

Merger & Acquisition Focus



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and get a better price

Ask the Advisor



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Does smaller really mean easier?

ACQUISITION CHALLENGES FOR LARGE COMPANIES

You might assume that acquiring a small private company is a breeze compared with buying a large one. But in most cases, you'd be wrong. Small companies can offer large company buyers great growth potential or access to unique assets, but they can also pose due diligence, negotiation and integration headaches. Any buyer that regards a small company purchase as an "acquisition lite" is in for a rude awakening.

The appeal of small-caps

Like most of the M&A sector, small-cap company deals have been in a funk lately. In the first nine months of 2012, companies smaller than \$50 million represented only \$88.2 billion in deals. That's down 11% from the same period in 2011, according to Thomson Reuters.

Buyers may find that acquiring a small company requires more extensive — and possibly more frustrating — financial due diligence.

On the bright side, the small-cap company segment generally is the first to benefit from economic improvements and resurgences in deal activity. The reason is simple: Small companies are more affordable for a range of potential buyers.

Buyers looking to make an acquisition in the coming year can expect to find an array of attractive small companies in a variety of industries. Getting small-company owners to sell at a bargain price or make major deal term concessions, however, is another story.



Tough talk at the table

If anything, buyers face tougher negotiating partners in small business owners. Founding owners often have an emotional attachment to their businesses, and are quick to defend anything the buyer labels as a shortcoming. Because such sellers are relatively inexperienced in negotiating business sales, they're also more likely to push aggressively to get what they consider a fair price — a price that buyers may balk at.

Small business sellers also are likely to have detailed knowledge about the company's strengths and growth potential — more than a buyer could ever glean from the due diligence process. For example, owners who have literally built their business's client base, one customer at a time, will be eager to challenge any buyer "misperceptions" about these customers' loyalty or long-term value. For this reason, a buyer may want to require the seller to remain with the company for a period after the deal closes.

Other obstacles

Buyers may find that acquiring a small company requires more extensive — and possibly more frustrating — financial due diligence, particularly

if the seller is a small or family-owned operation with no previous M&A experience. The seller may not follow GAAP or regularly engage outside auditors. Further, small-company owners define “business expenses” differently and often commingle their personal and business finances.

Such companies can also pose a greater *legal* risk. Loosely defined employee and client contracts, pending litigation, or undocumented intellectual property holdings could, at best, make integration harder. At worst, poor legal recordkeeping might invalidate what were considered by the buyer to be valuable assets.

When acquiring a private business, public companies need to think about SOX compliance as well. The target may not, for example, follow the whistleblower rules required of public companies — or even adequately enforce internal controls. Cultural issues, especially if the seller is family-owned or a loosely structured entrepreneurial operation, are likely to arise, as well. New employees may have trouble adapting to the buyer’s managerial style and more formal procedures.

Smart selling

Although small company sellers may be inexperienced with M&As, they’re no less likely to be tough negotiators. Buyers need to prepare for vigorous debate, high price expectations and some resistance to making concessions. The deal may seem small for the buyer, but the stakes are huge for the selling business owner. ■

How to negotiate with a big buyer

Negotiating an M&A deal with a sophisticated corporate buyer can be the most arduous and nerve-wracking task any small-business owner undertakes. But there are ways to make the process easier and less stressful. With the assistance of seasoned M&A professionals, approach the negotiation table calmly and resolve to keep your emotions in check.

Negotiations are more likely to run smoothly and provide you with fair compensation and favorable terms if you:

Are reasonable about price. You may have an ideal number in mind, but odds are your buyer won’t offer it. Your buyer needs the deal to be profitable, too. So, be sure you’re able to distinguish between a decent opening bid and an attempt to lowball your business. Deciding beforehand on a lowest acceptable offer or a “walk away number” will help you deal with the buyer if it attempts the latter.

Focus on key details. Does the proposed sale agreement put your company on the hook if the buyer encounters unforeseen postdeal costs? This could put what sounds like a great offering price in a whole new light. How your buyer finances the acquisition and how your sale proceeds are taxed are also potential make-or-break details.

Concede strategically. If you agree to a key buyer protection or a lower price, require the buyer to give up something of value. Also, don’t concede all at once, but instead stagger the concessions. Otherwise, your buyer will sense that you’re desperate and you’ll lose any leverage you have.



Stop employee integration problems before they start

When companies merge, the race for cultural dominance often begins with the deal announcement. Employees of the acquired company, in particular, may feel they're at a disadvantage — assuming they'll have to adopt the buyer's culture and compete on an uneven playing field for management roles and resources.

Buyers need to be aware of the potential dangers of this situation because it could foster resentment and power struggles and lead to the departure of key employees during the delicate integration stage. You can head off such problems by making an effort to welcome new personnel and clearly communicate their value in the merged organization.

Meeting with opinion leaders

If you're a buyer, start off on the right foot by meeting with the seller's executives, managers and other key employees at the appropriate time (depending on the deal and employee). Such a forum enables both sides to ask and answer questions, assess the likelihood of a good fit between the two sides, and discuss future goals.

Including key employees in planning discussions provides your company with a couple of useful benefits. First, employees' inside information can help you set strategic priorities — for example, which products and markets would benefit from immediate attention and resources or which underperforming units could be profitably spun off.

Interacting with these key employees also enables you to spot leadership talent as well as identify those individuals who are enthusiastic about the merger and will be in a position to influence the



opinions of rank-and-file employees. Emphasize that you consider your seller's personnel one of its most valuable assets going forward, and provide examples of how the merger is likely to benefit them. For example, you may offer bonus programs for high performers or greater opportunities to move up the corporate ladder.

To give the seller's employees a sense of ownership in the new enterprise, involve them in integration planning and implementation.

Leadership roles — who has them and who keeps them — are likely to be a major concern for key employees. If the seller's managers must interview for positions in the merged organization, ensure that the evaluation process is fair and that existing employees aren't given preferential treatment.

Keeping information flowing

Once your deal has closed, it's time to discuss the future with all the seller's employees. Be as transparent as possible and address any concerns

personnel might have about potential layoffs, facility closings, benefits changes or cultural differences. It's critical that information flow both ways, so make sure you listen as much as you talk. And work with your HR team to follow up on any questions you can't immediately answer.

To give the seller's employees a sense of ownership in the new enterprise, involve them in integration planning and implementation. For example, IT staff of both companies should share knowledge and ideas on merging the two networks — whether that means the seller adopts the buyer's system, the

buyer adopts the seller's system or both systems are overhauled.

Communicating respect

The integration stage is where most M&A transactions eventually fall apart. To make your acquisition a success, you need the full support of employees. By greeting your seller's staff with a hearty welcome, answering their difficult questions candidly and providing frequent integration progress updates, you'll communicate respect for these workers — making it much more likely that they'll reciprocate that respect. ■

How to leverage location — and get a better price

Everyone knows the real estate industry's mantra: location, location, location. While location may not be quite as critical to the success of an M&A deal, sellers and buyers can't afford to ignore it, either. The physical location of a seller's operations — whether it's the business's office or its production facilities — can contain hidden sources of value.

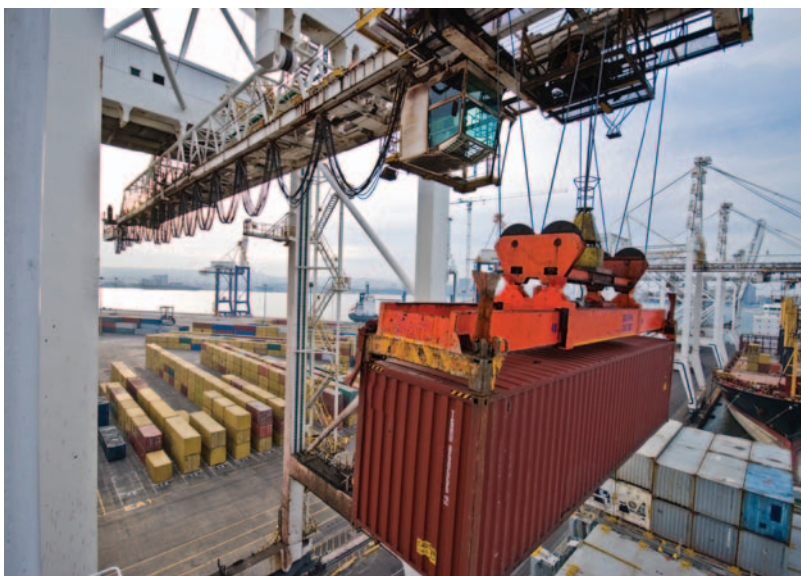
Location can even help boost a business's sale price. Companies located in prime real estate markets or in low-tax or low-regulation states often are attractive to buyers — particularly if the buyers' own facilities are in less-desirable locations. So during deal negotiations, selling owners shouldn't downplay a potentially valuable asset.

Tax advantages

One significant enticement selling companies might offer prospective buyers is tax savings. If your buyer

is currently headquartered in a state with high municipal and state tax rates, the buyer could save substantially if it relocated the business to a lower-tax state.

Among the states considered to be "low tax," according to the research group Tax Foundation, are Wyoming, Nevada and South Dakota. These



states currently have no corporate taxes or individual income taxes — which could be enticing for relocating executives. Other states offering tax savings include New Hampshire and Montana, which don't levy state sales taxes.

Reduced regulations

A reduction in regulatory burdens might also appeal to potential buyers. If your company is located in a low-regulation environment, you might encourage a buyer to move production facilities to your location and use it as a springboard for future development.

As you can imagine, much depends on the regulatory environment of your state. But many sellers can craft an appealing narrative wherever they're located. For example, Texas doesn't tax property used for pollution control, goods in transit or manufacturing equipment. Kentucky's state government recently started an online interface to simplify business filings, and Missouri has passed strong tort reform in a bid to reduce class-action lawsuits.

Also, there's a reason why more than half of public and Fortune 500 companies are incorporated in Delaware. For large companies, the state's reduced regulatory burdens and corporate and personal tax advantages can't be beat.

Pick your selling point

Many other factors come into play when buyers evaluate a seller's location and property holdings. These include:

Geographic convenience. A buyer currently located in a landlocked state or in an area that lacks adequate airport, highway or railroad infrastructure may

be interested in buying your business if it's located near a major transportation hub.

Upgraded facilities. A sparkling new office or recently upgraded factories are always a plus for buyers.

One may agree to pay more for your company because it won't have to renovate offices or replace aging equipment.

Property sale options. If your business owns property in a hot real estate market where commercial property prices are consistently spiking, buyers might regard it as an appealing source of revenue. Your buyer could quickly fatten up its balance sheet by selling off your real estate at a profit.

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You may be able to monetize your property — before selling your business — via a sale leaseback. In such arrangements, a finance company purchases the property and leases it back to your business. Or if you include real estate in the business sale, your buyer may conduct a sale leaseback to recapture invested capital or fund future growth.

The tipping point?

In most cases, a business seller's location or property holdings won't be the centerpieces of their M&A deal. However, a good location could mark the tipping point for buyers that are on the fence — and it might raise the amount of your buyer's offer.

Work with your M&A advisors to determine how your location fits into the larger selling strategy. If you have something that potentially offers buyers significant revenue, make the most of it at the negotiating table. ■

Ask the Advisor

Q. Should I allow an investor to take a minority stake in my company?



A. Along with selling, one of the toughest decisions a privately owned business can make is whether to allow an outside investor to take a substantial minority stake. In many cases, accepting a minority stakeholder is the first step to an eventual sale to that party. Even when it isn't, however, minority stakeholders can provide the impetus for a company to consider selling in the future.

Ideal arrangement?

Most public companies' largest minority shareholders are investors who have purchased a substantial percentage of shares. By contrast, private companies that need new capital to fund growth seek out minority investors and offer them a percentage of the business at a negotiated price.

This type of arrangement can be ideal if your business isn't able to borrow what it needs from a bank or raise cash via an IPO. And because minority stakeholders typically don't have a say over strategic decisions or day-to-day business matters, owners don't have to worry about losing control. However, depending on how much you need the capital, minority investors may request certain

rights, such as voting provisions that enable them to intervene in key hires and major asset sales.

Minority stakeholders also can help prepare your company for a potential sale. Having new people with fresh ideas at the table may provide the push you need to improve operations, streamline financials and sharpen long-term strategies.

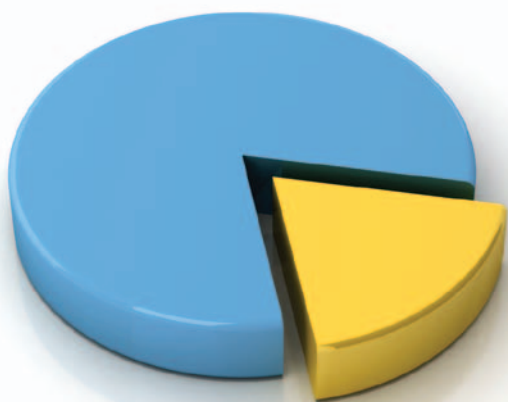
Potential risk

Of course, there's always risk in accepting outside investors and you should expect some changes — especially if your business is small and run by its founders. You must provide minority stakeholders with access to certain financial information, such as tax statements and quarterly earnings. And you need to inform them when you make major business decisions.

Although minority stakeholders lack legal power to control your business, they can make things difficult. For example, they might sow dissent among owners, thus undermining your management's ability to run the company, or they could sell shares at a loss, weakening your company's value.

Best case scenario

There are many reasons why a company might add a minority shareholder. But the ideal scenario for most businesses is when such investors intend to buy the company. A minority owner's financing can relieve a cash crunch and enable you to finance growth initiatives. At the same time, the investor learns about your business and its culture, paving the way to a smooth ownership transition sometime in the future. ■





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 HealthConnect and on the board of directors of CHRISTUS Health Gulf Coast and Community Health Choice, Inc., a Medicaid HMO serving 250,000 members throughout Southeast Texas. 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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