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M&A Outlook Brightens for Second Half of 2010 and Beyond

It's an interesting time in the world of mergers and acquisitions. Coming out of the "Great Recession" with more than two years of depressed earnings, financing difficulty and labor reductions, business owners are ready for a change. Some are anxious to sell. Others are ready to buy. Private equity groups are flush with capital and looking for deals, and corporations are looking for strategic acquisitions. Is the M&A resurgence here?

The first half of 2010 showed some signs of hope, including steady increases in equity markets, positive corporate earnings and improving credit markets.

The second half looks even brighter. According to the recently released ACG-Thomson Reuters Mid-Year 2010 DealMakers Survey, 85 percent of dealmakers expect an increase in M&A activity in the next six months – a sharp uptick from the 56 percent who said the same thing just a year ago.

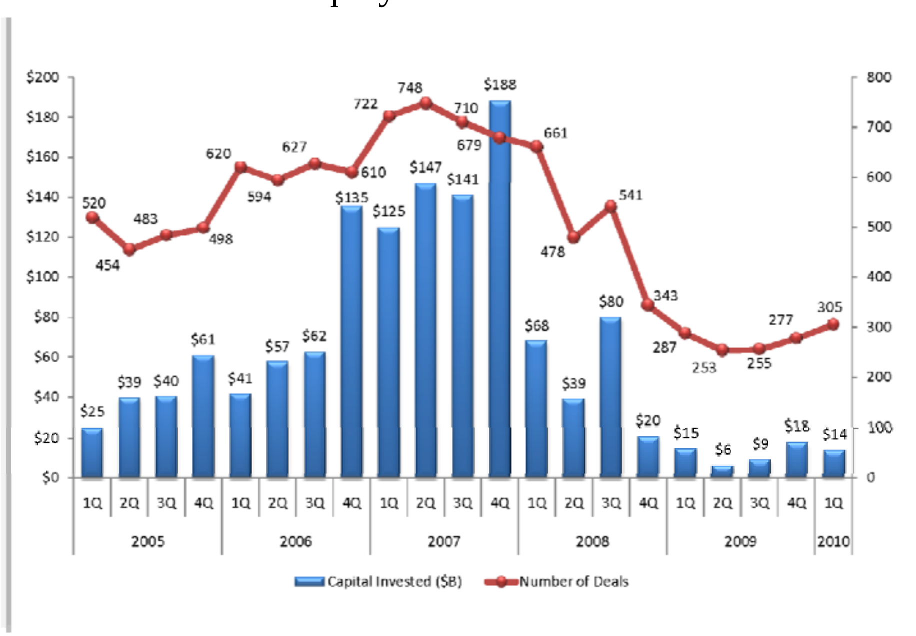
The long-term M&A environment is looking up because of several factors: the number of baby-boomer business owners ready to retire, market consolidation driven by rapid technology advances, long-term growth in the appetite of foreign investors for U.S. companies and a buildup of cash at the nation's 4,000 to 8,000 private equity groups (PEGs).

PEGs Looking to Spend

While many PEGs are eager to exit deals that they have been in for an extended amount of time, they also have plenty of pent-up capital that they're looking to spend on the few quality deals that are available in the marketplace. According to a March *Bloomberg* article, leveraged buyout firms are "sitting on half a trillion dollars committed by investors," most of which was raised before the financial crisis.

But private equity investments are picking up. In the first quarter of 2010, more than $14 billion was invested in U.S. companies through 305 private equity investments, an increase in deal flow of 10 percent from 4Q 2009, according to independent research firm PitchBook. If the flow of deals continues at this pace, PitchBook predicts the year will finish with more than 1,200 deals – a 14 percent increase over 2009.

Total U.S. Private Equity Deal Flow



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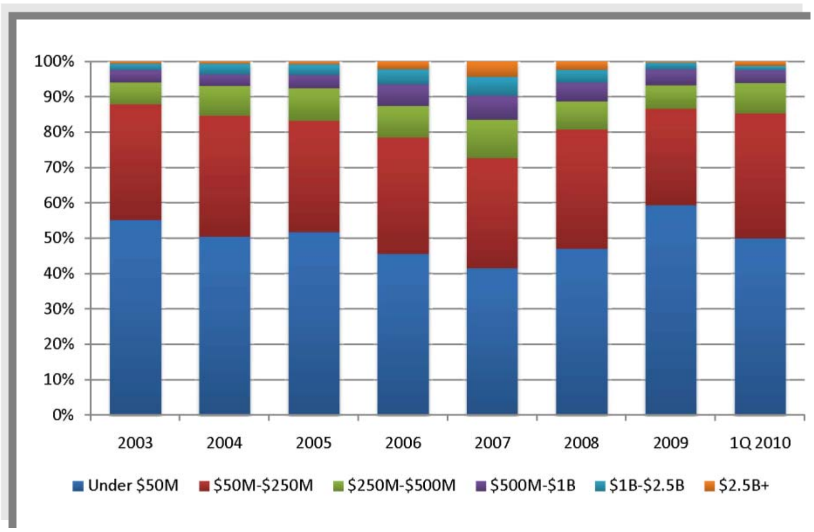
The middle market continues to play a large part in private equity investment. Deals under $50 million accounted for 50 percent of the 82 private equity deals tracked by PitchBook in 1Q 2010, with deals between $50 million and $250 million deals making up another 35 percent.

Exits also picked up in the first quarter; private equity groups completed 65 exits – more than double the 31 exits in 1Q 2009.

Percent of Private Equity Transactions by Deal Size



Source: PitchBook Data, Inc.

Hot Sectors

Dealmakers responding to the ACG/Thomson Reuters survey expect the following sectors to experience the most merger activity in the second half of 2010:

- Healthcare/life sciences (20%)
- Manufacturing & distribution (20%)
- Financial services (13%)
- Technology (12%)

Dealmakers expect the most organic growth to be in the healthcare and life sciences (25%), government-related (15%), business services (13%) and technology industries (13%), according to the ACG/Thomson Reuters survey.

Going Abroad

Interestingly, a significant number of recent M&A transactions have been cross-border, and many middle-market companies are looking abroad for growth.

There are a couple of reasons for this. First, foreign transactions are where the growth companies are at this time. Second, continued devaluation of the U.S. dollar is expected. When translated back to U.S. dollars at a future date, this means more dollars for the buyer.

Trends for the Future

Looking ahead, distressed companies are hot, buyers are on top, deals are taking longer and many are requiring a lot of creativity. Here's more of what we're hearing:

- **Distressed is Best**
  Private equity firms have been accumulating their debt, hedge and distressed funds in order to acquire distressed companies. More than half (54 percent) of private equity respondents in the ACG/Thomson Reuters survey said they are actively pursuing distressed and undervalued companies.

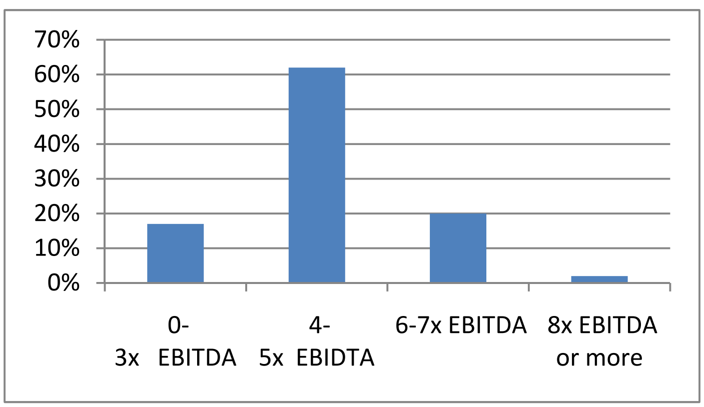
- **Invest Strategically**
  In addition to distressed sales, the current environment is characterized by select strategic investments — acquisitions made to gain access to a particular product or technology, entrance into a new region or a new set of customers. In some cases, buyers may be looking for sellers that have solid intrinsic value, but happen to be in financial trouble.

  The ACG/Thomson Reuters survey reveals that 70 percent of dealmakers said the current market favors strategic investors, and 97 percent of dealmakers expect strategic investments to accelerate in 2010.

- **Buyers Are Wary**
  Buyers and sellers have been far apart in terms of their expectations, adding to a difficult environment in which to close deals. While expectations are starting to come back in line, poor economic conditions and weak company performance are making buyers extremely cautious in the evaluation of new opportunities. They are spending a lot more time trying to find stellar companies yet are looking for bargains in the marketplace — a problem for middle-market sellers.

  In addition, buyers are applying discounted valuation multiples to lower earnings across many industries. For the most part, we're seeing multiples currently range between four and seven times normalized earnings before interest, taxes, depreciation and amortization (EBITDA). The ACG/Thomson Reuters survey bears this out, showing that almost 80 percent of buyers did not expect to pay more than five times EBITDA for companies in the second half of 2010. In addition, 35 percent of private equity firms responding to the survey have marked down their portfolio company values. It is not surprising that the same survey reveals that 80 percent of dealmakers think the current market environment is a buyer's market.

What buyers expect to pay for next six months:



Source: ACG-Thomson Reuters Mid-Year 2010 DealMakers Survey

- **Sellers Have Great Expectations**
  Sellers, on the other hand, are trying to hold out for bigger deals. The greatest drag on M&A activity today is sellers' unwillingness to accept multiples offered, according to the ACG-Thomson Reuters survey.

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Baby boomers, in particular, are looking to fund their retirements. But, given the difficult M&A environment, sellers most likely to get deals done are those who are motivated and can prove through historical performance that the company can adapt during times of stress. Sellers also need to prove to cautious buyers that they have stabilized in the improving economy. They must present a strong management team, realistic financial expectations and strong financial documentation with annual reviewed or audited statements from a reputable accounting firm.

When looking for buyers, sellers should be targeting those with a solid balance sheet that shows a strong cash position and low leverage. Sellers should look for reasonable offers, proof of financing and an indication that the buyer understands the industry players and how the seller fits into the picture. Sellers with companies that are not currently performing well should wait out the market, and not sell their ventures prematurely. However, the potential for tax rates to increase in 2011 is a powerful incentive for many business owners to complete a deal this year.

The New Deal

How are deals getting done? Sellers who want to move forward are finding it increasingly necessary to finance some of the purchase price in order to complete transactions via what is referred to as "structured deals." Because of the difficulty getting credit and completing leveraged transactions, cash deals are preferred. Leveraged recapitalizations are also taking place where sellers recapitalize their business, often with a PEG investing so that the seller can take capital off the table yet retain an ownership interest, which is often in the range of 20 percent to 40 percent.

Some analysts believe a buyer should be willing to put up at least 50 percent of the purchase price in cash equity. However, since PEGs are constrained in the amount of equity they can have in a deal, limited debt financing continues to negatively impact private equity investment.

While buyers still aren't paying sellers' expected prices, the buyers often concede a share of the upside. And sellers are increasingly willing to partner with buyers in structuring deals. Earn-outs and other forms of deferred compensation are common, in which the seller gets full credit for future value of cash flows and contract backlogs.

In addition, management buyouts (MBOs) are becoming a popular way for middle market companies to divest their assets. These types of deals are more common with mid-market companies that have a slower growth rate. Still, like most buyers, the management of these divisions are encountering problems funding the buyouts.

Yet, some analysts believe that middle-market deals are growing in number because they do not require the delicate financing work the large deals require. Mid-market deals generally require less assistance from the capital markets, and less structuring of highly leveraged loans. As a result, a number of well-capitalized corporations may purchase a complementary middle-market company in 2010 in order to take advantage of reduced competition for deals, low cost of capital, and in some cases, lower purchase prices.

In addition, there are more nonbank lenders emerging to provide cashflow lending. While most banks lend based on hard asset collateral, other companies, such as hedge funds, are willing to make loans based on projected cash flows.

Another aspect of the current acquisition climate is an increased amount of time to close a deal. It is taking longer to complete deals because buyer and sellers are more cautious with due diligence and financing is more arduous.

In fact, many of the deals completed in 2009 were in the works for 12 months to 18 months, compared with the nine months to a year that was normal in 2005 through 2007.

The Bottom Line

Lots of private equity cash sitting on the sidelines may bode well for the future of the M&A market, but don't expect deal activity to reach 2007 levels for several years.

In the short-term, to help the acquisition process along, both buyers and sellers need to be prepared. Sellers need to start the exit planning process early and be ready for rigorous due diligence. They must have their paperwork in order, including documentation of verbal promises owners have made with key employees should a deal go through. Companies that have properly prepared for a sale will have a greater likelihood of a successful outcome.

Buyers should expect to spend more time evaluating deals up front, looking for opportunities to grow and improve existing portfolio companies or pursuing strategic investments.

Because the economy remains iffy and job losses persist in many markets, there isn't a surge of enthusiasm and confidence among M&A analysts at the moment. However, opportunities certainly exist for buyers and sellers who are prepared, diligent and anxious to make a deal work.

Whether buying or selling a business, you need to be aware of all options in order to maximize value and minimize risk. BMF has helped many companies execute successful transactions. If you would like to discuss your options in buying or selling your business, please contact our Transaction Advisory Services practice leader and partner Mark Bober, CPA, ABV, CVA, CFF at mbober@bobermarkey.com or 330.762.9785.

For more information:

"Dealmakers More Optimistic About M&A Environment: ACG-Thomson Reuters Mid-Year 2010 DealMakers Survey Reveals Portfolio Company Performance Improving; Corporate Professionals Predict an Increase in Strategic Investments," http://www.acg.org/

"PitchBook 2Q 2010 Private Equity Breakdown," http://www.pitchbook.com/