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INVESTMENT BANKERS

IN$IGHT
PERSPECTIVES ON THE CAPITAL MARKETS

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Mergers and Acquisitions 2005

Favorable merger and acquisition conditions are likely to prevail through 2005.

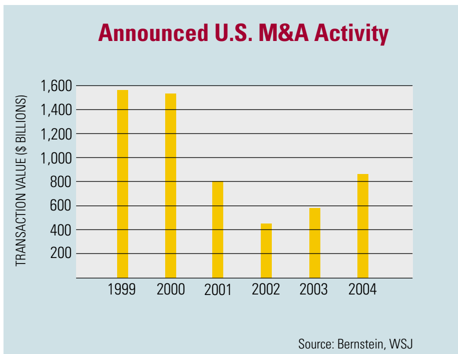
by William S. Hanneman

Much has been written lately about the strong rebound in M&A activity over the past several years. The market is more active, relative to the dearth of activity that followed the late 1990's deal frenzy. From our perspective, this has been a welcome improvement. However, we suspect that the recovery has not been quite as robust or broad-based as one might expect from the headlines in the popular press and the supportive economic conditions.

In 2003, the M&A market began to emerge from a deep trough, when financial sponsors, attracted by improved equity valuations and the availability of high-yield debt, picked up the pace of acquisition activity. Total deal value grew by 22% to $570.3 billion in 2003. Predictions in early 2004 anticipated a return of corporate strategic acquirers and a resultant M&A market boom.

Indeed, M&A deal flow did surge in the first quarter of 2004, registering a 40% increase over the previous quarter's performance. However, in the second and third quarters, M&A volume fell off, as corporate acquirers exhibited caution in initiating new transactions. The apparent pause in activity has been linked to concerns about the ability of acquisition candidates to comply with the financial reporting standards of the Sarbanes-Oxley Act (see related article) and questions regarding the sustainability of U.S. economic growth. M&A activity heated up again in the fourth quarter, as transactions valued at more than $260 billion (including a number of mega deals) were unveiled in December. In 2004, private equity firms accounted for roughly 15% of the $1.95 trillion of global M&A activity, with in excess of $300 billion in new investments.

Historically, M&A activity has been closely correlated with confidence in future business performance and the cost and availability of debt and equity capital. While most of these activity drivers are in place as we enter 2005, concern persists over high energy prices, rising interest rates, a weakening dollar, lofty levels of consumer debt, and progress in the war on terror. In spite



of expectations of moderating economic growth in 2005, business leaders seem to be more confident about the outlook for their companies. As a consequence, we see signs of greater interest in middle-market M&A opportunities among strategic purchasers.

That interest is more selective than it was during the 1990's deal frenzy, which, in our opinion, bodes well for a healthier and sustainable M&A market. Today, corporate

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acquirers tend to focus on building a portfolio of businesses around a strategic theme, rather than on diversification. It is fair to say that focused acquisition strategies offer the best opportunities for creating value through improved asset utilization and cost savings.

PUBLIC VS. PRIVATE COST OF CAPITAL

The recent sale of our client, Mikron Industries, the leading North American producer of extruded vinyl and composite profiles used in the fabrication of windows and doors, to Quanex, a publicly traded firm with a significant presence in the building products industry, is an interesting benchmark of the current market. Quanex has built through acquisition a stable of subsidiaries that produce highly engineered window and door components. While the two companies' product lines do not overlap directly, they are complementary and the distribution channels are the same. Quanex's confidence in the strategic benefits of a business combination enabled them to pay approximately one times Mikron's annual revenues of $215 million.

In spite of the obvious strategic benefits that Quanex expects to derive from Mikron, values put on the business by rival financial buyers were very close to Quanex's winning bid. Competition to acquire the company was keen. The final group of bidders included a mix of corporate and financial buyers. In part, this is due to the fact that the credit markets are currently quite accommodative for larger middle-market businesses with track records of stable cash flow. In effect, the higher borrowing capacity afforded these companies reduces the weighted average cost of capital for financial buyers to a level that approaches that typically enjoyed by publicly owned corporate acquirers. Just a year ago, this would not have been possible and, even today, remains unlikely for transactions of less than $100 million.

In smaller M&A transactions, financial buyers do not typically enjoy comparable cost of capital competitiveness. This often puts them at a disadvantage when competing with corporate acquirers, particularly in situations where strategic buyers have opportunities for revenue enhancements or cost synergies.

THOUGHTS ON TIMING

Low interest rates, liberal credit availability, and expectations for stable economic growth combine to make this an advantageous point in time, relative to recent years, for the owners of larger private businesses to

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consider a sale or recapitalization.

Owners of smaller middle-market firms may also find this to be a relatively good time to seek a buyer. Although strategic buyers have been a little wary, many private equity funds are anxious to put their capital to work. These equity funds have finite life spans—typically 10 years—but usually are restricted to investing that capital in new investments over the first six years of the fund's life. Equity funds established in the boom years of the late 1990s are nearing the end of their investment period, hence their desire to invest any remaining capital. The amount of capital available to private equity funds is estimated to be over $100 billion, its highest level in at least 15 years.

It is rare for all of the factors necessary for a vibrant M&A market to align at once, as they arguably did in the late 1990's. It is even more unusual to line up an individual owner's investment horizon with a robust M&A market. Because these factors rarely move together, transaction timing always boils down to a subjective business judgment. From our vantage point, it appears that favorable M&A market conditions will prevail through 2005. ❖

Zachary Scott

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1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

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.

Mark D. Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Brian J. Kremen
206.838.5526
bkremen@zacharyscott.com