

VIEWPOINT

ISSUE 36

FOR MORE INFORMATION ON SOME OF THESE TOPICS, PLEASE SEE:

VIEWPOINT #35: De-Leveraging Means Tight Credit Will Continue Through Year-End 2009

WHY THIS MATTERS:

If you are considering a sale of your business within the next twelve months it's critical to undertake a review of those external variables which impact deal activity levels.

We expect as more buyers come off of the sidelines, more sellers will receive unsolicited sale inquiries. As such, before you take on the significant distraction of entertaining an inquiry assess the bid-ask spread.

Shifting market conditions impact which buyers might provide either the best valuations for your business or highest probability to close. While cheap debt capital enabled financial buyers to increase their valuations higher than those offered by strategic buyers in 2007, the valuation pendulum has swung back in favor of strategic buyers, given tight credit markets. Similarly, tighter credit markets also introduce the prospect of lowering the probability of close for those deals that require debt financing.

MIRUS MIDDLE MARKET M&A SURVEY AND OUTLOOK

By Peter Alternative, Konstantin Voziyan and Matt Yu

We asked 130 lenders, attorneys, investors and investment bankers when they believe middle market M&A activity will pick up again. There is a growing consensus among professionals that deal activity levels are on the upswing. In this edition of Viewpoint, we summarize the survey's key takeaways regarding how today's changing economic conditions, investor confidence levels and deal financing environment will impact future M&A activity levels. Based on our analysis of the survey results and our secondary research, we believe that middle-market M&A activity will begin to gradually recover by the end of the fiscal year and will reach 2003-2004 levels (approximately 9,400 transactions) by the end of the second quarter of 2010, representing a 15% year-over-year improvement.

OUR CAUTIOUS OPTIMISM IS BASED ON THREE PRIMARY OBSERVATIONS:

1. the top three obstacles to improved deal making are waning;
2. historical precedents suggest that the year following a recession will yield heightened deal making activity; and,
3. the dealmakers surveyed are experiencing improved dealmaking in their respective practices and expect that trend to continue over the next several quarters.

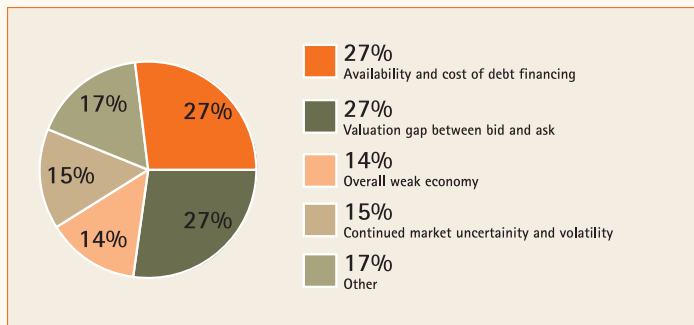
KEY BARRIERS TO IMPROVED DEAL MAKING ARE STARTING TO WANE

We asked our surveyed dealmakers to identify the primary obstacles to improved dealmaking. Their responses suggest that, while those obstacles still temper more robust activity levels, they are beginning to wane. More specifically, the top three obstacles we analyzed and discuss in greater detail below, as seen

below in figure 1, include:

- (a) the valuation gap between bid and ask;
- (b) availability and cost of debt financing; and,
- (c) continued economic uncertainty.

FIGURE 1:



A. WANING OBSTACLE: VALUATION GAP BETWEEN BID AND ASK

Strengthening of stock market bolsters buyer confidence but is unlikely to fully bridge "valuation gap" in the near term.

There's an adage in the M&A market that, when circumstances change, it takes two years for sellers' valuation expectations to change, whereas it takes two minutes for buyers' expectations to change. The Q4 2008 market correction was no exception to that rule. In the wake of the market's spectacular 700-point one-day drop following the Lehman Brothers bankruptcy, many buyers wanted to "re-trade" fully negotiated deals that were days away from closing because their trading multiples had fallen so dramatically below the contemplated acquisition multiple. Interestingly, as recently as Q2 2009, we heard buyers explain that they remained on the sidelines with respect to M&A, despite the more favorable valuation environment, because they were still waiting for sellers' expectations to reset downward.

Predictably, the rapid decline of the equity markets during the second half of 2008 created a significant valuation gap between potential buyers and sellers. More specifically, sellers were still looking at deal multiples nine to eighteen months old and expected exit multiples at levels not far below pre-recession levels. Conversely, buyers were seeing deal multiples older than September 2008 as irrelevant. Instead, buyers viewed public trading comparables as the only current and relevant valuation criteria.

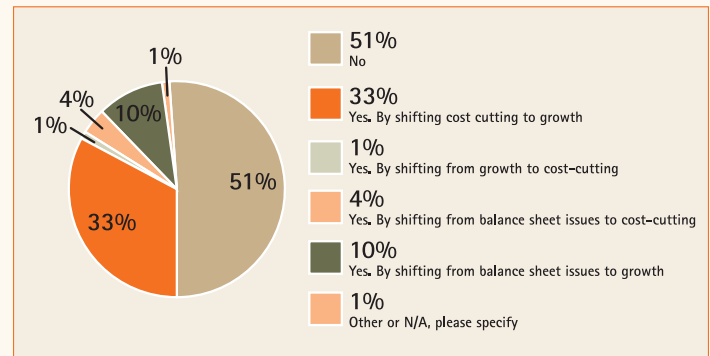
As a quick proxy for the magnitude of this valuation gap, we looked at the change in average enterprise value/EBITDA multiples over this timeframe. Recent market forces have pushed the average purchase price/EBITDA multiple for transactions below \$500 million to 6.3X for the first two quarters of 2009, as compared to the 8-year average of 7.1X from 2001 to 2009 and 8.4X in 2007¹. This metric probably

understates the magnitude of the gap, since it doesn't account for the scores of deals that simply didn't happen due to the mismatch between buyers' and sellers' expectations.

Already much has changed since March, 2009. As the new administration continues to pour money into the economy, investor confidence continues to rise, and according to State Street Investor Confidence Index has already returned to mid 2003 levels². The S&P 500 gained over 29.65% since February 17th (and 17% over the last three months), when President Obama signed the American Recovery and Reinvestment Act of 2009 into law. In July alone, the Dow surged 725 points, or 8.6%, and then climbed additional 1400 points between July 1st and October 9th, a nearly 17% gain. We believe that continued strengthening of the stock market will help improve buyers' confidence in the future, thus inspiring them to start doing deals again.

Consistent with the increasingly optimistic market sentiment, our survey found that approximately one third of companies surveyed are starting to shift their focus away from cost cutting - which 65% of respondents stated was their (or their clients') primary focus during the first half of 2009 - and toward growth, as seen below in figure 2.

FIGURE 2:



While our survey focused on smaller to mid-sized businesses, we believe that these sentiments are consistent with those felt in larger companies. Focused on cost-cutting, S&P players laid off employees and turned their attention inwards - streamlining operations became the topic of discussion for every CEO. Operating earnings rebounded after previously collapsing from \$15.96 per share in the 3rd quarter of 2008 to \$-0.09 per share by the end of the 4th quarter of 2008. By the end of the first quarter of 2009, S&P 500 earnings were \$10.11 per share. Second quarter earnings climbed up to \$13.81/share, and third quarter projection currently stand at \$14.91/share³.

As companies once again turn their sights to growth, they are likely to use some of their built-up cash reserves, which for the S&P 500 index reached an aggregate balance of \$1.1 trillion by the end of 2008, to fund a new cycle of strategic acquisitions. Anecdotally, this cycle seems to be gathering

¹Standard & Poor's industry research

²http://www.statestreet.com/industry_insights/investor_confidence_index/historicaldata.pdf

³http://www2.standardandpoors.com/spf/xls/index/jee500_gics.xls

some momentum with the recent announcements of Xerox buying Affiliated Computer Services for \$6.4 billion; Dell's agreement to buy Perot Systems for \$3.9 billion; Walt Disney's planned acquisition of Marvel Entertainment for \$4 billion; Adobe's acquisition of Omniture for approximately \$2 billion; coupled with the increasing consolidation occurring in the life sciences arena. As can be observed by the aforementioned deal activity in the IT outsourcing industry, deals beget deals which should further bolster the start of a new M&A cycle.

B. WANING OBSTACLE: AVAILABILITY AND COST OF DEBT FINANCING

Normalized credit markets are encouraging; however, higher debt capital costs and constrained availability will temper the M&A rebound.

One factor that has seriously undermined the turnaround of M&A activity is the availability of credit. As a recent Mirus Viewpoint entitled "[De-Leveraging Means Tight Credit Will Continue Through Year-End 2009](#)" suggested, debt financing for M&A transactions will continue to be constrained. The results of tightening credit markets can be observed via the debt-to-EBITDA ratio for leveraged mid-market transactions. In 2007 the average debt-to-EBITDA ratio for leveraged mid-market transactions was 5.6X, which declined to 3.5X in the first quarter of 2009.⁴

The good news is that the frozen credit market is showing signs of the first thaw. The TED spread (the spread between the 3-month Treasury Bill and the 3-month LIBOR rate – a measure of the lending market's overall perceived credit risk) is currently fluctuating around 20-21 points, levels not seen since the first quarter of 2007. Not surprisingly, yields on high-yield, high-risk U.S. corporate bonds fell to 9.17 points in June from 16.62 points on December 31, 2008,⁵ and the high-yield debt market saw its strongest quarter since the second quarter of 2007. By the beginning of September, the overall yield-to-maturity for BB-rated bonds had fallen from 11.4% to 9.8%⁶. In short, credit is still tighter than in the 2007 heyday, but strong indicators suggest that the pendulum is starting to swing back.

C. WANING OBSTACLE: CONTINUED ECONOMIC UNCERTAINTY

Macroeconomic conditions are improving. Finally.

Undoubtedly, the overall state of the economy has a significant impact on the M&A activity levels across all industries.

Surveyed dealmakers overwhelmingly indicated that improved economic indicators (particularly GDP and unemployment rates) are indicative of restoring broad investor confidence and reducing market uncertainty. The good news is that macroeconomic conditions are improving and the

recession is likely over. The bad news is that it is going to be a gradual recovery, as recently noted by Federal Reserve Chairman Ben Bernanke.

Several recent forecasts have projected U.S. GDP to break the recent declining streak and return to positive growth in the third quarter of 2009. The Congressional Budget Office (CBO) projects positive economic growth of 1.6% during the second half of 2009⁷. The Conference Board projects real GDP growth of 3.2% and 2.4% in the third and fourth quarter of 2009 respectively⁸. Finally, Goldman Sachs projects real GDP growth of 3% for the second half of 2009⁹.

With respect to labor markets, support for people getting back to work and thus improving confidence levels further is mixed. In August, the unemployment rate hit 9.7%, or the highest since June of 1983¹⁰. Moreover, the CBO projects unemployment to increase in the second half of 2009 and early 2010, reaching its peak somewhere in the middle of 2010.

However, temporary increases in unemployment rates are not necessarily inconsistent with the economic turnaround. Unemployment rates typically lag behind economic recovery. First of all, employers generally try to squeeze as much work as possible from their existing workers. The increased productivity rate of 6.6% in August of 2009 (highest increase since the third quarter of 2003) is a case in point¹¹. Second, more people enter the workforce looking for employment during the first months of economic recovery, causing official unemployment rates to increase for a short period of time.

Accordingly, the gradual improvement in the overall economy is expected to have a favorable impact on M&A activity, though it will be neither dramatic nor immediate.

HISTORICAL PRECEDENTS SUGGEST PRIVATE EQUITY WILL SUPPORT IMPROVED M&A ACTIVITY

According to Thomson Reuters *Mid-Market M&A Review*, approximately 8,200 total transactions were announced between 7/1/08 – 6/31/09. In comparison, there were approximately 12,900 transactions announced during 2007 calendar year. In 2007 approximately 17% of total transactions involved private equity firms. This proportion declined slightly through 2008 and the first half of 2009, when private equity accounted for only 15% and 14.1% of total transaction volume, respectively.

⁷ http://cbo.gov/ftpdocs/105xx/doc10521/2009BudgetUpdate_Summary.pdf

⁸ Conference Board. Accessed on October 9th, 2009. <http://www.conference-board.org/economics/stalk.cfm>

⁹ http://www.forbes.com/feeds/reuters/2009/08/05/2009-08-05T184101Z_01_CHB002616_RTIDST_0_USA-ECONOMY-GOLDMAN-GDP-URGENT.html

¹⁰ <http://www.forbes.com/feeds/afx/2009/09/04/afx6849104.html>

¹¹ http://money.cnn.com/2009/09/02/news/economy/nonfarm_productivity_reut/?postversion=2009090208

⁴ Id.

⁵ Barclays Capital Inc. index data

⁶ http://www.businessweek.com/investor/content/sep2009/pi2009093_551758.htm

With the Dow Jones Industrial Average breaking through the 10,000 mark as of October 14th, Dealmaker confidence levels are expected to rise.

However, this trend is likely to reverse during the first half of 2010. Seeking higher returns for investors, private equity firms are likely to play an active role in the economic recovery. Historically, the number of private equity acquisitions has increased dramatically during the year following the recession year. A recent report by Sonecon, a Washington based economic advisory firm, calculates that the number of private equity transactions increased by an average of 55.1% during the initial years of recovery following the 74'-75', 80'-82' and 1991 economic recessions. While the approximately \$500 billion of un-invested capital accumulated by private equity buyers over the course of the last ten years is more than enough to fuel this type of dramatic rebound, Mirus believes the year-over-year increase is likely to be smaller given the access and cost of credit. Therefore, Mirus believes that by the end of the second quarter of 2010, the total volume of private equity backed M&A transactions will increase to approximately 1,500 transactions, representing a 30% increase from the previous 12 months.

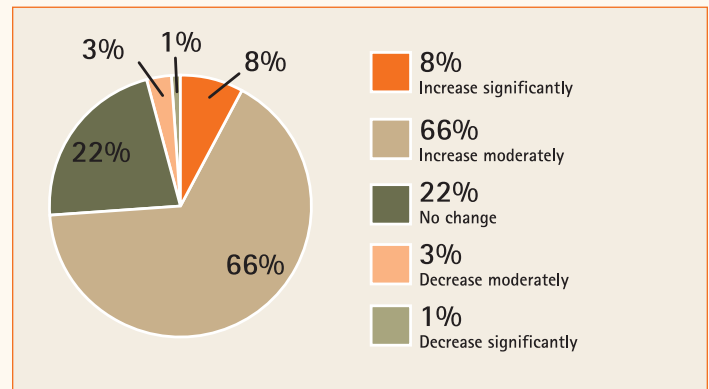
DEALMAKERS' OBSERVATIONS ALL POINT TO IMPROVED ACTIVITY OVER THE NEXT TWELVE MONTHS

Not surprisingly, the mood of many deal makers has also improved as more and more professionals expect their practices to pick up in the later half of 2009. Of the people surveyed, nearly half indicated that they expect to close a slightly higher number of deals in the second half of 2009,

when compared to the number of transactions they anticipated to close in the first half of 2009. Only 11% of respondents hold lower expectations for the second half of 2009 than they did for the first half.

Finally, an overwhelming majority of the people (as seen in figure 3) surveyed also believed that the overall number of M&A transactions in the market place will increase.

FIGURE 3:



CONCLUSION

The recent economic downturn resulted in a severe slowdown in middle market M&A activity. Fortunately, the worst appears to be over. Economic indicators such as GDP growth and unemployment rates appear to have stabilized, improving equity markets are helping to close the gap between buyers' and sellers' expectations, corporate buyers and private equity investors look poised to increase their respective dealmaking activities, and credit markets appear to be heading in the right direction as well. These findings, coupled with the growing confidence levels of both financial and strategic deal makers suggest that M&A transaction volume will gradually improve to approximately 2003-2004 levels or approximately 9,400 transactions by the end of the first half of 2010 calendar year.

Please contact Mirus at info@merger.com with questions and comments or to obtain full results of the survey.



Peter Alternative is a partner at Mirus Capital Advisors, Inc. Mirus is a middle-market investment bank that specializes in advising companies in strategic mergers and acquisitions. By combining a proven process, industry and transactional expertise, creative thought, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Mirus is a registered broker-dealer and NASD/SIPC Member. For more information, visit www.merger.com.

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