

THE CATALYST

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PROVIDING VALUE-ADDED CAPITAL

Welcome to our fall newsletter. In this issue we focus on another transaction technique: earn-outs. Catalyst/Hall has effectively used earn-outs in many transactions, both as a buyer and a seller. Properly structured between fair-minded parties, earn-outs can be extremely effective.

The third quarter has been exceedingly active at Catalyst/Hall as we have made several investments and have opened a new office in Dallas. As you will read, one portfolio company management team recently received a prestigious award.

We continue to seek excellent management teams who are looking for more than just capital. We emphasize long term relationships and a process of building value over an extended time horizon.

Thank you for your interest and support.

The Team at Catalyst/Hall

Earn-Outs: A Worthwhile Tool for “Win/Win” Structures

By Rick Herrman, Principal, Catalyst Hall, Houston

The current market for mergers and acquisitions is challenging for many reasons, including gaps in price expectations between buyers and sellers. In order to bridge the price gap, deal structures featuring price contingencies, especially earn-outs, are becoming increasingly popular.

The Earn-out Structure

The earn-out structure is designed to satisfy the seller’s demand to receive compensation for the anticipated future value of the business and the buyer’s desire to avoid overpaying for potential value. The typical earn-out divides the purchase consideration between payment at closing and one or more contingent payments dependent upon the satisfaction of future sales targets, product developments, earnings, or other predetermined milestones.



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Catalyst/Hall specializes in middle market equity and mezzanine debt investments from their offices in Dallas, Houston, Oklahoma City, and Westchester (Chicago).

Catalyst/Hall provides capital for growth and expansion, recapitalizations of family owned or closely held companies, generational changes in ownership, and Management buyouts.

Current Trend

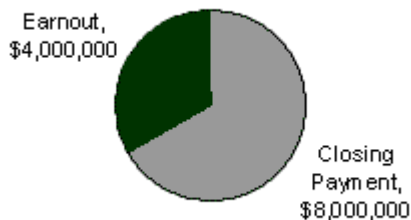
There are several acute factors that explain the rise in popularity of earn-outs, including the inaccessibility of the public markets and the reduction in venture capital and other capital. Additionally, the June 2001 change in Generally Accepted Accounting Principles (GAAP) requiring companies to annually review the value of acquired goodwill and book impairment charges to reflect reductions in such value heightens the reluctance of buyers to avoiding overpaying.

The Earn-out in Practice

In discussing a sale, sellers argue that the TargetCo's value is substantially greater than a simple multiple of EBITDA or cash flow. Prospective buyers are disinclined to pay excessively for the intangible value and potential of the company, particularly where there may be some concern about securing the continued involvement of TargetCo's key personnel. In this situation, the consummation of a transaction may require a structure involving initial proceeds at closing and designing a structure to pay additional conditional proceeds upon the further exploitation of TargetCo's potential.

Instead of a potential transaction collapsing over pricing, an earn-out can be designed to create a win-win situation for both buyer and seller. TargetCo's owners can secure their exit at a reasonable current value, and retain an economic incentive in the TargetCo, thereby potentially earning a substantially greater payout than would otherwise be available sans the earn-out.

As an example, let's assume the TargetCo generated \$2 million in net cash flow in the prior accounting year and has no debt. The buyer has offered to pay a multiple of 4 times cash flow or \$8 million to purchase the company. TargetCo is forecasting \$3 million in cash flow for the next year and seeks to be paid on a multiple of next year's cash flow or some \$12 million. An earn-out could be structured so that the seller could realize some or all of the additional \$4 million dollars (the valuation gap between the Buyer's \$8 million and the Seller's \$12 million) if next year's cash flow reaches a predefined target of \$3 million.



The buyer avoids the risks associated with overpaying for forecasted potential while preserving a meaningful incentive for the key TargetCo personnel to work with the buyer post closing, to increase the value of the company. The buyer also has the benefit of paying for some of the "future potential" value with future, realized cash flow.

Earn-Out Issues

Some of the issues that the parties should carefully consider that could arise in the structure of an earn-out and in the post closing operation of the business include:

1. The earn-out must avoid undue constraint of the operation of the acquired business, which could harm both the buyer and seller, since their interests are aligned.
2. The seller would like to insure some control or input regarding material matters affecting the business prospectively.
3. The buyer naturally wishes to retain flexibility and the ultimate ability to run the business without the need for approval from the seller for less material matters.

In a win-win earn-out structure, the seller and the buyer will both be required to accept some risk of unforeseen factors that could adversely affect the expected results of the earn-out.

The operating personnel representing the buyer and seller must carefully and thoughtfully develop the terms of the earn-out as part of the principal business terms for the transaction. The preliminary term sheets should define the earn-out in some detail and include how it will actually work.

Questions for the Seller

What can I control after the sale? The seller should reasonably expect to secure some control over use of the assets, capital budgets, etc. Sellers should require an acceleration of some, or possibly all of the earn-out upon the sale of the buyer's business or the disposition of assets.

What will happen to the key employees? The seller should insure there are retention incentives for the key people required to execute the business plan. These incentives can come from both the buyer (in the nature of stock options, performance bonuses and the like) and from the seller. A seller should consider rewarding or penalizing key members of the TargetCo's personnel who remain with TargetCo, to allocate a portion of the earn-out.

How are disputes handled? Buyer and Seller benefit by insuring that the metrics for the earn-out are clear and comprehensive, in order to avoid disputes after the closing. Objective, easily identifiable and measurable targets are very important.

Questions for the Buyer

Do the earn-out limitations and provisions extended to the seller unduly restrict the operations of the company? By structuring control provisions and key employee retention programs the new owner may have lost the ability to make the changes necessary to maximize the business.

Does the earn-out unduly reward the seller for operational performance improvements made by the buyer? The buyer may have major changes planned for the business and may be able to expose the business to new prospects and potential employees. Will the earn-out excessively reward the seller for cash flow that the prior owners business plans did not project and could not have delivered?

Earn-outs can foster cooperation between the parties and can represent an attractive option for dealing with valuation gaps. In practice, they are somewhat complex and they do leave both sides vulnerable to post closing operational risks. It is essential to the success of any earn-out agreement that the earn-out formula is well defined and that operational issues are properly addressed.

Catalyst/Hall Expands to Dallas/Fort Worth Metroplex

Catalyst/Hall announced recently that it has opened an office in Dallas/Fort Worth to bring a greater focus to the area and allow the private equity firm to better serve the capital requirements of middle market businesses based in the Metroplex. Although this is its first office in the Metroplex, Catalyst/Hall has been involved and invested with several firms in the Dallas/ Ft. Worth area since its inception in 1990. Catalyst/Hall is expanding in Texas for several reasons, according to Roger Linn, managing partner in the Dallas office: "We believe Texas is poised to take advantage of the economic recovery and our expanded capital base offers businesses an opportunity to expand during the recovery. Dallas/Fort Worth has a large group of attractive middle market companies that now have an additional capital source".

For more information on the Dallas office, please call Roger Linn 214-739-4647.
For more information go to our Website :: www.catalysthall.com

Catalyst/Hall Announces \$3 million Investment in Gexa Energy Corp.

Catalyst/Hall also recently announced the private equity firm and Gexa insiders have invested \$3 million in Gexa Energy Corp. Gexa Energy (OTC: GEXA.OB) is a Texas corporation engaged in the business of providing electricity to residential as well as the small and medium sized commercial customers in the newly deregulated Texas electricity market. Gexa offers cost effective electricity services to its customers with a focus on customer service.

Gexa has successfully penetrated the deregulated market in the entire Texas market, servicing approximately 60,000 customers. The Company expects to serve 3% of Texas' retail power market over the next three years. Gexa is also planning to move into other deregulated states over the next five years.

For more information on Gexa Energy Corp. :: www.gexaenergy.com

Louisiana's LHC Group CEO Named "Entrepreneur of the Year"

Keith G. Myers, chairman and CEO of LHC Group, LLC, received Ernst & Young's Entrepreneur of the Year Award at an awards ceremony in June 2003, in Houston. A Catalyst/Hall portfolio company, LHC Group provides home health care, hospice services and rehabilitation care to patients in Louisiana, Mississippi and Texas.

LHC Group, with more than 2,300 employees, has current annual revenues in excess of \$70 million. Myers attributes the success to the company's talented staff of clinically driven professionals who are able to make decisions based on patient care needs and not financial restrictions. Also contributing to the company's success is a unique cost management system, which Myers developed and implemented, that is patent pending in the United States and international markets.

For more information about the LHC Group :: www.lahcg.com