

Middle Market M&A: Rebound of 2010 or The Beginning of the Double Dip of 2011?

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Transaction volume has risen, financing costs remain low, and confidence in the overall economy is up. It seems that the storm has passed and the markets are set for smooth sailing in the foreseeable future. Is it too good to be true?

Positive Fundamentals

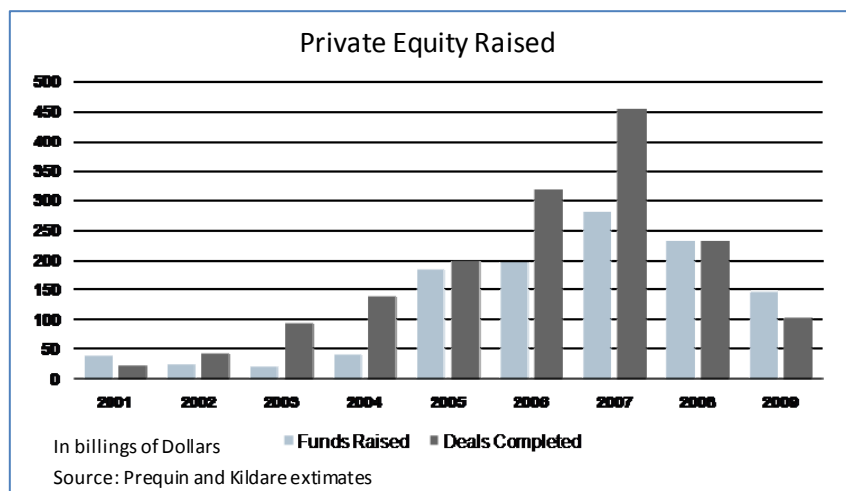
North American middle market deal activity has picked up significantly in the last three quarters. Recent major North American deals include the US\$490 million acquisition by IBM Corporation of Unica Corporation, the US\$475 million acquisition by GI Partners of SoftLayer Technologies, Inc., and the US\$475 million acquisition by Pace plc of 2Wire, Inc. According to CapitalIQ, in July 2010 total North American transaction volume was approximately US\$63.8 billion versus US\$46.5 billion in July 2009, a year over year difference of US\$17.3 billion or 37.2%. The year-to-date July 2010 comparison is also compelling: for the first seven months of July 2010, approximately US\$477.5 billion in transactions were completed or announced as compared to US\$414.9 billion during the first seven months of 2009, a year over year difference of US\$62.6 billion or 15.1%.

Thanks in large part to the dearth of transactions processed and completed during the market downturn, the backlog of transactions had increased significantly. Companies that experienced failed auctions or who simply delayed selling are now entering or reentering the market as valuations return to normal levels. Current mean multiples for middle market transactions (companies with total enterprise values of US\$25 million to US\$100 million) were 1.4x last twelve months (“LTM”) revenue and 7.1x LTM EBITDA.

This compares to last year’s 1.4x LTM revenue and 5.8x LTM EBITDA.

Part of the story is the return of investors and strategic buyers to the market. The “over funding” of private equity firms and the return of strategic investors to the deal table has resulted in increased activity in the M&A market during the first

half of 2010. Private equity firms are coming under pressure to deploy capital or return it to their limited partners along with any management fees that were earned.



Estimates are that private equity firms have over \$400 billion in committed but uncalled capital; some limited partners have requested delays in capital calls. Strategic investors, who were on the sidelines during the market downturn, are also coming under pressure from shareholders to either deploy the capital built up on their balance sheets or distribute it through dividends; CEOs are eager to spend the surplus cash on acquisitions.

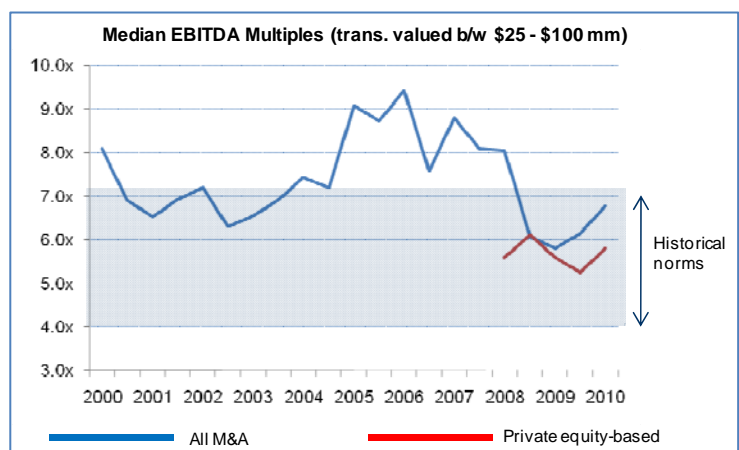
The sustained low financing costs are also contributing to the buying spree. Credit markets continue to defrost and money is trickling out to fund middle market transactions. Current financing costs for healthy middle market companies with assets to secure the funding are in the neighborhood of LIBOR plus 3.5% - 5.5%. This rate reflects a common propensity by most central banks toward stimulus vs. austerity allowing financial institutions a lower cost of funds. Despite the “defrosting” in the middle market, the market for highly leveraged loans above \$1 billion is not likely to return anytime soon.

Negative Indications

While these fundamentals support the growth of M&A volume, they only paint part of the picture. Left out of the discussion are the potential global economic risks, the limitations associated with low cost financing, the shrinking backlog of M&A deals, and the sunset of the Bush-era tax cuts.

Global economic uncertainty remains in focus for most U.S. investors and corporations who operate on an international basis. This lack of clarity is impacting capital expenditures and corporate development, resulting in corporate boards of directors disapproving potential investments. In Europe, risk surrounds many countries impacted by the recent debt crisis of Greece, and to a lesser extent Spain and Ireland. Should significant cracks emerge in the Euro-zone countries, there could be another deep global financial crisis. Regarding China, ever-changing trade relations and the effect of potential currency devaluation on manufacturing costs are concerns. Latin America, for the most part, seems to be rebounding from the market downturn, being led by countries like Brazil and Chile.

While interest rates remain low, financing is still difficult to secure. Most banks require hard assets to secure any new senior credit facility. Even second lien and mezzanine lenders are reluctant to finance companies on a cash flow basis. Furthermore, once there is a term sheet, the time to close a financing has been extended due to more comprehensive underwriting procedures and new, stringent approval processes. In the current market, senior debt and total debt multiples for middle market companies have been in the



range of 2.5x and 3.3x LTM EBITDA, respectively. This compares to senior debt and total debt multiples from a year ago of 1.5x LTM EBITDA and 2.0x LTM EBITDA, respectively. The cost of senior debt is approximately 5.0% to 7.0% and the all-in cost of mezzanine debt is approximately 15.0% to 17.0%.

During the typical “summertime lull”, monthly transaction volume has nearly doubled on a year-to-year basis. In June, 37 transactions in the \$10 million to \$250 million range were either closed or announced, an increase of 15.6% over June 2009. July had 39 transactions closed or announced, a difference of 15 transactions over July 2009, or a 62.5% increase. In August, 42 transactions were closed or announced, a difference of 18 transactions over August 2009, or a 75.0% increase. Companies that delayed going to market have either begun or completed the sales process. As the backlog of available middle market companies in the \$10 million to \$250 million range is worked off, will there be sellers to replace the backlog?

The expiration of certain tax cuts put in place by President George W. Bush are set to expire in at the end of 2010, likely causing additional pressure to get deals done this year. The two major tax-cutting bills from the Bush era were the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, and the Jobs and Growth Tax Relief Reconciliation Act of 2003. With the expiration of these cuts, deal volume and pricing will may be negatively impacted due to the redefinition of tax brackets, a rise in the capital gains tax, and the tax treatment of dividends. The change in tax brackets would result in an increase of approximately 4.5%. The change in the capital gains and treatment of dividends would increase tax costs by approximately 15% to 20%. Combined, these changes result in an additional 20% to 25% in overall costs for sellers.

In the end, we may look back on middle market M&A in 2010 as both “The M&A Rebound of 2010” and “The Beginning of the Double Dip of 2011.” While the market fundamentals favor continued middle market deal volume and growth in 2010, the underlying fact that valuations will need to be significantly higher after December 31, 2010 for sellers to break-even may put the brakes on deals for the first half of 2011.

Mr. Haemmerle is a Managing Director at Translink-Kildare and has over 15 years of investment banking and commercial banking experience. Previously, he worked as a Director at Amper Investment Banking and before that for seven years with the New York-based merger and acquisition advisory team of WestLB Panmure, where he was involved in several international transactions. Prior to joining WestLB, he worked as an associate in the New York corporate finance advisory group of Bankhaus Metzler GmbH. Mr. Haemmerle has advised clients in various industries including: technology, media and entertainment, communications, life sciences, industrial manufacturing, logistics and transportation, and business services. Bill maintains the FINRA series 7, 63, 79, and 24 licenses.



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