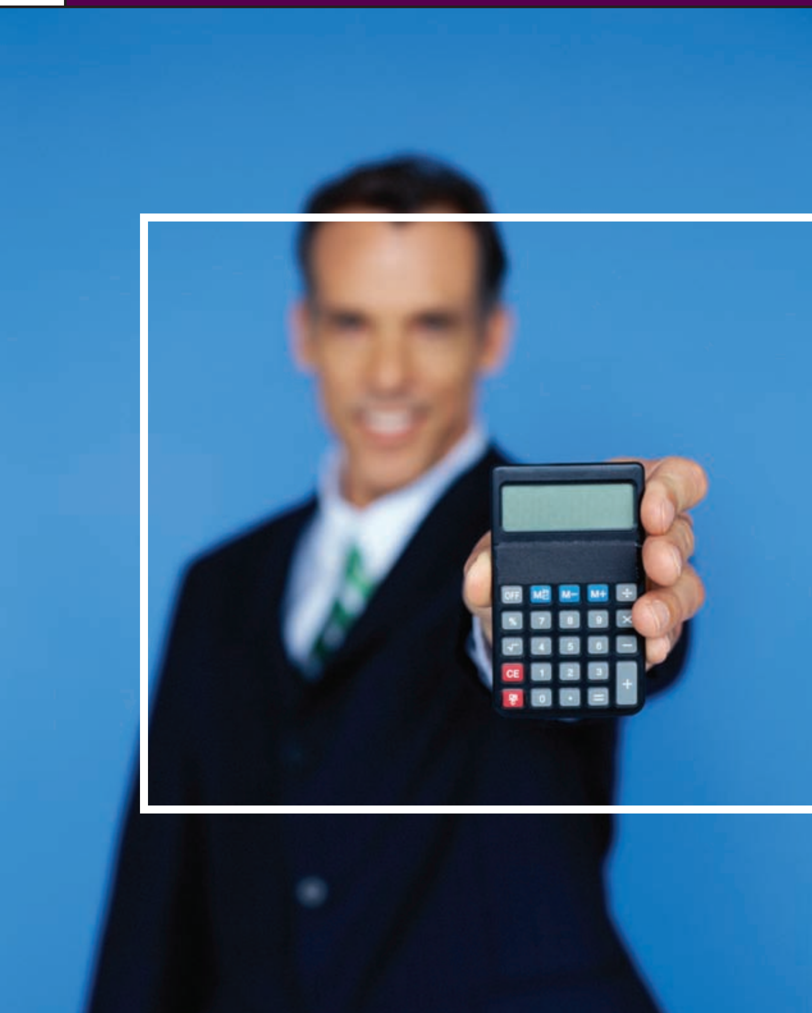
Merger & Acquisition Focus



August/September 2009

Dealing with debt

MANAGE YOUR COMPANY'S LIABILITIES BEFORE YOU TRY TO SELL

Given the current economic environment, prospective business buyers generally are wary of assuming additional debt when making an acquisition. So if you're trying to sell your company, you must address the issue of debt — both the amount of debt on your balance sheet and the nature and terms of this liability. Depending on your business's circumstances, several solutions may be available for improving your debt profile.

Perform a self-evaluation

The first step in reducing debt is to study your company's financials and determine exactly what you have and how it compares to industry averages. Potential buyers are likely to operate in the same business sector, and will know whether your debt load is typical or extraordinary for the industry.

The ratio of total debt to EBITDA (earnings before interest, taxes, depreciation and amortization) is often used as a benchmark for debt risk. Rating agencies typically consider a company with a ratio of five or greater to be overleveraged. And in the current market, even three or four times debt-to-EBITDA may raise red flags for possible buyers.

A maturities swap results in lower monthly financing payments, and improved cash flow and working capital.

Industry averages, however, vary, and what may be considered high in a retail business may be only average for an equipment-heavy manufacturer. Start-ups with cash flows that are still maturing tend to have particularly high debt levels, as do real estate companies, whose ordinary operations depend on leverage.

Slim down

The most straightforward method of reducing your company's debt is to pay it down. Of course, that may be easier said than done if you need all the revenue you make to keep the business operating day-to-day. And even if you could have reduced debt two years ago, your cash flow has probably slowed in tandem with the economy.

Selling assets is one option. If your company owns its office or production facilities, consider selling those properties and then leasing them back. This strategy can generate a substantial amount of cash to pay down debt. For example, in March the New York Times Co. sold part of its Manhattan office building for $225 million, leasing back the space and using the sale proceeds to pay down some of its over $1 billion in long-term debt.

You might also consider a debt buyback, which involves purchasing your own bonds with cash at auction or in a tender offer. If your company buys back a substantial amount of debt, it could enjoy a significant discount — as high as 50% off the bonds' face value. But be sure you work with an experienced advisor to secure a good deal.

Consider refinancing

If you simply don't have the cash to reduce debt and are unable to raise it by selling assets, you may still be able to improve the terms of your outstanding obligations by swapping maturities. In this type of transaction, you exchange short-term debt with high interest rates for longer-term debt with lower rates. A maturities swap results in lower monthly financing payments, and improved cash flow and working capital.

Or look into making a debt exchange in which you replace an outstanding bank line of credit with more favorable financing, such as newly issued equity. In a standard trade, a debtor company offers investors higher yields in exchange for longer maturities. For example, newspaper conglomerate Gannett is planning a roughly $200 million offer in which it will exchange 5.75% notes due in 2011 for 10% notes due in 2015, sweetening the deal with early participation payments. Even though you'll be paying higher interest rates, you can reduce monthly debt payment obligations, and exchanging maturities can push back an upcoming debt settlement.

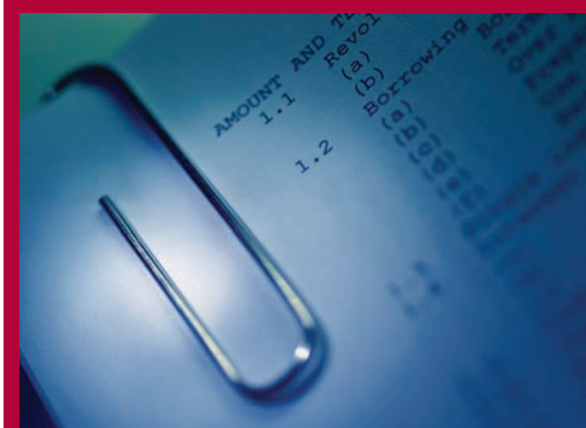
Another option is to find a more favorable type of financing. Banks have grown conservative in the past year and many are no longer willing to negotiate extended maturities or more lenient terms. So you might want to replace your bank loans with public or private bonds or equity investments. You could use the private placement market to issue convertible debt and preferred equities, and then apply the proceeds to an outstanding bank line-of-credit. Finally, some lenders provide loans against receivables, called factoring.

Buyers also need to watch their balance sheets

Business sellers aren't the only ones that need to worry about their debt load. Concerned that a bank may pull its financing at the last minute, many sellers look for buyers that have the cash to self-finance the deal in whole or part.

To raise cash, buyers should consider selling assets that aren't essential to their larger strategic plan and approach private-equity investors about a possible partnership. If you still need bank financing for an acquisition, understand that your lender will hold you to more stringent requirements than in the past, including more frequent reporting and stricter covenants.

You can improve your loan application and chance for favorable terms by paying off outstanding obligations and reducing overhead costs, if possible. And be sure to provide clear, up-to-date financial records so that it's easy for a potential lender to evaluate your company's creditworthiness.



Keep in mind that these transactions can be costly, so be sure to factor in any refinancing and legal advisory costs.

A critical move

Whether you reduce your debt or improve the terms of your outstanding obligations, it's likely to enhance your position on the M&A market. Given this challenging environment, a successful debt strategy could be the glue that cements an advantageous deal. ■

Buyer's market

WHAT A CHANGING M&A LANDSCAPE MEANS

In the earlier part of this decade, business sellers enjoyed an advantage over buyers. A strong economy and the popularity of growth-via-acquisition strategies meant that selling companies typically received the attention of at least several — if not many — suitors. It was easier for sellers to demand lucrative deal terms and, in some cases, substantial deal protections.

That's not the case today. M&A activity has dried up across the board, and some sellers may have trouble attracting even one reasonable bid. If your company hopes to sell or buy in the near future, you need to understand how the M&A landscape has changed in the past few years. You may, for example, need to recalibrate your expectations or, in some cases, explore new types of opportunities.

Balance of power shifts

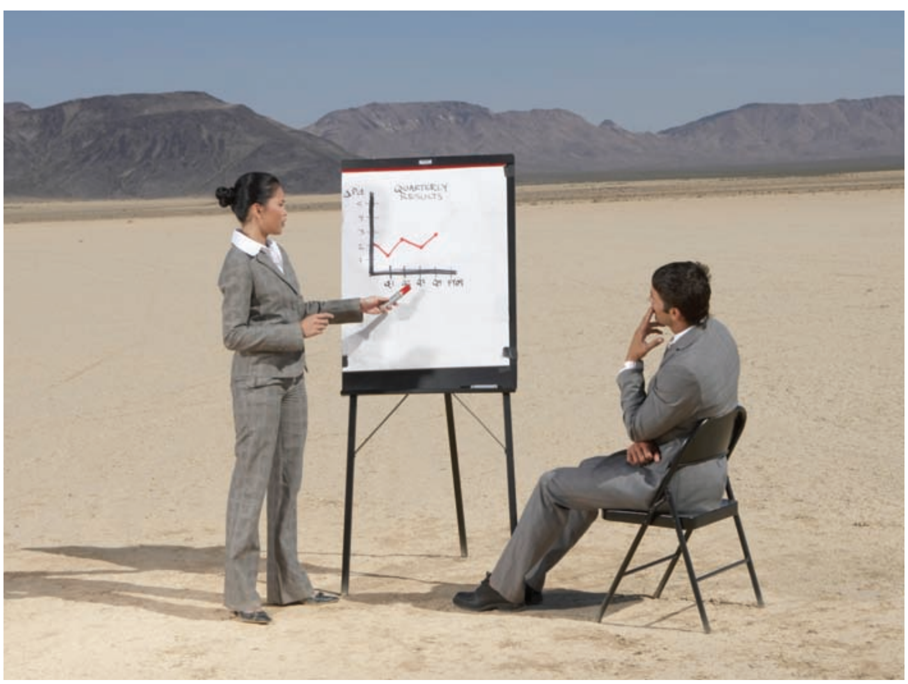
Two mergers illustrate how the balance of power has shifted from sellers to buyers. In mid-2008, Dow Chemical agreed to acquire Rohm & Haas Chemicals Inc. for $15.3 billion and accepted the seller's stringent contractual terms. This year, however, Dow Chemical attempted to pull out of the deal, citing poor economic factors. But because Rohm & Haas had demanded deal protections when it still had leverage, Dow was forced to complete the transaction.

Buyers must be wary because some problems run too deep to be fixed with a capital infusion.

On the other hand, when Pfizer Inc. agreed to acquire Wyeth for $22.5 billion in early 2009, Wyeth, reflecting its weak position, didn't fight for heavy deal protections. Pfizer accepted safeguards requested by its lending syndicate, agreeing that lenders could end their financing commitments if Pfizer were downgraded. Although it increased the likelihood that the deal would fall apart, Wyeth agreed to those terms.

Opportunity or challenge?

At first glance, it may appear that buyers are in the M&A driver's seat. There are fewer of them with access to adequate financing and sellers are less willing or able to hold out for higher sales prices or push for strict deal terms. Yet buyers have their own challenges that they need to keep in mind when negotiating with prospective targets.



Financing remains the toughest issue for buyers. Banks have adopted much more conservative lending policies in the past year and some buyers have lost deals when their expected financing fell through. This trend was especially pronounced in the first months of 2009, though federal government funding has since eased the financing freeze somewhat. The situation remains serious, however, and buyers may need to get creative when it comes to finding the money for their acquisition.

In this environment, buyers also must ensure they've adequately researched their target before committing to an acquisition. The M&A marketplace is brimming with distressed businesses and their number is expected to rise throughout the year. Though a seller's financial trouble may enable a buyer to pick up a potentially valuable company cheaply, buyers must be wary because some problems run too deep to be fixed with a capital infusion.

Buyers may, therefore, want to push for greater protections, including expense reimbursement or the right of first refusal, so that they are compensated for the time and money wasted pursuing an ultimately failed deal. Such requests, of course, may not survive the negotiation stage and, by making such demands, buyers run the risk of alienating sellers from the get-go. So if the deal is vital to its future, buyers may want to take a more conciliatory approach. M&A advisors can be particularly helpful in this type of sensitive situation.

Sellers clean up their act

In light of current market conditions, sellers, for their part, will likely need to revise some of their price and deal terms expectations. Yet sellers shouldn't become overly discouraged. Plenty of opportunities remain for companies willing to go the extra mile when preparing for the market.

For example, sellers might:

- Ensure that their financials are up-to-date, accurate and easy to review,
- Reduce debt or request better terms on outstanding obligations (see "Dealing with debt," page 2),
- Renegotiate with vendors for more favorable terms,
- Build cash by selling off underperforming divisions or assets, and
- Implement an accrual-based accounting system if they don't already use one. Regulators don't consider the main alternative, cash-based accounting, to fairly reflect a company's value.

Although it may seem like a massive undertaking, sellers should try to review and streamline all aspects of their company's operations, a process which could even include laying off workers. At the same time, they need to identify key employees and offer them incentives to stay. Sellers should also be willing to offer contract concessions to large and critical customers.

A delicate time

The economy remains delicate and the timing of its recovery unclear. Given such uncertainty, all parties to an M&A deal need to be flexible so that they can adjust to constantly changing conditions — both positive and negative. ■

Take your public company out of the public eye

As the economy continues to struggle and financial markets roil, many public companies can expect their stock prices to be extremely volatile, unsettling shareholders and making long-term strategic planning virtually impossible. Now might be a good time to consider getting off the rollercoaster.

Although public companies enjoy some advantages — mainly easier access to capital — healthy small- and mid-market public companies may benefit from going private. Not only can this kind of move stabilize company value, but it removes a company from much public and regulatory scrutiny and can save money.

Your own recovery plan

Given the economic malaise of the past year, it's probably not surprising that few public companies have chosen to go private recently — fewer than 30 in 2008, compared with nearly 100 deals completed in 2007, according to Forbes. Even when they want to go private, some companies have trouble finding equity partners to sponsor, or finance, the transaction. And in some cases, the costs of going private outweigh the benefits.

Once investors begin to feel the market has reached a bottom and share prices begin to stabilize, however, such activity is likely to pick up again. In the wake of the technology bust earlier this decade, a number of newly public Internet companies — including Agency.com and Buy.com — reverted to private status after their prices cratered.

Several advantages

Although public-to-private transactions aren't appropriate for every public company concerned about market volatility, you may want to consider its potential upsides:

Decreased performance pressure. Shareholders tend to have high expectations for quarterly and annual growth, which can be particularly challenging in a bear market. As a private company, you'd answer to a smaller, more manageable group of owners.

Going private can provide competitive advantages, make executive compensation decisions easier and enable you to pursue transactions without excessive scrutiny.

Less regulation. Although they're encouraged to adopt many of its rules, private companies aren't required to comply with the Sarbanes-Oxley Act (SOX). More important, private businesses don't have to spend the significant time and expense of meeting SOX regulations.

Greater privacy. Private companies aren't required to make SEC filings and reveal their company's financial and operational details. This can provide competitive advantages, make executive compensation decisions easier and enable you to pursue transactions such as acquisitions and restructurings out of the public eye.

Better M&A deals. Going private can improve a selling company's position. You can make the case for its value without public shareholders obscuring your argument and possibly realize a better price.

Tax savings. When going private, companies may be able to elect an S corporation structure. This provides certain tax benefits public companies don't enjoy. But you need to work with a tax attorney to determine your eligibility for S corporation status.

Look before you leap

Of course, public companies that go private face risks and potential negative repercussions. Unless you have a ready buyer, you'll need a large amount of financing to buy out existing public shareholders and cover the transaction's many fees — including everything from accounting to legal advisory services.

Most companies raise this round of new capital by applying to large investors such as private-equity firms and hedge funds. And these financing partners come with their own set of expectations, so it's important to understand what those are before you agree to accept their funding. Even if financing isn't a problem now, you may find it harder to raise funds in the future without the option of issuing new public shares.

Private options

If you decide that the pros of going private outweigh the cons, you have several options. In a going-private merger, the public company asks shareholders to approve a prospective merger with a newly formed private entity (often formed by a prospective buyer). The company's public shareholders exchange their holdings for "merger consideration" — typically cash — leaving the surviving corporation with one stockholder, a subsidiary of the buyer.

Also common are tender offers, in which the public company or its buyers purchase shares directly from stockholders. Tender offers typically require the buyer to hold at least 90% of each class of stock at the end of the offer.

You might also consider a reverse stock offering. Here, smaller shareholders are cashed out when outstanding public shares are converted to fractions of new shares. Once the company's shareholders fall under 300, the SEC allows it to de-register its public securities via a tender offer.

Big decision

The decision to go private shouldn't be made lightly — it's a life-changing event with many potential long-term consequences. However, if you're confident that your company can better thrive outside the public sphere, it's worth serious consideration. ■

Ask the Advisor

Q. How should I juggle my succession plans with a possible merger?

A: Succession can be difficult for any business, whether a founding owner is ceding power to the next generation or a company has unexpectedly lost its CEO. Add the many stresses of an M&A and the situation becomes even more challenging.

The best strategy is to take the issues one at a time and resolve your company's succession issues before considering a merger. Prospective buyers may not be interested in purchasing a company in the process of transferring power — unless, of course, the buyer itself is seating the new management.

What's more, succession planning can build value into your company over time. When you're ready to move on, your company is prepared for a smooth — and profitable — transition.

Put it in writing

Regardless of its size, industry or strategic goals, every company should have some form of succession plan in place. Even if you're not willing to share your plan with the public (Berkshire Hathaway and Procter & Gamble, for example, don't disclose theirs), all affected individuals should be aware of its existence and critical information involving them.

Some small companies — particularly family businesses — have only tacit agreements about who will replace the current owners once they step down. If that's the case with your company, you need to formalize the agreement as soon as possible.

First, ensure that succeeding family members or employees actually want to assume leadership roles. Then, put your plan in writing and name the individuals, the positions and responsibilities they'll assume, and under what conditions they'll assume them. This will help prevent destructive power struggles and organizational chaos should you leave unexpectedly, and it enables you to openly groom successors for their roles well in advance of your retirement.

Communicate with stakeholders

You might make a sale or merger with an outside party part of your formal succession plan if neither family members nor business partners express interest in assuming leadership or buying you out. Companies with several owners, however, should have a buy-sell agreement in place that gives remaining partners the option to buy a departing partner's shares at a reasonable price.

Once you have a plan, be sure to communicate it with people who may assume they're part of it, but aren't. Dispelling hopes can be difficult and there's a chance employees will resign. But it's better that they know now, rather than waiting to find out on the day you transfer the business to your nephew or liquidate its assets to fund your retirement in Florida. Above all, keep the lines of communication open with everyone who may have a financial, professional or emotional stake in the business.

Laying the groundwork

Succession plans aren't ironclad guarantees against business tumult. An unexpected death or severe financial decline could make yours obsolete overnight. However, a succession plan lays a sound foundation for your company's future so that you — and your successors — can take the kinds of strategic risks necessary to grow. ■