Merger & Acquisition Focus

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Ask the Advisor

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Today's business climate poses many challenges — from increased global competition to a tight capital environment — that can hinder or even destroy a business. Companies struggling with poor cash flow, inadequate capital and weak leadership are especially vulnerable. Such companies can provide significant upside potential to the right buyers. But to turn an unprofitable company around, new owners must have an implementation plan and be ready to execute it.

Getting to the core

If you're a potential buyer of a troubled company, you must examine it closely for hidden values, such as untried territories or poor leadership. Then decide if these opportunities mitigate acquisition risks and potentially provide enough financial benefits.

It's essential to understand the company's core business — specifically, its profit drivers and roadblocks. Without a clear understanding of this, you may misread the company's financial statements, misjudge its financial condition and, ultimately, devise an ineffective course of rehabilitative action.

Due diligence matters

While due diligence is an important part of any acquisition, it's probably the most critical stage in a turnaround deal.

Buyers should take their time performing due diligence and not be afraid to request supporting documentation or perform personal audits that cross-check reported and actual data. At this stage, buyers must pinpoint the source of the company's distress (such as maturing products or overwhelming debt) to determine what, if any, corrective measures can be taken. They also need to determine if the business harbors significant liabilities, such as pending legal judgments, product claims or dissatisfied customers.

This is the time to find hidden flaws. But due diligence may also unearth potential sources of value, such as tax breaks or proprietary technologies. Benchmarking the company's performance with its industry peers' can help reveal where opportunity lies. (See "Does your business measure up?" on page 3.)

Hit the ground running

Generally, the first post-transaction step is for new owners to determine what products drive revenue growth and which costs hinder profitability. This may be the time to divest the business of unprofitable products, services, subsidiaries, divisions or real estate. Staff cuts may further be in order.

Implementing a longer-term cash-management plan and forecast based on receipts and disbursements is also critical. Owners can manage each line item of the company's weekly or daily receipts and disbursements in accordance with:

- Profit and loss projections,
- Changes in working capital, and
- Major debt and capital expenditures.

With a strong cash-management plan and a thorough evaluation of accounting controls and procedures, buyers should be able to identify lost revenue opportunities, such as unbilled services. This plan can also help buyers determine where they might be able to cut costs.

Mapping the future

Buyers should ensure that accounting and reporting systems are producing the data necessary to run effective management reports. If these systems don't accurately capture all company transactions and list all assets and liabilities, company leaders will be unable to fully pursue opportunities or respond to potential problems.

One troubled manufacturing company, for example, wasn't tracking future purchase commitments. When the new owner took charge, it prepared and circulated among managers a comprehensive commitment and contingency report that helped senior management renegotiate the terms of the customer agreements.

Because the task may seem overwhelming, it's easy for new owners to focus only on the business's day-to-day operations. But a strategic plan that maps the path toward revenue growth and improved cash flow is necessary. Buyers may find, for example, that the company's best revenue-producing assets aren't reaching customers and that their potential could be realized with a more sophisticated marketing campaign or bigger sales staff. Macro- and micro-level planning are equally important.

Selling a turnaround

If you're attempting to sell a troubled company, fix performance issues such as stretched payables, escalating inventory levels, unnecessary costs, and low sales margins, if possible. It will likely help you negotiate a higher selling price.

Sellers should review and clean up their balance sheet — which will likely be the focus of prospective buyers — and indicate as much liquidity as possible from receivables, inventories, intangibles and fixed assets. Sellers also need to revalue their assets.

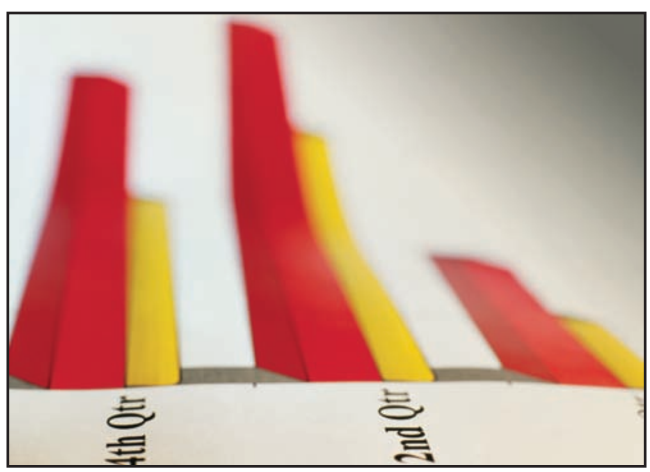
Return to profitability

Only a small window of opportunity is available to realize a turnaround's potential. To take full advantage of it, buyers must get up to speed on the acquisition's products, departments, delivery systems, staff and overall operating systems as soon as feasible.

Does your business measure up?

BENCHMARKING FINANCIAL PERFORMANCE

Thinking about selling a business or acquiring one? Benchmarking — or comparing a company's financials to those of industry peers and its own historical performance — can help sellers determine value and achieve a fair sale price. It may also give buyers insight into the future profitability of a potential acquisition.



Putting it in perspective

Business buyers use balance sheets and income statements to determine the viability of a potential target and decide whether the acquisition is worth the cost and other risks. Buyers generally prefer, and often require, audited financial statements to ensure the accuracy of financial information. Depending on the outcome of this initial review and interest in the business, buyers may seek documentation relating to such items as inventory control, employment agreements, receivables, payables and debt agreements.

Buyers are particularly interested in data related to growth history and potential, profitability, debt capacity, ownership structure, and overall liquidity. They use this information to prepare budgets and forecasts for the acquisition, as well as set objectives, such as eliminating nonperforming product lines or increasing sales.

To fully understand current financial statements, buyers should benchmark items against the company's historic numbers (from at least the past five years) as well as against similar companies' financials. Otherwise, they may overestimate the significance of a piece of data, or worse, miss red flags.

For example, one-time gains in operating income might lead a buyer to think that the seller's accounting is too aggressive. Sellers can help avoid misinterpretations by pointing out extraordinary financial events for the buyer when supplying them with documents. Sellers should also explain the implications of the items to the business — positive or negative — and whether they should affect future cash flows and valuation.

Working with ratios

To identify trends and growth patterns, the company performing the benchmarking should convert five years of balance sheets and income statements to "common size" format, so that numbers are expressed as percentages rather than dollars. This will make it easier to compare them with industry statistics, which are typically produced in this format.

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Comparing the financial ratios of a company with industry averages can help identify areas for improvement and sources of concern. Your accounting advisor will know which ratios are most appropriate to use depending on the company's operations and its industry norms.

These might include:

Profitability. This includes both income statement profitability and rates of return, such as return on equity or return on assets. Profitability measures such as net income, EBIT (earnings before interest and taxes) or EBITDA (earnings before interest, taxes, depreciation and amortization) are key items.

Liquidity measures. There are two short-term liquidity ratios: 1) current, which is current assets divided by current liabilities, and 2) quick, or cash plus receivables, divided by current liabilities. These measures may help determine whether working capital is inadequate or excessive.

Leverage. The primary balance sheet leverage ratios are debt to equity and equity to total assets. If the company's leverage ratio is below industry averages, it may imply unused borrowing power.

Utilization. Utilization ratios measure how efficiently assets are being deployed. Typical ratios include accounts receivable turnover, inventory turnover and asset turnover (sales divided by assets).

Go to the source

Several sources of company data can help you evaluate the health of a company relative to its peers. Benchmark information may be available from commercial vendors, financial advisors or, depending on the industry, trade associations.

One of the most popular sources is *RMA Annual Statement Studies.* This two-volume set from the Risk Management Association includes balance sheets and income statements, plus 16 financial ratios, for each of 330 standard industrial classification (SIC) groups. Each group is broken into four size categories, based on total assets and sales. Comparative historical data for the prior three years is provided for each financial ratio.

The annual *Dun & Bradstreet Key Business Ratios* calculates 14 ratios for each SIC group. Companies are broken into three categories, based on total sales. For each category within an SIC group, each ratio's median, upper and lower quartile values are shown.

Using data culled from corporate federal tax returns, the *Almanac of Business and Industrial Financial Ratios* covers professional practices. It's sectioned into more than 175 business and professional practice groups (such as medical and law).

Financial Studies of the Small Business, published by Financial Research Associates, compiles approximately 25,000 financial statements submitted by more than 1,000 independent accounting firms. This publication focuses on companies with assets of $500,000 or less and includes over 50 types of small businesses and professional practice groups.

These resources are typically available from your M&A advisor or can be purchased from the publishers. Other potential sources of industry data include trade association publications and periodicals, and Standard & Poor's Industry Surveys.

Tools for success

It's important for both sellers and buyers to compare a company's financial performance to others in its industry, as well as to its own historical performance. Even if you're not contemplating such a transaction at this time, regularly benchmarking your company's financials can help you keep an eye on the big picture. ■

Put your money where your mouth is

COMMUNICATING EFFECTIVELY WITH M&A STAKEHOLDERS

Clearly communicating your M&A with employees, investors and other stakeholders can mean the difference between a good deal and no deal. Market perceptions play a critical role in how mergers progress, so both sellers and buyers need to develop a formal communications plan that will help relieve anxiety about impending changes and drum up internal and external support.

Start from the inside

It's usually not advisable to inform employees about a possible deal before the due diligence phase. But once due diligence seems imminent, both companies should begin informing employees. Early and candid communications can help deter rumors and alleviate fear. Even if you can't share specific details, you can discuss the new direction of the company.

To keep employees informed as the transaction progresses, schedule regular Q&A sessions, send e-mail updates, establish a hotline or create a section on your company's intranet where information is posted as it becomes available. Then, be sure to incorporate employee concerns into your deal structure. These stakeholders, for example, may want existing management to continue leading the company for a specific amount of time after the transaction closes. If you can make this happen, you may

increase the likelihood that the best employees will stick with the company.

Honesty — even when it involves unwelcome information such as facility closings and layoffs — ensures that you don't lose credibility with employees. Communicating with your staff can keep customer and vendor relations on track, too, because employees are your front line with these important external stakeholders. Disgruntled workers who badmouth their company and the one it's merging with can damage the company's bottom line. They may even harm public perception enough to reduce the final sale price or kill the deal altogether.

Work the plan

Consider hiring a communications expert to assist you in what may be the biggest employee and public relations challenge in your company's history. Bring the expert on board early in the process so that he or she can develop a plan to devise appropriate messages for employees, investors, lenders, customers or clients, vendors, and the media. Some businesses may also need to communicate with unions, regulators, strategic partners, rating agencies and business analysts.

Your communications plan should explain how the transaction benefits both those on the sell-side and buy-side, and provide compelling evidence for future growth. Investors and employees, in particular, must be convinced that the new organization will be able to deliver on its promises and that these parties will be better off when the deal is completed.

Case in point

While your company probably doesn't operate on the same scale, PepsiCo's acquisition of Quaker provides an example of good M&A communication. PepsiCo clearly and succinctly explained the deal's rationale to investors and shareholders early on, and it developed a detailed press release and investor presentation that outlined the strategy and benefits of the deal for external stakeholders. The company's plan further included an analyst/investor call and Webcast.

PepsiCo publicly stated that the deal would pay for itself in the first full year after closing and could even anticipate an increase on invested capital of 600 basis points over five years. Thanks to this detailed information, everyone knew what to expect and could visualize how the deal would be advantageous.

The personal approach

Press releases, stakeholder meetings and employee newsletters are tried-and-true formal communications tools for merging companies. But depending on the size and type of business, you may want to consider other, more informal, methods.

Owners or executives of smaller and less-structured organizations could schedule lunches or one-on-one meetings with employees. This is especially important to long-time staff members and those who have played a significant role in the business's growth. This kind of personal interaction can help instill confidence and loyalty when the company needs it most.

Collateral damage control

Professionally developed collateral materials such as press releases, brochures and fact sheets can help you get the word out. But even if you issue detailed statements and press releases, expect plenty of questions — and some criticism. Distribute frequently-asked-question guides to managers so they can sufficiently address staff queries. You may want to provide a separate guide to employees who communicate with investors, lenders and the media.

Questions that need to be addressed include:

- Will layoffs take place and, if so, when, and how many employees will lose their jobs?
- What assistance and support will the company provide exiting employees?
- Will compensation and benefits remain the same?
- Will facilities be closed and, if so, when?
- How will the merged organization be structured and managed?

Stakeholders will also want to know what assumptions have been made for the transaction to meet its financial objectives. For example, does the acquirer expect extensive operational synergies once the two organizations merge?

Close the deal

Internal and external buy-in is essential if your deal is to meet its short- and long-term goals. So be sure to keep stakeholders informed about its progress.

Ask the Advisor

Q: How can I prepare my business for a tighter credit cycle?

A. Tightened credit conditions are almost inevitable when the economy slows down. The cost of credit rises and lenders naturally become more risk-averse. There's no way to get around the reality of tighter credit markets, but certain strategies can help your business survive — and even grow — during the downturn. Consider these six strategies:

1. Keep lenders in the loop. Communicate proactively and frequently with your lenders, instead of waiting until you have an urgent need or problem. Keep them abreast of your company's strategic plans and share your successes. But also let them know as soon as possible about potential issues. Your lenders are likely facing increased scrutiny themselves, and will feel more comfortable knowing you're keeping them in the loop about how your company is doing.

2. Give lenders more business. Whenever possible, give potentially lucrative noncredit business to your most important lenders. Consider, for example, transferring deposit accounts to your lenders. This will help build goodwill and strengthen your relationship. Moreover, lenders are more likely to support a good customer when financial conditions are tight.

3. Maximize your flexibility. Add flexible provisions to the terms of your credit agreements before you actually need them (when you'll have fewer options). Discuss with your lender extensions and other options for existing loans as soon as possible.

4. Talk to a credit arranger. A credit arranger, who helps negotiate or develop credit terms and documents, may be useful if you're trying to access multiple forms of capital. Credit arrangers can also help if you need several investors to carry out growth plans, such as an acquisition. For many smaller businesses, however, a CPA or financial advisor — professionals who have objective credibility with banks to negotiate terms — can assist with these matters.

5. Manage liquidity. Keep receivables profitable with strict payment terms, sales tracking and frequent reviews of excess inventories that can be reduced or eliminated. Also, your project budgets may have been drafted well in advance of actual projects, so be sure to reassess budgets closer to the project's inception and on an ongoing basis for possible overestimates.

6. Plan ahead. If you're anticipating a sale or acquisition in the near future, build in extra time to complete the deal. When credit is tight, lenders are likely to conduct more extensive due diligence and require stricter compliance with collateral requirements and documentation. And lenders may more closely scrutinize your growth projections and analysis to determine how your deal might withstand a harsher economic climate.

These are just a few ideas to help prepare for a slowdown in the credit cycle. Depending on your business's size or industry, you may need to consider other strategies. Just remember that, beyond stringent numerical guidelines, all banks have the capacity to make subjective decisions and sign off on your loan terms. ■