Zachary Scott
INVESTMENT BANKERS

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Credit Critical to Deal Market

With access to cheap capital throttled and credit availability tight, the deal market is far from active.

by Mark D. Working

There is little doubt that the roaring mergers and acquisitions market of yesterday has gone soft. Barely a trickle of deals is flowing through the pipeline, as most sellers and financial and strategic buyers have stepped back from the market. According to Venture Economics, thus far in 2001, M&A activity is off 50% from the previous year and at the lowest level since 1997. The late '90s provided an environment in which historically high prices were offered for private companies. Two engines fueled demand for private-company buyouts. The unprecedented ascendance of the public equity markets provided corporate acquisition teams cheap currency in the form of common stock to buy companies. At the same time, financial investors competed by funding their deals with an historically higher proportion of low-cost, liberally structured debt.

INVESTORS FINALLY BALK

It is now apparent that, in early 2000, as investors finally balked at the inflated prices for financial assets, they set in motion a precipitous correction of the stock market. This decline effectively throttled access to cheap

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capital for acquisitive public companies. In response, these firms have turned their emphasis from the buyout market to internal initiatives that may improve performance and positively impact corporate value. Prices that such "strategic" buyers are prepared to pay for acquisitions have dropped in concert with their reduced appetite for risk and the diminished value of their stock as currency.

One would think that this would leave the private-company market wide open to financial buyers. Unfortunately, they have found themselves hamstrung by tightened credit availability. Ready access to liberal amounts of credit is a key element of an active deal market. Ultimately, the amount and structure of debt is an important determinant of the price that can be offered by financial investors in a buyout transaction.

ECONOMICS OF A BUYOUT

To illustrate this point, we present a simple comparison of the economics of a buyout in the "go-go" environment of 1999,

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relative to the current market. The focus of our comparison is a hypothetical manufacturer of widgets earning $10MM of EBITDA on $100MM of revenue. Management believes that there are some immediate improvements that can be made in the company's performance and that its long-term growth prospects are attractive.

Example Transaction...*an investor's view of the economics*

($ IN MILLIONS)	1999 DEAL	2001 DEAL
Revenue	$100.0	$100.0
LTM EBITDA	10.0	10.0
Pro-forma Improvements	1.0	-
Expected Cash Flow	11.0	10.0
Acquisition Multiple	6.0X	6.0X
Enterprise Value	$66.0	$60.0

In 1999, investors and lenders would have been positively influenced by management's expectations of performance and would have factored the $1 million of pro-forma improvements into their EBITDA expectations. The deal would be priced at a multiple of six times expected EBITDA, yielding a value of $66 million. In the current market, the primary difference would be a reluctance to believe and pay for the improvements that might be realized in the acquisition. That is, today, the deal would be valued only on proven performance. Assuming the same purchase multiple, the price would be $60 million.

Same Company...*different financing structure*

($ IN MILLIONS)	1999 DEAL		2001 DEAL	
Acquisition Price	$66.0		$60.0	
Transaction Costs	2.3		3.0	
Total Acq. Cost	$68.3		$63.0	
FINANCING STRUCTURE:				
Senior Debt (EBITDA MULTIPLE)	$38.5	3.50X	$25.0	2.50X
Mezzanine (EBITDA MULTIPLE)	$16.5	1.50X	$10.0	1.00X
Total Debt (EBITDA MULTIPLE)	$55.0	5.00X	$35.0	3.50X
Equity (EBITDA MULTIPLE)	$13.3	1.18X	$28.0	2.80X
Total Capital (EBITDA MULTIPLE)	$68.3	6.18X	$63.0	6.30X
Equity as % of Total Capital	19%		44%	

Even more differences can be seen in the capital structure employed to fund the acquisition. The first disparity is transaction costs; financing fees and credit spreads are significantly higher today than two years ago, even though the debt level is lower. In 1999, an investor could expect to arrange senior debt of up to 3.5X expected EBITDA (including pro-forma improvements). Today, those same lenders are likely to fund only 2.5X proven EBITDA. Mezzanine lenders are anxious to fill any funding gaps. In 1999,

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they could be expected to add another 1.5X EBITDA of subordinated debt, to bring total leverage in our hypothetical example to $55.0MM. In the current environment, it is likely that mezzanine debt will be limited to 1.0X EBITDA. Total borrowing capacity in today's environment, therefore, would only be $35.0MM. The gap between value and credit availability has to be filled with equity capital. In 1999, that meant $13.3MM (19% of the capital structure). In today's market, it means $28.0MM, nearly 44% of the capital required to complete the deal.

Of course, this doesn't tell the full story. In 1999, investors had to believe that, within five years from closing, the company would have a total value of at least $86.0 MM, enough to repay the remaining debt, allow mezzanine lenders an all-in return of at least 20% per annum, and provide the equity investors a 30% annual return. Assuming a sale multiple of 6X EBITDA, investors would have to be convinced that EBITDA would grow to $14.3 million, a 5.4% compound annual growth rate (CAGR). This was an expectation that would have been readily accepted.

Five Years Later *to justify the deal investors will need…*

($ IN MILLIONS)	TARGET RETURN	REQUIRED VALUE 1999 DEAL	2001 DEAL
Equity	30%	$49.4	$104.0
Mezzanine	20%	$ 9.8	6.1
Remaining Mezzanine Debt		16.5	10.0
Remaining Senior Debt		10.0	-
Enterprise Value		$85.7	$120.1
EBITDA Exit Multiple		6.0X	6.0X
Implied EBITDA		$14.3	$20.0
EBITDA CAGR		5.4%	14.9%

INVESTMENT MATH CHANGES

Today, the investment math is a bit more challenging. To provide the capital suppliers their required returns, the business will have to be worth $120 million at the end of five years. Assuming, again, a sale multiple of 6X, EBITDA would have to grow to $20MM, a 14.9% CAGR. Given the competitive environment in which most businesses operate, this kind of growth, especially without significant additional investment, is extremely rare. Few investors are likely to buy into a challenge like that.

So, what gives? As long as credit remains tight, either values have to come down, or equity investors must accept lower returns. Otherwise, deals won't get done. In reality, all of these forces are at work. Many deals are being negotiated at lower prices. Some owners are helping to finance the sale by providing junior subordinated debt (probably without current-pay provisions). And, equity investors are beginning to accept lower returns, on the logic that their risk is lessened by the more conservative capital structure. Until senior lenders feel their portfolios are under control and begin aggressively looking for more business, the M&A market likely will be less robust. ❖

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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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