement age. So if you're hoping to sell, the current market presents both opportunities and challenges: The number of willing buyers is growing, but so is competition for the best deals.

## Opening a window

Although an improving economy is beginning to lift every boat, 2012 M&A deal volume has been strongest in the energy, health care and manufacturing sectors. In these and other industries, frustrated sellers and eager buyers have created the perfect storm. Deutsche Bank's M&A affordability index, which measures variables such as debt financing costs and growth expectations, indicates that conditions are now the "strongest in recent history."

*Fortunately for prospective sellers, a substantial number of corporate buyers are capable of making deals.*



you're a baby boomer hoping to retire in the next few years, don't drag your feet. In a trend that started in 2011, and will continue for the next two decades, baby boomers will reach retirement age at a clip of 10,000 per day, according to the Pew Research Center.

Remember, too, that there's already a surplus of sellers. In a better economy, many owners would have sold their businesses and retired in the late '00s. Instead they were forced to wait for conditions to improve and are now, therefore, prepared and anxious to find buyers.

## Taxing issues

Tax concerns also might contribute to a growing crush of potential sellers. Unless Congress and the president reach an agreement, Bush-era tax cuts will expire at the end of 2012 and the long-term capital gains tax rate will rise to 20% from its current 15%.

The difference in tax savings could be substantial for some business sellers. For example, a seller of a \$5 million company who recognizes a \$3 million

long-term gain could save \$150,000 in taxes if he or she sold in 2012 instead of 2013. That's a nice incentive to find and close a sale this year.

### Solid set of suitors

Fortunately for prospective sellers, a substantial number of corporate buyers are capable of making deals. Even if the credit market remains relatively tight, U.S. companies have cash to spend on acquisitions: According to a December 2011 Ernst & Young survey, the Fortune 1000 has an estimated \$2 trillion in cash available.

Private equity investors also can be expected to return to the M&A market in force — and with plenty of resources. Despite the weak economy, private equity raised \$300 billion in 2011 alone. What's more, limited partners in private equity firms are putting pressure on fund managers to boost investment returns. Managers, in turn, are beginning to reinvigorate their portfolios by acquiring fast-growing companies.

That said, private equity activity also could contribute to the pool of sellers. Limited partners eager to see a return on their investment are likely to pressure managers to sell currently owned companies that have reached the end of their growth cycle.

### Opportunity knocks

Thanks to long pent-up supply and a slew of retiring baby boomers, competition among sellers will be high in 2012. But because there's pressure on buyers to put their cash to work on growth initiatives, demand should be equal to it. If you've been eyeing retirement — or another business venture — now could be an opportune time to sell your company. ■

## Stand out in the crowd

If your company is looking for a good deal in an increasingly crowded M&A market, you need to find a way to distinguish it from the competition. Although every buyer is different, certain qualities are universally appealing. So be sure to:

**Make profitability key.** Buyers will understand if your company's sales slowed during the recession, but they'll be less impressed if you failed to address costs and your profitability has flatlined as well. To the extent you can, cut expenses to boost profitability — or to pay down outstanding debt.

**Project professionalism.** If some of your business processes are performed informally or ad hoc, that needs to change. Formalize all vendor and client relationships, ensure that intellectual property is owned by your company and protected, and put your key employees under contract.

**Simplify the sale.** Buyers prefer companies that are easy to integrate into their existing operations. So consider everything from replacing your proprietary IT system with an open-source model to standardizing employee benefits to shutting down poorly performing divisions and product lines.



## COST SEGREGATION STUDIES

# New Tax Court ruling rewards early birds

**B**efore agreeing to an M&A deal structured at least in part as an asset sale, consider conducting a cost segregation study. While it may seem premature — or like the kind of minor checklist item you can easily do later — you should, in fact, complete this task as early as feasible.

The recent U.S. Tax Court decision in *Peco Foods v. Commissioner* effectively prevents either buyers or sellers from modifying purchase price allocations after they've been agreed upon. So if you perform a cost segregation study after assenting to an asset sale and determine that you need to make allocation changes, you may be out of luck.

### Behind the ruling

Peco Foods acquired two food-processing plants in separate transactions with Green Acre Farm and Marshall Durbin. In its original agreements with the sellers, Peco agreed to how the purchase price would be allocated among assets. With Green Acre, the price was allocated among 26 different asset types, with an appraisal specifying more than 750 individual assets. The Marshall Durbin acquisition had only three broad categories of allocations, but those categories were detailed in an appraisal listing more than 300 assets.

*Buyers most likely want to accelerate depreciation of asset costs to defer taxes.*



cost segregation study and, based on the study's results, Peco subdivided assets from both purchases to gain more favorable tax treatment. In 2008, the IRS sued Peco for tax deficiencies.

The Tax Court took a dim view of Peco's actions and sided with the IRS. It ruled that, in most cases, when the parties to an asset acquisition agree in writing about 1) the allocation of the purchase price among various assets and/or 2) the market value of transferred assets, the agreement is binding. Specifically, the court ruled that Peco had no basis to reallocate the already agreed upon allocations and couldn't subdivide assets if such actions were at odds with the earlier agreements.

### Break it out

The *Peco* ruling potentially affects any deal that involves asset allocations. Whether you're the buyer or seller, you must diligently and accurately assess how you want to allocate the purchase price to the assets for tax purposes before signing any agreement.

Perhaps the best way to make such a determination is with a cost segregation study. This study, generally performed by a tax expert with input from

Two years after the Green Acre purchase and nearly four years after the Marshall Durbin acquisition, Peco unilaterally decided to modify its purchase price allocations. It hired a company to perform a



construction and other experts, enables your company to identify and break out “personal property” costs (such as decorative fixtures and security equipment) from “real property” costs (the building and land). It might separate components of an acquisition into those that are necessary for the operation of the business and those required to operate the actual asset. For example, in *Peco*, the company separated the food-processing machines from the plant facility.

### Limit tax exposure

If you’re a buyer, your company most likely wants to accelerate depreciation of asset costs to defer taxes. You might shift property from categories with extended tax lives to those with shorter tax lives. The property would enjoy greater depreciation during the early years of its life.

Most “pure building” components must be depreciated over 39 years. Components required for the

operation of the business can be depreciated for a period of between five and 15 years, depending on the asset type, and may be eligible for certain tax-favorable immediate expensing. Buyers will want to allocate acquired assets in the most tax-favorable way.

Sellers also want to try to structure a tax-beneficial deal. But opposing buyer and seller objectives can lead to challenges during deal negotiations. The parties, therefore, should try to find some common ground that yields mutually beneficial tax consequences.

### On the bright side

The Tax Court’s decision in *Peco* complicates matters for many companies considering an asset deal. But it also provides a valuable lesson to help you from falling into the same tax trap: Use a cost segregation study to determine the most tax-efficient purchase price allocation *before* you sign a deal. ■

## SUCCESS VS. FAILURE

# It all depends on how you measure your merger

**S**urvey after survey has shown that at least half of all business buyers consider their completed merger a failure. There are many reasons for this — for example, a buyer might pay too much, lose key people during the M&A process, fail to properly integrate the two entities or overestimate the value of synergies. Some of these issues can be anticipated and prevented, and some can’t.

One thing you definitely *can* control is how you measure the success of your merger. By setting realistic goals and indicators and closely monitoring



postdeal performance, you can spot potential problems and negative trends before they become intractable.

## Set your goals

Your integration team and other senior executives should be responsible for setting both postmerger goals and key performance indicators (KPIs) based on your company's larger strategic plan. Start by defining your goals before your deal even closes. This will make tracking achievements and failures easier when it does. Keeping your goals in mind during the deal process will also help you avoid common buyer pitfalls such as overestimating synergies.

Your company's goals will depend on many factors specific to your newly merged organization but might include the following:

- ❖ Create a new management structure and organizational chart.
- ❖ Monitor and ensure employee satisfaction.
- ❖ Consolidate operations to a single location.
- ❖ Eliminate duplicative positions and departments.
- ❖ Take advantage of cost synergies such as those related to scale discounts.
- ❖ Transition customer relationships.
- ❖ Leverage the merged customer base by cross-selling.

Whatever approach you take, make certain to clarify and disseminate the newly combined company's merger-related goals to all of your employees.

## Key differences

KPIs aren't the same as goals. Postmerger goals can be broad, general and loosely defined. KPIs, on the other hand, provide specific — often numerical and periodic — measurements.

For example, you may have a postmerger goal of greater profitability. To measure your progress, you could use such KPIs

as percentage changes in top line revenue growth or margins over the six-month, one-year and three-year periods following the acquisition. If your goal is to improve customer service, consider tracking how quickly calls are handled or conducting regular customer satisfaction surveys.

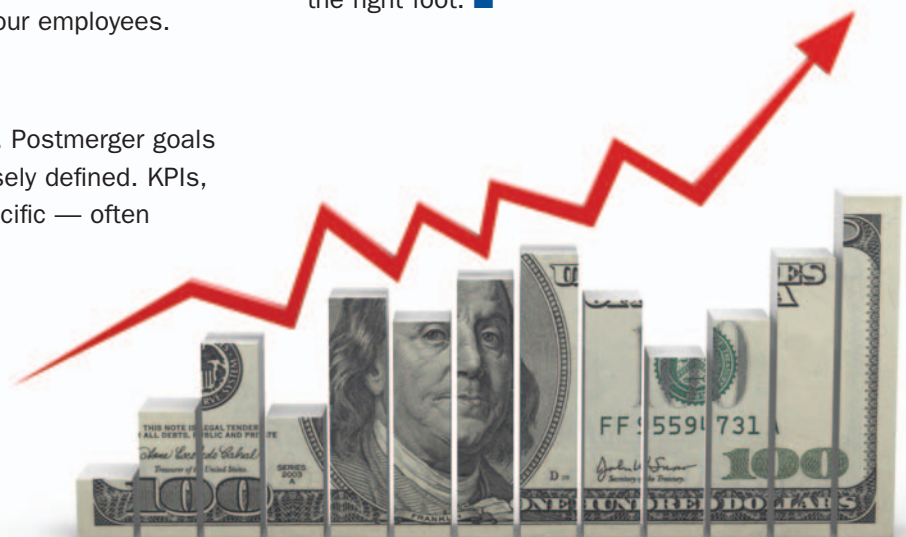
## Strike a balance

Balancing goals with KPIs can be challenging. But if you try to meet your objectives without carefully tracking specific KPIs, you might cut corners and make critical mistakes that jeopardize the merger's long-term success. Conversely, if you focus too much on hitting certain short-term numbers, you may slow down integration activities and make it impossible to reach your ultimate goals.

Try to complete merger-related items quickly while avoiding negative consequences to key stakeholders — particularly customers. The faster you fully integrate an acquisition, the sooner you can turn your full attention to financial metrics and other KPIs.

## Best foot forward

Setting goals and establishing KPIs that support them won't guarantee your merger's success. Much depends on the quality of your goals and accuracy of your measures, not to mention management and employee buy-in. But goals and KPIs can help ensure that your merged company is getting off on the right foot. ■



# Ask the Advisor

***Q. How much leverage should I use to finance my acquisition?***



**A.** After several years of restricting credit, bank lenders are beginning to finance business acquisitions again. And with interest rates at record lows, debt financing looks more enticing than ever. However, buyers should be careful about assuming a lot of debt.

## Starting in second place

Although there's no hard and fast rule about the right debt-to-equity ratio, anything over 2.0 is generally considered overleveraged. When you integrate an overleveraged acquisition, the new entity begins life at a disadvantage to its more nimble competitors. It will have to work that much harder to service debt and become profitable.

What's more, companies servicing substantial debt are more vulnerable to market volatility and unexpected events. For example, holders of short-term debt that needs to be refinanced every year may be forced to tap lenders during an economic downturn, resulting in a higher cost of capital. For public companies, a toxic combination of high leverage and underperformance can depress stock prices.

## Less flexibility

Leverage also limits the strategic shifts you can make. You might have plans to move into new markets or change your merged company's business model, but heavy debt will limit the risk you can take. A lender will closely monitor your debt-to-equity and other financial multiples and hold you to covenants designed to reduce risk.

The sometimes arduous process of obtaining bank financing also can sap energy during the acquisition process. Arranging major leverage requires buyers

and sellers to spend a lot of time researching and negotiating the deal's financing. This is valuable time that might be better used planning for postmerger integration. Substantial debt further increases the risk that the deal won't close.

## What's the alternative?

If your company has cash or can find alternative means of raising capital, that might be preferable to heavy leverage. For example, many deals successfully close with the help of seller financing.



In a recent transaction, Corn Products International avoided using a bank bridge facility (a short-term loan designed to fill the place of longer-term financing) to acquire National Starch and Chemical. It raised funds with long-term bonds instead. Obviously not every company will be able to finance deals via bond issues, but buyers should explore all options.

## Don't overextend

When considering an acquisition, research which types of financing offer the most attractive terms and be careful you aren't overpaying. In some cases, it may be better to walk away from a potential deal if it requires your company to overextend itself. ■



**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.



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