Zachary Scott
INVESTMENT BANKERS

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The Day the Earth Stood Still

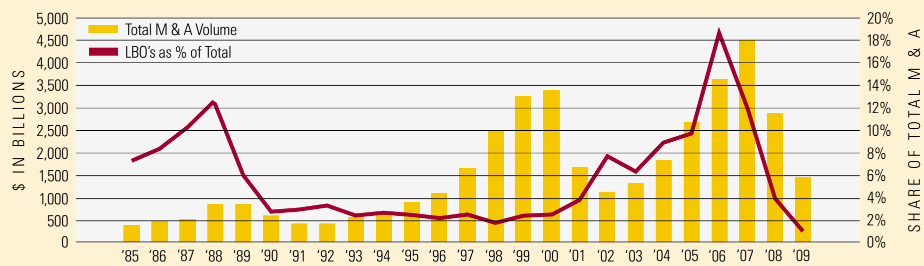
When the financial markets collapsed in 2008, mergers and acquisitions ground to a halt.

by William S. Hanneman

In the Fall of 2008, the earth's rotation ground to a stop, at least with regard to the world of mergers and acquisitions. Markets essentially confronted the reality that the credit foundation for the surge of buyout activity over the past several years was built of sand. Wall Street firms collapsed, banks faltered and some failed, and, in response, the federal government scrambled to roll out a veritable alphabet soup of support programs–TARP, TALF, TABS, ASSP, CPP, MLP, and more–all with the hope of stemming the carnage. In the midst of the turmoil, our consumption-oriented society stepped back a couple of paces. Financial activity creaked to a virtual halt.

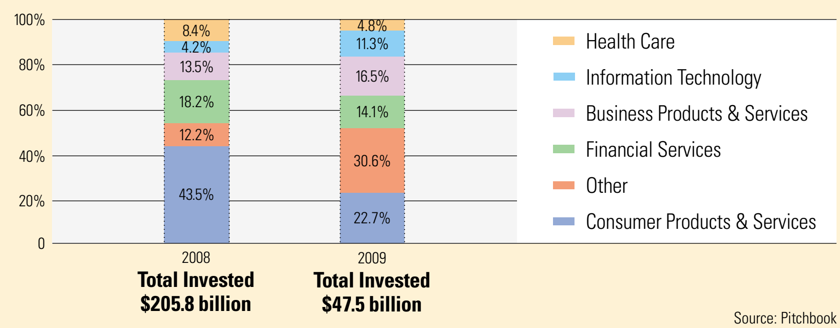
Uncertainty and fear supplanted the optimism that underscored the financial surge, as everyone (bankers, business owners, and government officials) had little choice but to sit tight until the smoke cleared and it was possible to evaluate actual conditions and potential next steps. That smoke is only now dissipating, and what has emerged should be of interest to every business owner.

Merger & Acquisition Activity



Source: Thompson Financial

M & A Investments 2008 / 2009



Source: Pitchbook

THE ENVIRONMENT

Without a doubt, 2009 was the worst mergers and acquisitions environment in memory. As can be seen from the accompanying chart, the dollar value of transactions hit a 12-year low, as did the role of LBO's.

In most cases, a sufficiently similar view of future business prospects is a prerequisite to a transaction, as it provides the basis for buyers and sellers to agree on price. In a weak economic environment beset with uncertainty, business owners, whether they were large corporations, individuals, or private equity firms, tightened their focus on survival and forswore new business combinations. Those that did seek buyout opportunities frequently found that the gap between the bid and ask was far wider than normal.

Nevertheless, the forces of creative destruction in a free economy cannot be forestalled indefinitely. A long restructuring process of squeezing excess human and physical capital capacity from the system is underway in an effort to adapt the means of production to today's demand reality. Owners of debt-laden businesses learned (or re-learned) the harsh lesson that leverage cuts both ways. Many businesses survived the bruising and many others perished, or will in time.

As might be expected, a principal strategy in this environment is to retire capacity and enhance productivity through industry consolidation. Strategically minded corporate buyers armed with cash have taken the lead. Acquisition of distressed assets from firms either already in or confronting bankruptcy/receivership, constituted a significant share of 2009 deal volume.

Another segment where palpable activity was found is in businesses based on enhancing the productivity and efficiency of other businesses. The above chart reflects an industry breakdown of 2009 private equity M&A activity relative to 2008. While deal volume was a meager 23% of the prior year, there was proportionally greater interest in business products and services, information technology, and a grab bag of industries lumped in the "other" category. Less desireable were consumer products, healthcare and financial service firms.

NEAR FUTURE

Our observation is that three themes are likely to dominate M&A activity in the near term: recapitalization of over-leveraged balance sheets, continued consolidation of industries to drive productivity, and liquidity transactions in industries as their futures become discernible.

First of all, there are many good businesses that are buried beneath the wrong capital structure. Lenders and owners have been able to defer the eventual economic reality, but we are seeing these situations only now coming to the fore. These businesses will change hands or alter ownership structure in transactions

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that right-size the balance sheet to current circumstances.

There is much capacity that has yet to be rationalized as evidenced by low industrial utilization rates across a number of sectors. Times like this give great impetus to learning to do more with less, often much less. As such, the wave of creative destruction that will reconfigure many industries has just begun to run its course.

Existing businesses, both large and small, are the tools best suited for this job. Private equity will play a role in the process in cases where capital can facilitate rationalization.

At the same time, both corporate and financial investors have an inexorable appetite for investment in stable businesses (e.g., food and beverage products and certain business services) and even more for businesses that exhibit prospects for healthy growth (e.g. healthcare, alternative energy, IT services, and government contracting).

Private equity firms, largely sidelined over the past 18 months, are increasingly poised to put capital to work. As discussed in the nearby IN$IGHT article, the improving credit markets and a less murky view of the future is unzipping private equity purses to pursue growth businesses and to back quality management teams in consolidation strategies.

VALUE GAP CLOSING

In many instances, the gap between sellers and buyers concerning the seminal component of any deal, value, has not been resolved. Sellers look at the recent stock market rebound and renewed economic growth and hope it's a sign that the "good ol' days" are back and presage a return of the lofty business values achieved at the pinnacle of the cycle in 2007. In most industry sectors, buyers and their lenders, on the other hand, are more cautious, as economic and earnings visibility remains hazy. This valuation disconnect persisted throughout 2009 and led to creative deal structures designed to bridge the value gap. These mechanisms, including earn-outs, significant residual equity positions for sellers, or multiple-stage closings, have become much more common. But, in sectors that demonstrate growth and stability, the "good ol' days" appear to be back. Because of the mismatch of capital available for investment and a dearth of good companies, competition is driving higher pricing.

In the final analysis, the value gap will close and deal activity will pick up for two reasons. First, businessmen and investors, in general, are beginning to understand the realities of the economy and what the future might hold. The second factor is the inevitability of time. Private businesses are owned by people, and those people age. Most private businesses are not transitioned from one generation to the next. Instead, sales of businesses are the mechanism to generate liquidity to foster wealth diversification. Many business owners would have already taken that step but for the environment of the last two years. The need to monetize wealth accumulated in privately held businesses can be delayed, but not eliminated. ❖

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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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