

Merger & Acquisition Focus



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Robust market makes
partial sales more attractive

It's about time

Keep your deal moving —
but not too quickly

Why buyers need to pay
attention to employee benefits

Ask the Advisor



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Decision to divest

ROBUST MARKET MAKES PARTIAL SALES MORE ATTRACTIVE

Merger activity has spiked in 2015, so it's not surprising that many companies are considering divestitures. Selling a portion of your business, or taking a unit public and subsequently spinning it off, can be a smart strategic move when the market is brimming with potential buyers.

But you need more than a hot market to make a divestiture work. You also need a good reason to sell — for example, is the unit a strategic outlier or consistent underperformer? Before diving in, be aware of the potential pitfalls associated with divestitures.

Long-term trend

Divesting has been on the upswing for some time, across a range of market sectors. Roughly 48% of M&A activity in the financial sector between 2011 and 2014 has involved divestitures in some form, according to Thomson Reuters data. That compares with 25.6% of financial deals in the 2000s.

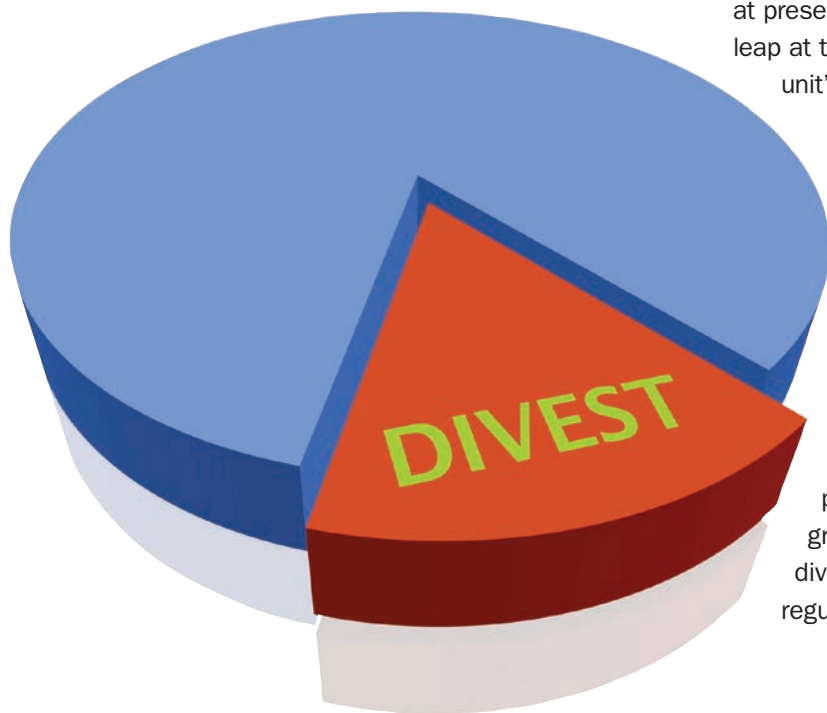
Dow Chemical, to name one high-profile example, has an ongoing divestiture program intended to shift resources toward more profitable segments. The company's goal is to raise as much as \$8 billion through non-core asset divestitures by mid-2016.

Another company with ready cash might leap at the chance to realize your underperforming unit's potential.

Best candidates

Divesting a unit can be a hard decision, but there are a number of reasons the move might be appealing. First is underperformance. If a unit is limping along, with declining market share or waning profitability, it's probably a drag on the rest of your company. You might believe that performance would improve with a major capital investment, but that's not feasible at present. Another company with ready cash might leap at the chance to realize your underperforming unit's potential.

The other prime divestiture candidate is a unit that doesn't fit the rest of the company. For example, it may be left over from an acquisition but has never meshed with your culture, targeted the same customers or shared the same strategic goals. Maybe it's a remnant of an earlier stage of your business, but your core interests have since shifted. Or perhaps the outlying unit's risk profile is greater than that of your company's other divisions due to economic, environmental or regulatory factors.



Transaction options

If you have a unit that meets divestiture criteria, you now need to choose the type of transaction you'll pursue. The following options all involve potential benefits and pitfalls:

Complete sale. This usually is the simplest, most effective option. The potential downside is that you may not have realized returns on your original investment in this unit and must cut your losses.

Business alliance. If you want to retain at least part ownership of a unit but turn management responsibilities over to another party, consider a business alliance such as a joint venture. Such transactions can enable you to keep a minority interest. However, the unit's performance will still affect your company finances — possibly negatively.

Spinoff via IPO. When a unit is a strong performer that simply doesn't fit your company's strategic profile anymore, a profitable option might be to spin it off with an initial public offering (IPO). But note that IPOs are complex, time-consuming and costly, and public companies are subject to regulatory oversight and market pressure.

Getting it right

Every divestiture carries risks, so whether you decide to pursue a straight sale or partial sale, or take your unit public, you'll need to plan the divestiture carefully and surround yourself with

Who are your buyers?

Before your company considers making a divestiture, do some digging and identify potential buyers (or, in the case of a joint venture, partners). Pinpointing buyers will help you understand how easy and profitable your divestiture could be. Knowing potential buyers also allows you to market the unit strategically.

Buyers worth looking into include:

Former unsolicited bidders. These are companies that have previously inquired about or made unsolicited offers for the unit. Companies that have already expressed interest in a deal may already know certain key facts and have performed necessary due diligence on the deal, leading to a faster sale.



Private equity firms. These firms can be good candidates for either an outright or a partial purchase. They generally have access to capital, are able to implement creative deal structures, and may provide strategic value through their other business holdings.

Foreign companies. International companies looking to establish a beachhead in the United States might be willing to pay top dollar for your unit. However, foreign sales can be complicated by regulatory issues — both here and in the buyer's home country.

Suppliers and customers. Your unit may serve someone else's core competencies. Just be sure that selling to a company in your industry won't create new competition for your core business.

When you spot an attractive possible buyer, get a sense of its financial condition and decide whether your unit might be able to advance its strategic goals. Also research its history to learn how successfully it has handled similar transactions in the past.

knowledgeable experts. For many companies, the rewards are worth the risk. A divestiture can help you streamline operations, focus on priorities and boost long-term prospects. ■

It's about time

KEEP YOUR DEAL MOVING — BUT NOT TOO QUICKLY

How quickly can you sell or acquire a business? As with most major transactions, it depends. Once parties agree to merge, deals typically take six to 18 months to conclude. The selling company's size and industry, the complexity of the transaction, and the buyer's ability to get financing, among other factors, can all affect timing.

Many issues, such as regulatory holdups, are ultimately outside your control. However, good organization can keep your M&A transaction on track and focused on the finish line.

Keep moving

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.

If you're a business owner, be wary of unsolicited "handshake" deals that promise a quick sale.

To estimate the kinds of issues that might cause out-of-the-ordinary delays, consider the type of deal. For example, is your M&A 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 can play a big role in deal timing. An all-cash purchase usually is the easiest type of transaction. But there could be delays if the buyer



requires debt financing from bank lenders and hasn't already secured it or is coordinating with the seller to qualify for the loan. Stock sales that require the parties to negotiate a fair exchange rate and deals financed by the seller or via earn-outs also generally take longer.

Also, if both parties operate in the same industry and have substantial market shares, the government could initiate an antitrust review — causing major delays, or worse. The Department of Justice's recent challenge to the Comcast/Time Warner merger, for example, fatally derailed the \$45 billion transaction.

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.

Slow down

Although it's important to keep your deal moving forward, you should never try to rush an M&A. This is particularly true for buyers, who need to devote adequate time to due diligence. One overlooked financial problem or legal liability could turn a

profitable acquisition into your company's biggest mistake. What's more, integration preparation — which includes getting to know key employees and gaining a thorough understanding of such functions as your seller's accounting methods, IT network and employee benefits — takes time.

If you're a business owner, be wary of unsolicited "handshake" deals that promise a quick sale. A speedy transaction that doesn't rely on an army of advisors — particularly when the offering price sounds generous — may be tempting. But if your business hasn't been professionally valued recently and you haven't kept up with comparable sales, you could end up with the short end of the stick. Also keep in mind that a sale is about more

than price. Deal terms, tax consequences and your current income needs and desire to play a role in the business's future all contribute to its success.

This is why it's important to rely on advisors' expertise and experience. Advisors help ensure that both parties are satisfied with the final price and terms of a deal and don't leave the negotiation table feeling cheated because they were rushed into an agreement.

Get the details right

Once you establish a rough timeframe for your deal, try to stick to it. But remember that it's more important to get the details right — even if working through them involves the occasional delay. ■

Why buyers need to pay attention to employee benefits

Employee benefits can be critical to the success of an M&A deal's integration phase. If handled poorly, the process of transferring and restructuring benefits might alienate key employees — and even expose buyers to legal claims.

To avoid such consequences, review your target company's current benefits package before the deal closes. In particular, keep an eye out for potential risks and liabilities and work to structure a benefit rollout (and revision, if needed) early in the postmerger process.

Due diligence

Once deal negotiations begin, you should perform due diligence on the seller's benefits programs. This can include:

- ❖ Compensation packages,
- ❖ Health plans,

- ❖ Retirement plans,
- ❖ Employee stock option plans, and
- ❖ Other incentives such as tuition reimbursement, leadership development and recognition programs.

Your M&A advisor can help you determine which documents require reviewing. But in general, you'll want to look at plan descriptions, annual reports, notices and amendments made to coverage, and audits and actuarial reviews.

Retirement plans

Employee retirement plan offerings have the potential to create major legal headaches. So start the review by ensuring that the company's plan complies with the Internal Revenue Code and Employee Retirement Income Security Act (ERISA).

Be on the lookout for underfunded pensions. A defined-benefit pension plan typically has a minimum



funding requirement. If the plan is inadequately funded or has made poor investment choices, you could be on the hook for outstanding obligations to the target company's employees.

Also review 401(k) offerings to ensure they are current with IRS regulations. These plans must pass annual nondiscrimination tests designed to prevent them from benefiting highly compensated employees at the expense of lower-paid ones.

Health care offerings

Employee medical plans are another minefield. Examine your seller's health care offerings to ensure they've met Affordable Care Act (ACA) provisions. As part of the Employer Shared Responsibility provision of the ACA, companies that don't provide "minimum essential coverage" may have to pay a penalty. If your target company owes but hasn't made this payment, you could be responsible for it. Your advisor can help you determine the selling company's compliance and any cost implications.

You should also review the company's continuation coverage under the Consolidated Omnibus Budget Reconciliation Act (COBRA). And be sure to note any health care-related agreements with

former employees, such as a guarantee of lifetime medical coverage at a fixed cost. Such agreements can represent heavy financial obligations, and may require some alterations as part of the transaction.

Anticipate challenges

Once you have a solid grasp of the selling business's various offerings, come up with a transition plan. Start working on any major changes — such as moving your acquisition's employees to your health care plan — as soon as feasible. If the health coverage costs

employees more or features fewer benefits, be prepared to meet possible legal challenges or employee attrition.

If a pension plan is inadequately funded, you could be on the hook for outstanding obligations to the target company's employees.

If you intend to terminate your target company's pension plan, anticipate and budget for penalties or liabilities you may incur. And if you plan to downsize your acquisition's workforce, get up to speed on the company's severance plan and change-in-control agreements.

A tricky process

Handled poorly, employee benefits can represent major obstacles to the integration process and long-term success of an acquisition. If you face obligations to an underfunded pension plan or employee resistance to switching health care packages, it's best to know *before* you close the deal so you can factor such challenges into the sale price. ■

Ask the Advisor

Q. What's the "walk-away" price and how do I determine it?



A: Before starting M&A negotiations, both buyers and sellers can benefit from setting a “walk-away price.” Consider it a safeguard measure. An amount below (for sellers) or above (for buyers) the walk-away price signals the end of merger negotiations.

For sellers, anything below the walk-away price grossly undervalues the company’s assets and earnings, and suggests that the buyer is simply looking for a bargain and possibly isn’t playing fair. A number above the buyer’s walk-away price indicates that the acquisition no longer makes financial sense to the buyer given expected costs and synergies.

Sellers: Honest assessment

Typically, sellers determine their walk-away price by starting with objective information and an honest self-assessment. To prevent overestimating your business, consider hiring a professional valuator to appraise the company based on current assets and financial statements, as well as projected earnings.

Then discuss the current market with your M&A advisor. An active, high-volume market may suggest you can afford to hold out for a better price, particularly if companies similar to yours have sold above their original asking prices. A sluggish market may mean that you need to lower expectations — and your walk-away price.



The timeframe also influences the walk-away price. If you’re in a hurry to sell — for example, due to poor health or a need to raise cash — you probably can’t afford to set too high a price because you’ll need to accept the first decent offer.

Buyers: Facts on the ground

For their part, buyers need to walk a thin line. Naturally, you’d like to get a “bargain,” but if you really want to make a particular acquisition, underbidding and alienating the business’s owner isn’t the way to do it. If the company is in strong financial condition and is being courted by several buyers, the seller can afford to ignore you.

So make sure your walk-away price addresses facts on the ground. Carefully assess the business’s earnings and assets relative to industry norms. And be realistic about potential deal synergies. Often, buyers base synergy expectations on projected cost savings or revenue increases that never materialize.

Make it work

Whether you’re buying or selling, the walk-away price doesn’t necessarily have to be a doomsday device. There may still be room for discussion if both parties really want to make the deal work. However, if the other party seems unwilling to budge from its position, it needs to respect your decision to walk away. ■



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, he 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. Mr. Herrera currently serves as Chairman of the Rebuild Houston Advisory committee, whose role is to advise the City on project prioritization, project selection, process methodology and community outreach regarding the dedicated drainage and street renewal fund; Immediate-Past Chairman of the Houston Hispanic Chamber of Commerce, the largest Hispanic business-oriented, membership organization in the country; 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 and in 2013 was named a Chairman Emeritus. 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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