



VIEWPOINT

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M&A STRATEGIES IN A DOWN MARKET

By Jamie Grant and Andrew Redmond

With the U.S. economy heading in the wrong direction and the equity markets in disarray, Mirus considers in this issue how middle-market companies should be approaching mergers and acquisitions. This month we will examine how sellers can expect to fare in the current market. We'll also discuss why it is that healthy middle-market companies and their shareholders — many of whom may have been planning for an exit — may instead want to consider making an acquisition in the next 12 months.

WHY THIS MATTERS:

- *Sellers have fewer options in today's market; knowing how to take advantage of these options is critical.*
- *Down markets obviously pose opportunities for buyers, but knowing how transactions made in today's market may differ from those in years past is important.*
- *Putting together an experienced M&A team is always vital but never more so than in a down market.*

There's no ignoring that the capital markets have taken a beating, with all major indexes down by more than 20 percent since their October 2007 highs, and down considerably at the end of Q3 2008 as the world awaits congressional action. In addition to a bear market, the significant shocks to the financial system in September have created unprecedented volatility in share prices, and the highest TED spread since the October 1987 crash. Bail-out talk combined with the election cycle have given rise to increased speculation about tax reform. Amid this uncertainty, some buyers have already cancelled or postponed pending deals.

How will all of this impact the mergers and acquisitions market? That question will remain open for several months as the near-term impact on the equity markets comes into focus. However, if history is any guide, then by looking at recent M&A market activity in the context of the past several years, we can at the very least discern where the trend has been heading. Charts A and B on the next page, taken from Capital IQ's September 2008 "Monthly Market Observations," show total M&A value and deal volume in North America for three-month trailing periods going back to 2004. The spike in deal valuations in Chart A during the most recent three-month period, when total deal value reached \$397 billion, was caused by a few very large deals. Prior to this period, aggregate deal value during the past 12 months has been depressed to a level not seen since the September-November time frame of 2004.

VALUE OF NORTH AMERICAN M&A

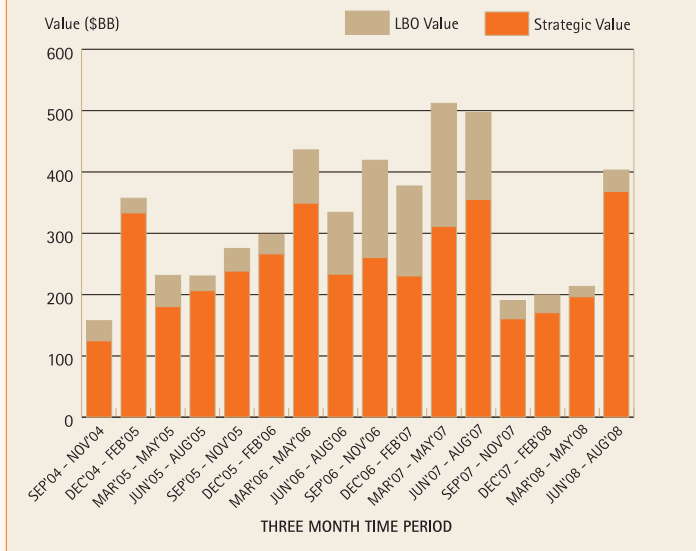


Chart A

Source: Capital IQ September 2008 "Monthly Market Observations"

VOLUME OF NORTH AMERICAN M&A

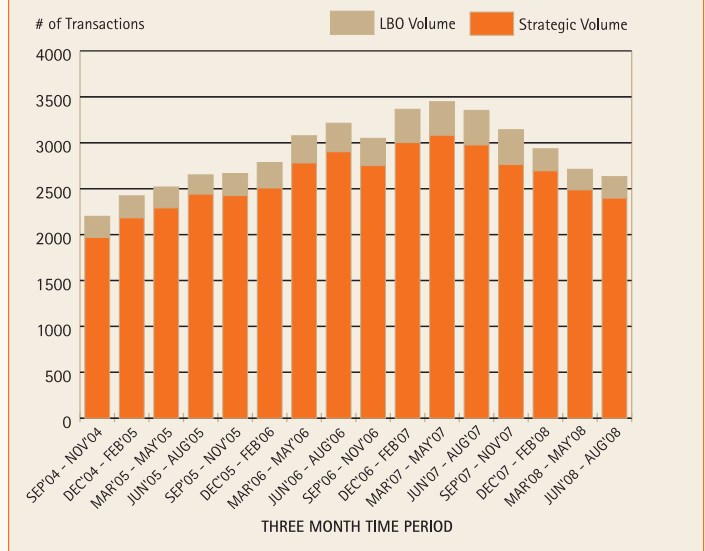


Chart B

Source: Capital IQ September 2008 "Monthly Market Observations"

While down year-over-year, the total transaction volume (Chart B) looks somewhat better by comparison. Total deals for the period were comparable with the same period in 2005, with 2,631 deals transacted from June–August 2008.

All things considered, the past year has not represented a severe drop in transaction volume considering the gloomy overall sentiment in the market. It could even be argued that some market correction was inevitable, and therefore the disruption in the credit markets prior to September was merely a catalyst and not the root cause of market correction. However, the events of the past few weeks represent a meaningful shift in investor sentiment globally.

As the transaction landscape levels out, it is likely that today's transactions will provide far more upside for shareholders than those completed in 2006 and 2007, when deals were more plentiful but in hindsight, perhaps overpriced. It is also important to recognize that the current downturn is not hitting every industry sector. Obviously financial companies and real estate are down, but manufacturing (excluding building products and automotive) is doing quite well since a weak dollar is making U.S. goods more attractive. "There are still pockets of the economy and different industries that are doing quite well," notes **Mark Olsen**, a co-founder of the Mirus Special Situations Group and of the Daymark Group, "but there are obviously pockets of distress."

CHOICES FOR DISTRESSED COMPANIES

Companies in distressed sectors of the economy are no doubt facing increased pressure from their lenders. Banks and finance companies are cash constrained and looking for any way to reduce their outstanding loans and improve their balance sheets. As a consequence, companies that default on loan covenants will find themselves in workout relatively quickly. "There is definitely more pressure being put on companies that are underperforming," says

Dan Sklar, a co-founder of the Mirus Special Situations Group and also of the Daymark Group. "As I look back over my 30 years of working with distressed companies, I never understood how a lender can give a company just 60 to 90 days to sell. That was unrealistic in the 1980s and it still is today. Unfortunately, that's what we're seeing."

This is not to say that there are no answers left for companies in distress. As we discussed in **Viewpoint: Issue 30, "Finding the Right Fit in a Tight Credit Market: An Overview of the Lending Environment for Middle Market Companies,"** while refinancing is more expensive in the current market, it's still readily available for companies looking to borrow against their assets.

"There are more non-institutional lenders out there," says Sklar, referring to the myriad of finance companies that have entered the market in recent years, many of which have strong balance sheets. These private lenders are looking for a high yield and they're playing the 'loan to own' game. They'll make the loan with the underlying understanding that the loan will be profitable if repaid, but if it is not repaid, the lender is prepared to take over the company. "There are a number of these types of funds that are very active now in the mid-market; these options weren't there in past down cycles."

If refinancing proves unfeasible, there are still plenty of buyers in the market, including many that are interested in distressed and/or over-leveraged companies. The key to getting such a transaction done is to have realistic expectations. "I have a couple of situations where client companies definitely need to do something or they'll be in trouble," says partner, **Joe Volman**, co-chair of the Business Law Department at Burns & Levinson LLP in Boston. "I think if their expectations are reasonable, they'll be okay. They have to reset their expectations because they're not going to get [the valuation] they would have gotten a year or two ago."

"If you have reasonable expectations you're more likely to

be able to complete a transaction," Volman added. "You'll show less desperation in the process. If you're not showing that you are professional about the process and are not well-prepared, buyers see that and smell blood in the water." The appearance of relative strength or weakness will have an impact on how quickly a deal can get done and will also have to be balanced with the seller's expectation of the deal. Patience is needed when the lenders are continuously asking for additional due diligence material, and if steps have not been taken to prepare for this well in advance, deal fatigue can become a real problem.

OWNERS OF HEALTHY COMPANIES STILL WANT AN EXIT

Of course, not every business that's for sale right now is available because of a financial distress. "There is a natural cycle of businesses that need to sell for succession reasons, or the owner wants to get out, or the entrepreneur wants to move on, or the VCs are at the end of their run," notes Volman. He cites the example of a software client that closed on a sale recently. The company was doing well and had, in fact, built a great niche market for itself. But it had been mostly self-funded by the two owners and family and friends, and they had reached the point where they either needed to do a capital raise or sell the company. They reached the radar screen of a strategic buyer in their industry. "This was a case of a healthy business with excellent management and that's still going to get a good price," explains Volman. "They had an expectation of what they wanted to sell the business for, and they will exceed that expectation somewhere in the middle of the earn-out."

For a seller in a down market, a contingent earn-out (essentially a post-transaction bonus paid based on achievement of some financial goal) can bridge the expectation gap between seller and buyer. When valuations go down, as in the case of a publicly-traded share of stock, it's up to the seller to either sell at the current "bid" price, or wait until the market improves and the bid comes up to meet the asking price. The difference between the "bid" and the "ask" is the valuation gap. However, with a private company, an earn-out can solve the problem of the valuation gap. If the seller believes business will achieve an incremental million dollars of earnings next year, the buyer can offer to pay an additional amount if and when the Company achieves that goal.

Acquisitions in the current market have been marked by increased attention paid to downside risk. Tempering these downside risks in the buyer's eyes can often lead to increased value for the selling shareholders when structured correctly. Mirus has seen earn-outs and other risk-sharing

structures work out very well for both parties, decreasing the buyer's downside risk and often increasing the value to the shareholders, sometimes significantly.

Downside risk is being scrutinized by both buyers and lenders in any deal in this market. Lenders are taking additional time for more in-depth due diligence on both the acquisition target and the buyer, paying close attention to the worst case scenario that the combined entity may see in an economic downturn. It is not uncommon for the lender to bring in additional third-party due diligence teams to review the financial viability of the post-acquisition business.

IF YOU CAN'T SELL NOW, WHY NOT BUY?

If a business owner has decided to put exit plans on hold because valuations are down, it doesn't necessarily mean there isn't a deal to be done. Hunkering down could mean that you may overlook the excellent growth opportunities presented by current market conditions. By becoming a buyer, your business may have the chance to be better positioned for an exit when the market inevitably bounces back. Companies with strong balance sheets are well positioned to make an acquisition in this market. There are relatively healthy companies right now that are shedding

non-core business units in order to raise capital and pay down debt. If one of those businesses would be a strategic fit for your company, it's a great time to buy. "If you have the resources, I think it's becoming a buyer's market," says Sklar. "Of course, you have to be aware that the financing you're going to get will be more expensive and you don't want to overextend yourself." Mirus

has recently surveyed the middle-market lending landscape and having spoken to almost 100 lenders from traditional banks to non-depository lenders such as finance companies, it is clear that financing for middle-market deals is still available.

Unsurprisingly, the out-of-favor industries are finance, construction, building products, real estate and automotive. With these exceptions, lending activity in the middle-market has not changed significantly aside from pricing and covenants – though with LIBOR rates spiking in recent weeks, pricing is way up. A revolving line of credit from a traditional asset-based lender today will be priced in the LIBOR +175bp to +200bp range. Cash flow loans are priced at about L + 400bp for a revolving line of credit to L + 600bp for "Term A" debt.

While buying in this market can be a smart move, if a company should adopt this strategy, it's important to focus on a business plan as much as price. "Being realistic about the amount of effort that goes into integrating an acquisition and realizing the synergistic benefits is always important," says Olsen, "There's the

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possibility that a buyer can get excited about [lower valuations] and perhaps not be as mindful of the deal's integration aspects. Just because you get a good price doesn't mean that in the long run it's a good deal." This increases the need for meticulous due diligence into both quantitative and qualitative aspects of the deal. Understanding the financial structure of the combined business and the reality of integrating cultures and recognizing synergies requires the full attention of M&A and post-deal advisors.

WHAT TO KNOW IN ADVANCE

No matter which side of the table you're on, getting an M&A deal done in a down market is different. Perhaps the biggest difference is competition. In any market, the posture of buyers will vary along a spectrum: at the low end are potential buyers that are not currently interested in acquisitions because of a recent change in their business or market, and at the high end are buyers that are actively seeking acquisitions. However, in a down market there are likely to be more of the former and fewer of the latter. Even if this dynamic results in just one less buyer for a given business, the subtle erosion in competition can change the dynamic from a seller's market to a buyer's market, not only on price, but on other material terms such as the exclusivity period, deal structure, etc.

"One of the things that happens in a market like this is that deals take longer," says Volman. "Buyers are more methodical about acquisitions and about their financial and legal diligence. That prompts people to get nervous, and there is always a worry that as deals drag on there is a greater chance that they won't get done. The message to sellers is that you can't expect a deal to close as quickly as you would in a better market. Financing is a little slower and things are taking longer."

On the other hand, if you're looking at a distressed company, the process may be shorter than normal. The seller in a distressed situation will trade value for speed in order to get liquidity. "For distressed companies, there's a more condensed process and you won't really have the time to do as much due diligence as you'd like," says Sklar. "You're not paying retail so you're not getting [standard] representations and warranties."

THE RIGHT TEAM MATTERS MORE THAN EVER

Having a strong advisory team is always important in the M&A market for both buyers and sellers, but never more so than when bad economic conditions are producing financial stresses that need to be uncovered for the buyer and managed for the seller during the deal process.

Middle-market companies demand a more hands-on approach than larger companies, many of which may have a significant internal organization for corporate finance and audit. Adds Volman: "You want an investment banker who understands the middle-market, can identify the right buyers and knows how to navigate the issues as they come up because these companies do tend to have more issues. The same is true for your lawyer and other advisors on your team."

For distressed sellers in particular having the right team of advisors at your side can go a long way to help assure a good outcome. "You have to have people advising you who understand the unique aspects of the situation, what the alternatives are and what the tools are that are available to sellers to accomplish their objectives," says Sklar. "Everything from knowing where to go for refinancing to having a working knowledge of what can and can't be accomplished in a bankruptcy or receivership, and understanding the duties and obligations of directors and officers—it's all important in terms of being able to advise or guide a company through a distressed situation."

For buyers and sellers alike, the current M&A market for middle-market companies presents opportunities as well as challenges. Through careful evaluation and due diligence, buyers can find deals that will help them build value for the long run. And even troubled companies still have options available to them. Understanding the downside risks that buyers are focusing on can help sellers to bridge the expectations gap and lead to a better transaction for both parties. With continued access to capital, deals are getting done in this economy, so as always, the key is to consider all options and determine what the appropriate M&A strategy should be for your company. The steady flow of bad economic headlines to the contrary, now might be the right time to act.



Jamie Grant is a partner and Andrew Redmond is an analyst at Mirus Capital Advisors, Inc. Founded in 1987, Mirus Capital Advisors is a middle-market investment bank that specializes in merger advisory, capital-raising services, fairness opinions and valuations to entrepreneurs, corporations and professional investors. By combining a proven process, industry and transactional expertise, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Our affiliate, Mirus Securities, Inc., is a registered broker-dealer and FINRA/SIPC Member. For more information, visit www.merger.com.

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