Zachary Scott
INVESTMENT BANKERS

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# The Perfect Storm: The M & A Market Today

*Cheap credit, economic prosperity, and market liquidity are driving merger and acquisition activity.*

*by William S. Hanneman*

The M&A market is the strongest it's been since the bursting of the bubble at the beginning of the decade. Historically cheap credit and relaxed credit standards, coupled with the expectation of continued economic prosperity and tremendous amounts of liquidity in the market have greatly accelerated the pace of M&A activity.

As illustrated in the chart, 2005 was the most active year in the M&A market since 2000. The total dollar value of M&A transactions in the U.S. reached nearly $1.2 trillion in 2005, nearly a third more than was recorded in 2004. This pace is the highest since the end of the last decade.

This rate of activity looks to continue. In the first quarter of 2006, middle-market dealmakers announced 969 transactions representing $63 billion in aggregate deal value, as compared to the 2005 quarterly totals of 1,068 deal announcements and $63.2 billion in aggregate deal value. U.S.-based private equity firms completed approximately 225 of those transactions, for a disclosed total of approximately $42 billion. Those figures are slightly ahead of the first quarter of 2005, when 221 acquisitions were completed, for a total value of approximately $40 billion.

**VALUATIONS ARE STRONG**

Not only has the pace of activity stepped up, the valuation of middle market companies has crested a new high, with average purchase multiples for leveraged-buyout transactions with less than $50 MM in EBITDA reaching up to 8.5 X EBITDA. This is a full two-and-a-half times (X EBITDA) higher than was recorded in 2001. Although purchase multiples vary from industry to industry and from company to company, this trend mirrors our experience in the Pacific Northwest.

**THE PERFECT STORM**

Higher volumes and values are the result of unrestrained appetite for business opportunities. Corporations, fueled with high levels of cash flow and cash balances, are using these resources in an effort to improve their competitive position, productivity, and scale. Corporate buyers are joined by growing numbers of private equity and hedge funds, all looking for deals. And, the credit markets are very accommodative—all coming together to create the perfect storm.

**CORPORATE CASH FLOW**

Unrelenting cost cutting and a revival of pricing power have resulted in corporate America generating massive piles of cash. Pre-tax manufacturing profits have almost quadrupled since 2001, while profits of all companies have doubled to $1.2 trillion. Industrial companies now have cash and cash equivalents of more than 7% of the companies' total stock market value, the highest percentage in nearly 20 years.

In addition to acquiring businesses, companies last year used their cash hoards to purchase a record amount of their own shares, totaling some $325 billion, a 64% increase over 2004. There is no let-up in sight. A recent survey of CFOs of mid-size and large U.S. manufacturing companies found that nearly three out of four expect their company's revenues to increase in the coming year—and nearly half (46 percent) predict higher profit margins.

**AVAILABILITY OF CREDIT**

While financial theory says that investment decisions should be separate from financing decisions, it is unmistakable that the current pace of activity and lofty valuations are being driven by the availability of credit.

Credit standards are as loose as they have been in a decade. This view is supported by the quarterly Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices that has recently reported the most banks loosening credit standards than at any time in the past 10 years. Banks are willing to aggressively extend credit because their portfolios are relatively clean. Default rates are at their lowest

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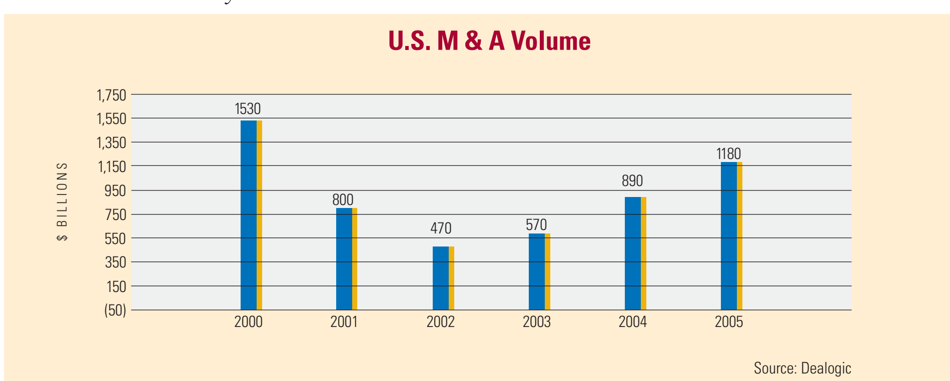
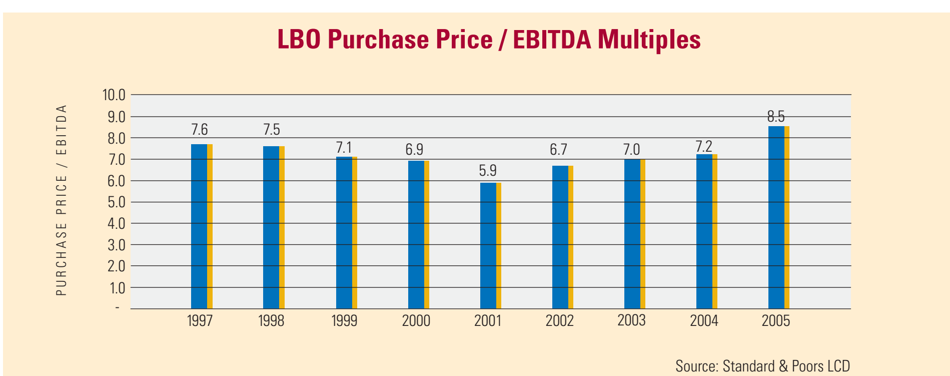



*The valuation of middle market companies continues an upward trend.*

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level in years and continue to decline.

Today's credit market is characterized by low credit spreads, lenient credit structures, and covenants that are quite loose or entirely absent. Standard & Poor's reports that bank debt multiples have steadily increased from an average of 3.7 X EBITDA in 2001 to 4.3 X today, a level that hasn't been seen since 1999.

**PRIVATE EQUITY**

Equity money is now available in greater abundance than ever before. Fifteen years ago, a handful of private equity firms managed a few billion dollars; today, more than 250 firms control some $800 billion in capital. Buyouts Magazine, which tracks private equity deals, estimates that nearly $175 billion in new money flowed into U.S.-based private equity firms last year alone. This equity capital, when leveraged with debt, implies well over $3 trillion of resources either already invested or looking for a home in the capital structure of private companies.

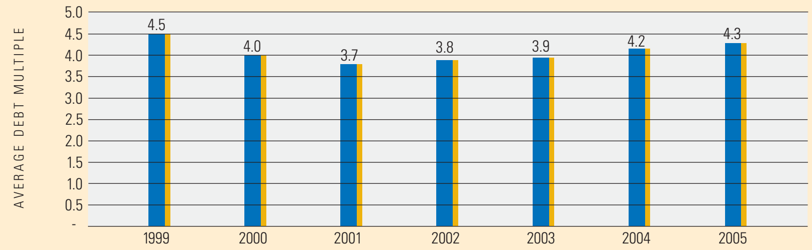
Hedge funds are also getting into the game. There are now reportedly over 8,000 hedge funds (perhaps better called unregulated investment companies) managing over $1.2 trillion, a portion of which is seeking the higher returns promised by private equity investments.

**SELLER'S MARKET**

This is a seller's market, where owners can often reap the benefit of receiving part of the value buyers expect to create following an aquisition. Among the most telling statistics of the competition for deals is revealed in a recent survey by KPMG's Transaction Services Group, which in the fall of 2005 reported that 43% of the synergies expected to be created in business combinations were included in the purchase price (i.e., paid to the sellers). While this is not a measure we have seen tracked over time, it is a clear indication that buyers are aggressively pricing acquisitions.

There are no signs on the horizon that this pace is likely to slow. A recent survey of CFOs reported that expectations for merger and acquisition activity are at an all time high. Thirty percent of manufacturing companies surveyed expect to participate in a merger or acquisition in 2006, up sharply from 23 percent last year. It is the highest percentage in the survey's history.

**Average Debt Multiples of Highly Leveraged Loans**




**CONCLUSION**

There is no question that, from an economic point of view, the current market represents an exceptionally good time to be a seller and quite a difficult time to be a buyer. Owners of successful companies will find many buyers and high purchase multiples. Purchasers need to show caution about paying too much for the benefits expected to result from a business combination.

Be certain, however, that this is an environment that will not persist forever; it never does. The change, when it occurs, is most often precipitated by lenders faced with borrowers missing financial expectations. History tells us that when that happens, lenders react quickly to tighten credit and the pendulum begins to swing in the opposite direction. ❖

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## ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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