Merger & Acquisition Focus

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Ask the Advisor

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Your CFO's role in an M&A deal

No matter which side of an M&A deal a company is on, its chief financial officer plays a central role. Typically, a buying company's CFO is charged with managing the deal's potential risks, including those that arise during due diligence. On the sell side, the CFO is primarily responsible for getting the company into financial shape for the buyer's scrutiny.

Both CFOs help ensure their companies get the best value for the transaction. They also play an essential role in transitioning their companies into one merged organization. During the integration stage, the two CFOs' working relationship can even determine whether the merged company gets off to a healthy start or stumbles out of the gate — setting it up for future problems.

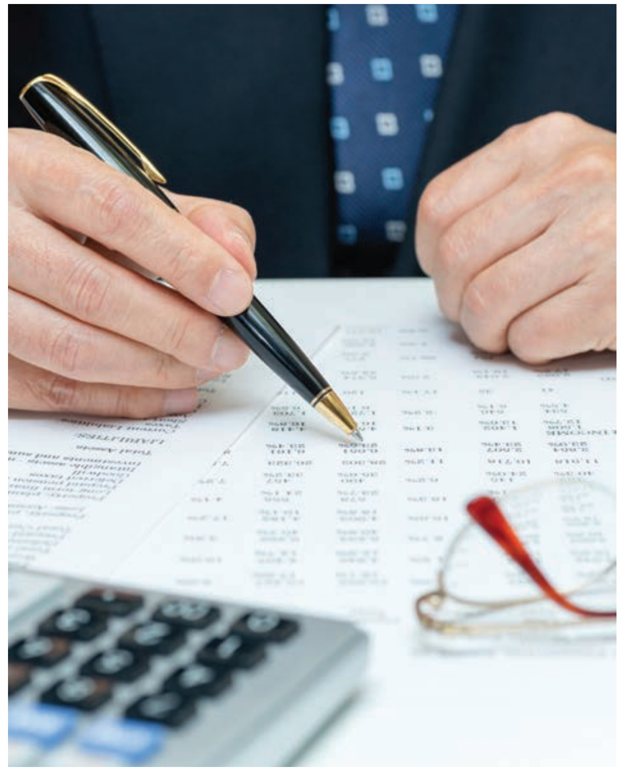
Buying CFO: Voice of reason

The CFO of a buying company may initially assume the role of house skeptic. Owners and other executives might perceive greater value in a potential acquisition based on a "gut" feeling. But the CFO rationally assesses a target's advantages and drawbacks and identifies costs and potential earnings depletions. He or she ensures that buying the target company makes financial sense.

Among the factors buy-side CFOs consider at various stages of an M&A transaction are:

Current condition. Is the target company profitable or is it losing money? What are its outstanding liabilities and obligations? Are there any potentially toxic business units?

Potential for growth. What are the seller's financial objectives and projected earnings for the next three years? Are they realistic? How do these objectives



compare with the company's past performance and the buyer's own growth goals?

Effect on buyer. What's the risk to the buyer's balance sheet — for example, how much debt will the buyer assume? Is the buyer adopting any potential legal liabilities? How much will the deal cost, including advisor fees, executive hours and potential diminished capital if, say, an acquired public company's share price declines post-closing?

Selling CFO: Financial housekeeper

When approached by a buyer, the CFO on the sell side helps determine whether a proposed deal fits the seller's goals and would be financially advantageous for the seller. But the CFO's real work begins when the owner agrees to receive an offer and the company starts preparing for due diligence.

Among the CFO's responsibilities are to ensure that the company's financial records are up to date, accurate and accessible. This may require the CFO to push for greater standardization in areas like employee compensation, taxation structures and working capital levels, if those functions have been handled differently by various divisions or departments. But sellers don't have to wait for an actual buyer: CFOs should continually assess business sale value attractors — as well as detractors.

Working together

Once due diligence begins, the sell-side CFO should regularly communicate with his or her buy-side counterpart to make sure the buyer's deal team has what it needs. Ideally, the CFOs will create a due diligence schedule so that the buyer doesn't bombard the seller with unexpected requests. For example, the two parties could agree to focus first on legal and debt obligations, then move on to earnings forecasts.

Even as due diligence is underway, both CFOs should start mapping out postclosing integration and prioritize the buyer's objectives. If it's a strategic acquisition — intended to expand the buyer's presence in a particular market or enhance its product lineup — the CFOs may work with other executives to integrate the departments where the merger's greatest benefits are expected.

If the buyer is a private-equity fund or other financial buyer, it probably expects to spin off its acquisition in a few years. So before the deal closes, the CFOs might focus on reducing costs and improving productivity. For all types of M&A transactions, CFOs should spend some time organizing upcoming integration procedures and creating prioritized to-do lists for the integration teams.

Ready for the role

How CFOs perform their many roles during an M&A deal can determine its ultimate success or failure. Make sure your company's CFO is prepared for this demanding undertaking and has the resources to cope with the many challenges associated with a merger. ■

The first 100 days

Once an M&A deal closes, the clock starts ticking for CFOs. The first 100 days of integration are critical. Mistakes made and opportunities missed during this time can haunt the merged organization for years.

Depending on the transaction, the selling company's CFO may depart once the deal is done or, if the acquired company is to operate as a distinct entity, remain in his or her role. Those who remain will want to work with the buyer's CFO to address the following:

Personnel. CFOs may coordinate with chief operating officers and HR managers to decide which employees from the selling company will remain and whether their roles, compensation and benefits will change.

Accounting systems. If seller and buyer use different accounting standards, reconciling them as soon as possible should be a top priority. This may be a time-consuming, but essential, task for the CFOs.

IT reconciliation for accounting. Different computer systems can cause costly integration problems. CFOs should work with chief information officers to determine the best course of immediate action, such as whether the selling company's IT staff should continue managing the old systems during the interim period.

The longer haul

HOW NEW PRIVATE EQUITY STRATEGIES AFFECT BUSINESS SELLERS

Due to the recent economic slump, once-opportunistic buyers like private equity (PE) funds are sticking with their acquisitions longer than they did a decade ago. Instead of performing quick turnarounds and reselling or taking their purchases public, many PE funds are buying to hold. Several studies have found that average holding periods have risen over the past five years anywhere from seven months to two years, or from approximately 3½ years to more than five years.

This can be good news for sellers. But keep in mind that PE funds with longer-term strategies will likely perform extensive due diligence and may take a harder line on price and deal concessions.

Hold on

PE funds are still buying — particularly "bargain" companies battered by the recession. PE-related M&A volume has been relatively stable in recent years and now seems to be on the upswing. For example, in 2012, the number of PE acquisitions dropped only 1% from 2011. And the $17.4 million in new deals this January was almost double the $9.9 million in January 2012.

But PE funds are having much less luck finding new buyers for their acquisitions, which is what has led them to become longer-term strategic buyers that are more focused on their targets' business development and financial health. Given a current surplus of companies for sale and a dearth of potential buyers, PE funds can afford to be picky.

In the absence of nonfund buyers, PE funds are increasingly selling their acquisitions to each other.

Seller strategy options

If you're trying to sell your company, there are a number of ways to improve the odds of attracting a PE fund. Deals with PE funds now are likely to involve longer timelines, which can make the process less predictable and more frustrating for both parties. Companies that can help expedite a deal — for example, by having all financial and legal documents ready for due diligence scrutiny — will likely increase their appeal to PE buyers.

Sellers with few longer-term issues are also more alluring. PE funds favor companies with low debt, high sustainable cash flows and steady revenue streams. Declining earnings forecasts or loans expected to come due in the next few years can put PE buyers off. So your company should concentrate on refinancing or paying down long-term debt and stabilizing cash flows.

Another twist

Even if your company is an attractive acquisition candidate, another factor could affect your ability to find a PE buyer: In the absence of nonfund buyers, PE funds are increasingly selling their acquisitions to each other. This has led to tougher negotiations between PE buyers and PE sellers. For example, some PE sellers have refused to provide postclosing indemnities, arguing they could take the company public and eliminate that risk.

PE buyers have pushed back, reducing their offers to reflect what they perceive as increased indemnity risk. And some have demanded greater amounts of seller-funded insurance. Not only do the PE-owned companies caught in the middle of such battles suffer, but more-stringent terms and a general reduction in prices may make it harder for other sellers to get a fair deal.

Possible market turnaround

The M&A market as a whole is thriving this year, with several headline-grabbing multibillion-dollar deals leading the way. While many buyers have been cash-heavy companies making strategic acquisitions, PE funds are in the mix. For example, 3G Capital recently teamed up with Warren Buffet's Berkshire Hathaway to buy H. J. Heinz. In fact, should current market volume hold, 2013 could be the biggest year for M&As since 2007.

If market conditions indeed improve and PE funds find it easier to unload acquisitions, they could return to their short-term ways. Until that happens, PE funds are acting like inadvertent strategic buyers, and sellers should approach them accordingly. ■

Family businesses: When selling is the only option

For some business owners approaching retirement age, the next step is clear: Transfer the business to a son, daughter or other family member who knows the company and is eager to run it. But many owners don't have that option. Their relatives may not be interested in or qualified for the job, or the owner may need the proceeds from a sale to retire in comfort.

Selling a family business, however, can be harder than selling other types of closely held companies. It's important, therefore, to get good professional advice as soon as you make the decision to sell.

Advisors enhance value

To buyers, your company represents a business opportunity. The memories and friendships you associate with it have little value to them. This includes loyalty to family members and employees and special working relationships with particular

customers and vendors. Although you'll want to do what you can to protect your stakeholders and preserve your culture and products, you also need to be pragmatic.

Start the process by asking an M&A advisor to assess your company's current market value and find ways to enhance it. Your advisor should be able to shine a light on your blind spots, such as poorly performing product lines that you've been unwilling to cut simply because you've had them since you founded the company.

It's common for family-run businesses to keep highly compensated, yet ineffective, employees on the payroll because they're related to the owner. But such practices reduce your business's value to prospective buyers. So don't be surprised if your advisor suggests some personnel changes. Advisors also may recommend selling off certain business units or monetizing assets for higher multiples to maximize your exit value.

Owners shape up

Enhancing value is only one part of preparing for the market. Buyers are just as concerned about risks associated with acquiring your business. During the due diligence stage, prospective buyers review documents related to finances, regulatory compliance, intellectual property, legal obligations, employee benefits and client and vendor contracts, looking for problems that might prove costly or time-consuming down the line.

Advisors may recommend selling off certain business units to maximize your exit value.

For many small businesses, filing and administrative tasks aren't a top priority. If this is true of your company, start organizing your records immediately so that they'll be in good shape when a serious buyer emerges.

Similarly, you may be used to making strategic decisions — such as opening a new store — informally, with no paper trail. That needs to change going forward. And you'll need to reconstruct all of your company's milestones and key strategic moves and organize them into a comprehensive summary for prospective buyers.

Looking forward

Some personal decisions need to be made at this stage as well — for example, whether you want to cut ties with your business after you sell it or stay on in some capacity. Your buyer may request you to run the company during the transition period or provide regular input as a consultant. Or you could look for a buyer that will begin as a minority owner with the option to take a majority stake in a few years.

Whatever you decide, make personal financial and estate plans *before* you sell, so you don't have to worry about income during retirement or how you'll someday pass on wealth to your heirs. When possible, involve family members who've worked for the company — and even those who haven't — in your plans to sell and retire. It can help mitigate hurt feelings and avert family arguments.

Challenges ahead

Whether you'd once hoped that a family member would eventually take over your business or you've planned to sell all along, the selling process can be difficult. In addition to getting your business in shape and making future financial plans, you may need to deal with your own emotional ties to the company, not to mention family politics. ■

Ask the Advisor

Q. What part does working capital play in a merger?

A. Working capital — a company's current assets minus its current liabilities — is a critical figure in any M&A transaction. This number often fluctuates between when a deal is signed and when it closes, so the sale agreement usually includes provisions for working capital adjustments as part of the overall purchase price.

Buyers and sellers must agree on a target amount of working capital for deal negotiations to ensure the acquired amount is sufficient to cover short-term operating expenses. Then the parties put protections into the final agreement should the actual figure at closing be higher or lower than the target. However, determining the target itself can be contentious.

Several factors considered

Working capital estimates and adjustments cover unforeseen events that could inflate or deflate a seller's capital during deal negotiations. These can include everything from liabilities discovered during due diligence to cost spikes that crimp a seller's short-term earnings. To come up with a target number that incorporates such contingencies, sellers and buyers need to consider several factors, including:

Historical data. A selling company's historical working capital levels — usually over the previous five-year period — help to establish a baseline number.

Market comparison. The financial statements of comparable companies of similar size, as well as industry-standard valuation techniques and other ratios, can indicate what the seller's industry considers adequate working capital.

Deal forecast. Does either party foresee a lengthy negotiation? The longer negotiations drag out, the larger the amount of working capital needed to fund the selling company's day-to-day operations until the deal closes.

Making adjustments

Once a target number is established, the parties need to negotiate a set of working capital price adjustments. Typically, they're rolled into a broader set of closing price adjustments that take effect at closing and apply for up to 90 days afterward.

For example, if there's a substantial difference between the target working capital number and the actual closing amount, the buyer might take the difference out of the final purchase price. Or if the final working capital figure is less than the target, the seller might receive a bonus.

Work together

Working capital can be a raw issue. Buyers don't want to have to scramble to cover their new acquisition's short-term operating expenses at closing. Sellers don't want their sale price cut. So the more specific the parties are about terms and the more dedicated they are to fairness, the less likely that working capital will disrupt an otherwise smooth transaction. ■

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 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 Chairman of the Houston Hispanic Chamber of Commerce, the largest Hispanic business-oriented, membership organization in the country; a Mayoral-appointee to Rebuild Houston Oversight committee charged with providing oversight regarding the dedicated street and drainage fund; and Vice Chairman of the Business and Financial Affairs committee of the Development Board for the University of Texas Medical Branch. 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.