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WHAT NOT TO OVERLOOK: THE MIDDLELAYER

One thing that will ensure Houston's midmarket companies miss out on optimal valuations is overlooking the significance of middle management, said Andy Ray, principal at Houston-based accounting and consulting firm PKF Texas, an independently owned affiliate of London-based PKF International.

"The No. 1 performance driver, the great untapped performance driver, in a business is the capability and commitment level of the middle-management team," said Ray.

And according to Ray, middle management is woefully unattended in Houston.

"From a support standpoint, what you see is nobody has any kind of formal development program. It's all on-the-job training. (Companies) don't invest in the development of their folks," said Ray. "Then they lose engagement and get beat up by the job."

And it can be a costly mistake for companies that are trying to develop an exit strategy. When a company is acquired, the C-suite becomes less important to the value of a company because the buyer has its own C-suite. Plus, it wants to be assured that what it's buying can run well even without the CEO, said Ray.

One of the biggest and quickest ways a company can boost its value in an acquisition is to establish a second-in-command role. This manager should be positioned to run the company if the CEO were to depart and would stick with the company after a sale. This one simple structural change can add anywhere between 5 and 10 percent to a company's valuation when it goes to market, said Ray.

"Unfortunately, very few have that kind of foresight," said Ray.

There are three ways companies that have neglected mid-level managers can make up for lost time and still drive up sales premiums if they want to transact this year:

1. **Establish that second-in-command role.**

2. **Get two or three profit-enhancement projects in the pipeline.** CEOs should make this happen by letting their middle managers come up with an extremely large volume of ideas, narrow it down to two or three, then let the managers run with them. CEOs should serve more as a mentor and project manager rather than someone with their hands in every step of the execution.

3. **Make opportunistic hires where you can.** If you can swap out a C-team manager for an A-team manager who's newly available thanks to energy job cuts, do it. That will boost the management team and later get baked into a stronger valuation.

"You need to look at your management team as an investment for the long run," said Ray. "The two evaluative components I use — I'm always gauging their commitment level and their capability, and that's not necessarily the ability to get through the day-to-day but rather their ability to affect change."

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TODD BRINEGAR, managing partner at fikser.us

THE DEAL YOU NEVER WANTED TO MAKE

Let's face it. You rode high when oil was $100 a barrel and weren't prepared when prices dropped to $50. You're over-leveraged and struggling to maintain a positive cash flow. You don't want to file for Chapter 11 and are looking for a deal to leave you with your dignity and a decent amount of dough.

If you find yourself in the position of needing a deal because cash flow has gone wayward and you're swimming in debt to the point that your lenders can't renegotiate terms anymore, you're in need of a strategic alternative.

To the extent you're able to, you may be able to dispense with parts of your business in miniature transactions without selling the whole, said Todd Brinegar, managing partner at fikser.us.

"That is very easy to do and very fast to do," he said. "It's a life line, and depending on how much control and ownership you want to give up, it's a great way to get operational cash fast. You can structure a deal in six weeks."

Whether selling parts or the whole company, if you're vulnerable, then discretion becomes even more important, said Brinegar.

Discretion in going to market is good, but complete transparency is important once you sit down with a potential buyer because deals are ultimately based on trust and credibility built up over many discussions, said Cliff Atherton, managing director at GulfStar Group.

When it comes to selling individual assets, there are private equity firms that specialize in assets from distressed companies, and if you don't already know who they are, then you may need to hire a third party that can help you find and vet a private-equity buyer.

Another process involving a private equity buyer is a controlled take down, in which your company files for Chapter 11, after which the PE firm will snag your business in the auction. This helps cleanse the business of debts, which could help you improve the purchase price. In fact, some particularly gamey business owners file for Chapter 11, exercise the company's debts, form a new business entity and buy their own company back after the fact.

But if that's a little too fast and loose for you, take advantage of the hungry private equity buyers and hedge funds currently on the market. There is still pent-up demand among investors for distressed companies. So if you weren't considering selling as a means of survival, there could be worse times to hit the market than now, said Brinegar.

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From left, Andy Ray, principal at PKF Texas; Cliff Atherton, managing director at GulfStar Group; and Todd Brinegar, managing partner at fikser.us.

DANIEL KRAMER/HBJ

"When you're selling your business, you need to have a realistic expectation of your value. I have yet to meet anybody that thought the offer (for their company) was priced fairly."

TODD BRINEGAR, Managing partner at fikser.us

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The dealmaker's guide to selling strategically

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WE KNEW THIS TIME WAS COMING: Houston dealmakers reached a consensus in January that mergers and acquisitions were going to heat up in the second half of the year as the drop in oil prices has hung some energy companies out to dry, and left others ready to buy.

"Smaller (exploration and production) companies — maybe they have more debt — they have less of an ability to weather a downturn, so they're the ones that are more likely to become targets of acquisitions," said Mike Telle, partner in the mergers and acquisitions and capital markets group at Houston-based law firm Vinson & Elkins LLP.

Perhaps you need a fresh infusion of capital, or you've made plenty of money and the time is ripe to retire. Or perhaps you suffer the ill fate of being forced to sell because you were over-leveraged. Whatever the case, focus on your exit strategy.

THE EXPERTS: These Houston experts have counsel for you on how to navigate the best deal.

CLIFF ATHERTON
Managing director at GulfStar Group

TODD BRINEGAR
Managing partner at fikser.us

ANDY RAY
Principal at PKF Texas

STEP 1

DECIDE ON YOUR ULTIMATE GOAL

If your company is struggling beyond recourse, but you don't want to file for bankruptcy, see "The Deal You Never Wanted to Make" on page 20A.

Otherwise, choose your course.

KEEP AND EXPAND YOUR BUSINESS

You know you have a solid core business with valuable assets. But, you hit a few bumps in the oil slump and need a partner to float you some extra capital and flag potential management issues.

OR

SELL YOUR COMPANY AND RETIRE

You've made a nice pile of money, and you're ready to enjoy what life has to offer beyond the 9-to-5.

STEP 2

STRATEGIC BUYER OR PRIVATE EQUITY?

Whether you're looking to retire or grow your business, buyers generally fall under two categories: strategic, meaning other companies, and private equity firms. To decide which one is for you, consider the following:

VALUATION
First, and perhaps most painfully, you have to determine how much you're worth. This step is the most uncomfortable but also the most important. This step also happens to be the one in which most business owners get it wrong. It's important to manage expectations, because if you sit down with a buyer and give them a number way above market price, you're setting the wrong tone for the rest of the negotiation, said Brinegar.

SYNERGIES
Among the things that can affect your valuation the most are proprietary products or processes that no one else possesses. Obviously, the more proprietary assets you have, the more your valuation goes up; but lacking that, you'll want to find a strategic buyer that has a space in its own specialties into which your business will cozily fit, also known as a white space, said Brinegar.

POST-SALE GAME
At this point, Houston-based GulfStar Group, a consultancy specializing in transactions with midmarket companies, would say in most instances a private equity firm will offer a higher purchase price. But of course most, not all, private equity firms are buying upper management, so this may not be the most likely route for those wanting to retire, said Atherton.

WORKFORCE HOPES
Another way to determine which way to go is to determine what your hopes are for your staff. With a strategic buyer, there's likely not room for redundancies, and so a certain amount of attrition is to be expected unless you garner a white-space scenario. A private equity firm is less likely to deconstruct the workforce.

WHEN TO GO TO A THIRD PARTY
You may want to hire a third-party consultancy to help you navigate your company's valuation, marketing and negotiations. However, there are circumstances in which it may not make sense to hire a third party, particularly if you know who your buyer is and you know it would be up for a deal, said Brinegar. If you don't have a specific buyer in mind, it may behoove you to hire a third party that can help you run a process to determine your company's valuation and go to market to find the right buyer.

STEP 3

THE STRATEGY

How to market your company once you've decided on a route.

KEEP AND EXPAND + STRATEGIC BUYER

One tactic that can be most useful if you'd like to preserve your business or legacy by selling to a strategic buyer is to precede the transaction with the aptly named arrangement — a strategic partnership.

"When you look at a strategic alliance, it's usually a 12-month process leading up to a merger. Now there's a huge risk in that, because your competitor will gain all this inside knowledge and still may ultimately walk away," said Brinegar. "When you start on that strategic alliance, it's sort of like the camel's nose peeking out of the tent. You know there's a lot of camel behind that tent."

If you don't want your business bought and then immediately liquidated, which does happen, start with a partnership that gives you time to examine the buyer and get the best sense of what would happen to your company post-deal. This method also allows you to go to market in a very gradual and controlled way. Sure, some investors might see through the partnership and call it a deal in training, but this route will render the possibility of a rush of mixed-bag buyers less likely.

KEEP AND EXPAND + PRIVATE EQUITY FIRM

This is where things get really interesting. If deployed correctly, this process can help you not only survive the oil slump, but come out better, faster, stronger and with more capital than when you were at your peak.

"We actually feel like your odds are much better of preserving your culture if you go with a private equity firm," said Atherton.

However, if you don't do your due diligence, you might wind up with a cruel task master that harangues your company with so much interest that your business is choked into an unprofitable position. This is where third parties really come in handy. A third-party firm can help you analyze a private equity firm's track record, documenting how many successful exits it's had and will even interview other business owners who worked with the firm before you.

"Private equity firms frequently offer up business owners that they've worked with. What we suggest is that our clients should call the references that are offered, look at the firm's portfolios and the exits they've had," said Atherton. "It's an opportunity for the seller to be proactive."

Houston is saturated with private equity buyers of many different varieties, so the opportunities in the current market are plentiful.

SELL AND RETIRE + STRATEGIC BUYER

There are plenty of sellers that market themselves on their own simply by approaching their potential buyers directly, or by dropping hints in the right circles and then waiting to see what comes of it.

"You look across the network, talk to your suppliers, ask them, 'Is there anyone in the market that you could see me combining with?'" said Brinegar.

While it does happen, it's important to know the drawbacks of this do-it-yourself approach. The most obvious, of course, is that it's difficult to vet your buyers in that situation, and you may get declarations of interest from buyers who either aren't serious or will run your legacy into the ground.

"If you're out there broadcasting, you create market confusion, and you also will get a lot of people who are not qualified," said Atherton.

So if you're hell bent on going it alone, try and be discreet. Discretion has a better shot if you have a single targeted buyer that you approach directly.

You can also go through a business broker, a matchmaker of sorts for buyers and sellers. The advantage of a business broker is that they tend to base their fees on the transaction values, so they'll no doubt be advocating for a higher purchase price. The drawback there is that brokers may push for higher purchase values at inappropriate times and poison negotiations. That, and you may find yourself paying a broker for introductions to businesses you already have a relationship with, so make sure you're ready to handle your broker if that's the method of preference.

SELL AND RETIRE + PRIVATE EQUITY FIRM

While by and large business owners turn to private equity buyers when they want to stay on with the business and oversee its growth and hopeful expansion, it is possible to sell to a private equity firm and retire. BUT, you have to make sure that your middle managers are solidly able to execute without you, and if you really want to drive valuation, instill a second-in-command in your leadership structure.

"It's going to be very important to the PE firm that the management team is committed and will stick around," said Atherton.

Making sure your leadership team is in a position to survive, if not thrive, without you will have a significantly positive impact on your business' purchase price. See "What not to overlook: The middle layer" on page 20A.