

Middle Market M&A Update - February, 2012

Overture Advisors is an investment banking firm focused on providing services to the “middle market”, defined as those companies generating annual revenues of \$5-100 million. Certain statistics cited herein pertain to the overall middle market, which include transaction sizes up to \$500 million. Few statistics are readily available which pertain exclusively to the middle market.

Optimism Abounds for Transaction Activity in 2012

Background-2011 Market Activity

Since the end of the financial market debacle commencing in late 2008 and continuing through 2009 (*middle market M&A activity actually “hit bottom” in Q3 2009*), it has been expected that M&A activity would enjoy a resurgence, if for no other reason than the “catch-up” associated with market ready deals that could not be transacted on acceptable terms during the downturn.

The resurgence has occurred, although not as rapidly as many predicted. In 2010, total middle market M&A deal volume (transactions less than \$500M) was \$174 BN, representing a doubling of deal volume over 2009, but 35% below middle market deal volume recorded in 2007. For the first 2 quarters of 2011, M&A volume was up nearly 20% over the comparable period in 2010, but fell off the remainder of the year. Assuming Q4 deal volume matched that of Q3, deal volume for the 2nd half of 2011 will

have been identical to that for the first half of the year. As a result, after a strong start early in the year, middle market M&A volume will have ended 2011 6% ahead of activity levels in 2010.

To be clear, the slowdown in the second half of 2011 is not indicative of lesser demand. Economic and political uncertainty, caused by the factors listed below, caused buyers and sellers to take a cautious approach to M&A:

- ❖ Political gridlock in Washington;
- ❖ Unclear tax and regulatory policy and environment;
- ❖ Upcoming presidential election;
- ❖ Impact of financial market meltdown in Europe (this issue tends to be of lesser concern to the middle market, whose participants conduct business mostly in the U.S.).

2012 M&A Conditions

The primary caveat for any prognosis remains the absence of a major economic or political event which raises the specter of a double-dip economic recession. Assuming no such event occurs, the following factors should contribute to increased M&A volume in the middle market in 2012:

- Slow but steadily improving economy (1.5-2.5% GDP growth);

- Continuing imbalance between buyer demand and supply of quality acquisition targets;
- Stable debt markets;
- Retirement of “Baby Boomers”.
- Risk of increased capital gains tax rate in 2013 and beyond.

Each of these factors is reviewed in greater detail below.

Improving U.S. Economy:

Robust economic growth is not necessary to support increased M&A activity, but the absence of any significant downdraft on the economy is crucial to the confidence required for buyers and sellers to agree on transaction terms. Accordingly, a stable economic environment will support an active M&A market, and the fact that the second half of 2011 saw a falloff in M&A will contribute to “catch-up” transactions in 2012.

It’s worth pointing out that a low GDP growth rate does not limit the ability of individual companies to grow at much higher rates. Anecdotally, we at Overture Advisors have witnessed many of our clients in the Businesses Services sector realize double digit growth during 2010 and 2011, and believe that annual growth in the high single digits is sustainable in an economic environment of 1-2% GDP growth. Companies realizing the highest growth rates are those in “hot sectors” (energy and healthcare technology are 2 examples), and those which offer services that improve operating efficiency of manufacturers and other service providers.

Demand/Supply Imbalance:

Two primary factors point to an increasing imbalance (more buyers than sellers) between

buyer demand and seller supply in the M&A market.

- 1) In a slow growth economy, strategic buyers seeking growth can most readily achieve it and market share increase via acquisition. Combine this with the fact that strategic buyers are flush with cash, and you have an environment where strategic buyers are aggressively seeking transactions.
- 2) Private equity firms are estimated to be sitting on \$400-450BN to invest in acquisitions. Add to this treasure chest the ability to leverage the equity with debt at the rate of at least 2-3X equity, you have PE firms capable of completing total transactions valued at more than \$1.5 trillion!! *Investors pay PE firms to deploy capital, not sit on it.*

Stable Debt Markets:

The market for loans available to finance M&A activity has improved dramatically since 2009, as both bank and non-bank lenders, (including both senior and mezzanine lenders), are increasingly aggressive in providing financing for buyout transactions. It is important to understand, however, that competitive financing is available to only the highest quality companies in the middle market, including:

- 1) Companies with EBITDA of at least \$10M;
- 2) Companies with strong competitive market share and position;
- 3) Companies owned by private equity investors.

Middle market companies with EBITDA >\$10M can attract competitive loan pricing and terms,

and can achieve leverage multiples (Debt/EBITDA) of 4-4.5X EBITDA. Companies with EBITDA between \$5 and \$10M are still attractive to lenders, but at leverage multiples of 3-4X EBITDA, and with less attractive prices and terms.

Middle market companies with EBITDA below \$5M are least able to attract the attention of lenders. Leverage multiples for these companies are limited to 3X EBITDA, and for the most part lenders are limited to asset-based lenders and an increasing number of small mezzanine lenders that have sprouted up to fill the void created by the lack of bank lending in this part of the corporate market.

Retirement of Baby Boomers:

2011 was the first year for retirement of the baby boomer generation, as those born in 1946 reached age 65. Over the next 17 years, some 78 million Americans will reach retirement age, or approximately 26% of the current U.S. population. On average, over 4 million Americans will retire every year during this period. This group of people also comprises the largest percentage of middle market company owners (an estimated 12 million businesses), most of whom will be seeking to exit their businesses during this period.

Capital Gains Tax Increase:

The current tax rate on long term capital gains is 15%, and will increase to 20% in 2013 unless the current tax legislation is extended. Determination of whether or not current legislation is extended likely depends on who wins the Presidential election in November. That being said, we believe there will be increasing pressure to increase all taxes, including capital gains taxes, in the near future (regardless who wins the White House), as opportunities to cut the federal deficit by reducing spending are limited.

Rarely is taxation a determining reason for a middle market business owner to pursue a sale transaction. That being said, we always tell our clients:

"It's not the sales price, it's what you walk away from the closing table with".

In a transaction valued at \$20 million, the difference between a 15% and a 20% capital gains tax rate is \$1 million more in the post-closing pocket of the seller. If an owner is considering selling during the next 2 years, the potential for a capital gains tax hike is a valid reason for transacting a deal during 2012.

Valuation

Coincident with increasing transaction volume and availability of debt financing, middle market valuations have been on the rise.

According to GF Data Resources, and based on their review of acquisitions by Private Equity in 2011, the average multiple for middle market transactions in the first and second quarters of 2011 was 5.8X EBITDA. ***Of particular note, however, is an increasing bifurcation of the market, with the highest valuations being afforded those middle market companies with greater size, as the buyer market associates larger size with greater safety. To illustrate, the average EBITDA multiple for all middle market M&A transactions was 5.8X in the first 2 quarters of 2011. The multiple, however, was 7.5X for those transactions valued over \$100M, while only 5.2X for those transactions valued at \$10-25M. Further contributing to the valuation disparity based on company size is the fact that the larger companies have access to relatively larger amounts of debt capital, and financial buyers can afford to pay a higher price for transactions if they can borrow more to finance the purchase price.***

Note from author: Valuation multiples expressed above represent "averages". The factor most impacting how an individual company is valued (higher or lower than average) is the actual and perceived growth rate associated with the business.

Transactions valued at less than \$10 million typically trade at 4-5X EBITDA, compared to only 3X EBITDA in 2009.

An interesting point regarding M&A transactions involving companies with EBITDA below \$5 million, or those that are otherwise unable to access debt to fund a sale transaction, is that a seller willing to provide significant financing to a buyer (typically via taking a note as part of the purchase consideration), should expect to realize a sale price 0.5-1.0X EBITDA HIGHER than might be realized in a cash transaction. Conversely, the cash buyer always expects to drive a hard bargain from a valuation standpoint.

Summary/Conclusion

We expect continued growth in the M&A for middle market companies in 2012, especially during the first half of the year. Volume will be driven by continued U.S. economic growth, closing of deals previously scheduled to occur in the second half of 2012, and the confluence of all of the other factors previously referenced herein.

The second half of the year will likely be affected by the Presidential election, and concern regarding potential changes to economic, tax, and regulatory policy.

Valuations for middle market companies will remain steady, and perhaps increase slightly, as an undersupply of quality target companies meets an oversupply of buyers with cash. In the case of financial buyers (Private Equity), higher valuations will be underpinned by their ability to access debt funding to finance acquisitions.

It seems apparent that while we might long for the good old days when visibility of economic and business conditions provided a means of planning with confidence, that time has passed. An increasingly complex and interconnected world requires that company owners and management be prepared to execute on

business plans when windows of opportunity open. Nothing can be more the case than with M&A transactions in the middle market.

About the Author



Philip de Roziere is a Managing Director of Overture Advisors, and has been an active principal and advisor in M&A transactions for over 25 years. On behalf of several global investment banking firms, he has advised on and arranged dozens of M&A transactions, ranging

in size from a few million dollars, to several billion dollars, in both domestic and international markets. On behalf of the largest privately-held company in the U.S., Mr. de Roziere orchestrated the acquisition of numerous enterprises, with the total value of acquisitions completed exceeding \$10 billion. He has also been an investor in numerous acquisition transactions, and periodically serves as an interim executive of acquired businesses.

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