



# VIEWPOINT

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## WHEN WILL THE M&A PARTY END?

A PRIVATE DEBT AND EQUITY PARTY IS BEING  
THROWN; YOU DON'T WANT TO MISS YOUR EXIT

By Peter Alternative

*As the third quarter of another strong year for mergers and acquisitions draws to a close, executives at middle-market companies are wondering how long this hot market can persist. People also want to know what signs they should watch for that might presage a cooling of the market. For this month's Viewpoint, we look at both of these important questions.*

*Obviously, the strong M&A market of the past couple of years cannot continue unabated forever, so the real question is not if the M&A party will end but when. Barring any unexpected geopolitical developments that cause major economic turbulence, we do not foresee dramatic shifts coming over the next year to 18 months. Today's strong competition for deals is expected to continue to produce an attractive valuation environment for growing and profitable middle market companies. The favorable supply and demand equation could be swayed by several factors that savvy entrepreneurs should keep an eye on. Let's look first at how we got to where we are today.*

### WHY THIS MATTERS:

- *With the IPO exit option still off the table for many mid-market companies, keeping an eye on the status of the M&A market is more critical than ever.*
- *Awareness of enhanced exit options, such as LBOs, recapitalizations or AIM listing, enables you to develop the best possible exit strategy for your company.*
- *It's important to monitor market shifts that might cause the favorable M&A window to close or shift from a seller's market to a buyer's market.*

### CLOSING BID/ASK SPREAD

Starting in 2004, a large number of buyers in the market coupled with lots of cheap capital began to create today's seller's market. Sellers' expectations came down and buyers were willing to pay more, closing the spread between the two sides and leading to the active deal making environment that we enjoy today.

Bob Fleming, founder of Prism Venture Partners, a venture capital firm in Westwood, MA, told us that a greater emphasis on capital efficiency in the VC community has also helped drive the attractive M&A exits that sellers are now experiencing. According to Fleming, "VCs are becoming far more capital efficient in their investments, making sure that they create value with a relatively small amount of capital so that if they have a \$100 or \$150 million exit, they can make money on

it. Companies are being built with realistic expectations as opposed to the tech bubble deals where too much money was piled into them."

M&A continues to be the preferred exit option for venture backed firms. The number of M&A deals and the average deal size has steadily increased over the past three years as illustrated in Exhibit I.

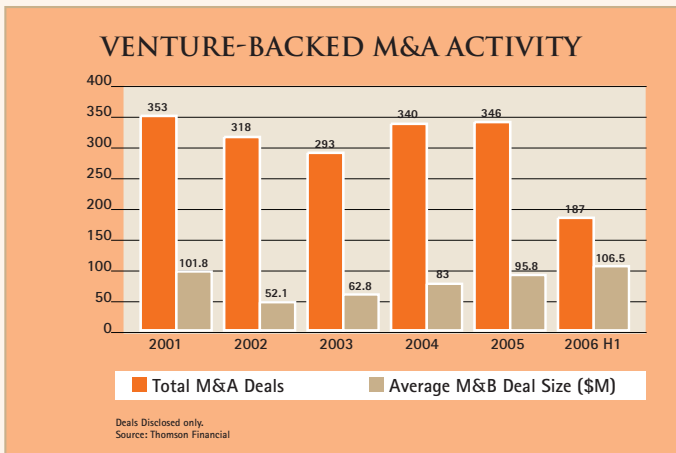


Exhibit I

"The IPO is still a little touchy, but M&A is absolutely going to be the most common exit strategy for the foreseeable future," according to Fleming.

## PRIVATE DEBT AND EQUITY CAPITAL FLOWS

Current macroeconomic conditions, including solid GDP growth, low interest rates, and low inflation, are buttressing the strong M&A market. These factors, coupled with the fact that 2005 and 2006 have been banner years for raising large volumes of private debt (see Exhibit II) capital, should support a positive M&A environment for the foreseeable future.

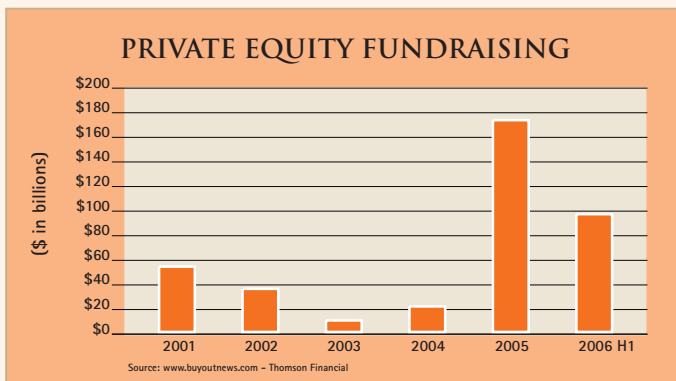


Exhibit II

As Jon Lemelman, general partner at Riverside Partners, LLC, a Boston-based private equity firm, pointed out, "Most of the private equity partnerships are 10-year partnerships with five-year investment periods, so based on the large volumes of money raised in '05 and '06, we'll see this overhang for the foreseeable future. I don't see deals in the \$50 to \$500 million range slowing down any time soon." The private equity firms have seized on cheap credit to buy \$300 billion worth of

businesses in the first half of the 2006, equal to the value of total buyouts in 2005, according to Thompson Financial.

The emergence of alternative lenders are primarily responsible for the availability of cheap debt which is another key factor driving M&A deal making. Hedge funds and other private alternative lenders are providing leverage for deals that commercial banks would not consider. In fact, alternative lenders hold between two-thirds and three-fourths of all leveraged loans, up from 45% in 1999. Companies are raising more and more capital through privately issued loan instruments, backed by pension funds, mutual funds and insurance companies, as opposed to public equity, such as selling stocks or bonds, according to S&P's Leveraged Commentary and Data. Since 2003, the after tax cost of raising debt has been much lower than the cost of issuing shares, even in the more expensive high-yield market, according to a recent cost of capital analysis conducted by Barclay's Capital. This debt includes second lien loans, which have a floating rate and give creditors lower levels of security but potentially high returns. These types of loans have been used by private equity firms to finance leveraged buyouts. As Exhibit III illustrates, the second lien loan market has taken off since 2003 and is expected to reach \$26 billion in 2006.

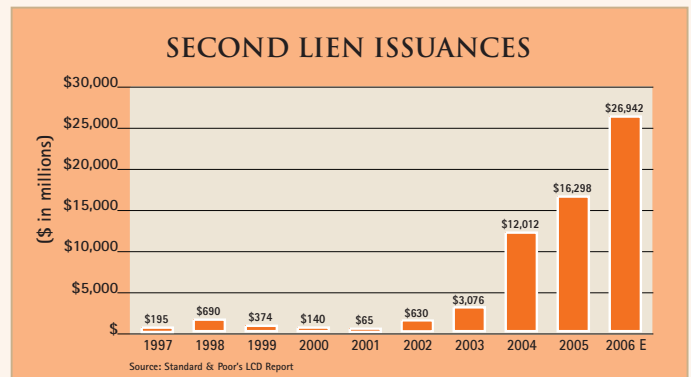


Exhibit III

This difference in the source of lending is significant. As Lemelman pointed out, "private credit investors tend to view investments more like equity owners than banks would, so the debt cycle may be longer to unwind since these lenders are generally more tolerant than commercial banks."

According to John Bowman, managing partner at High Point Capital, a specialty lending firm in Boston, where you fit into the middle market helps determine what your relationship will be with lenders. "There is no question that hedge funds operating in the mid to upper part of the market have a trading mentality," said Bowman. "They want to have liquidity and will move out of a space if it's not an attractive space to be in. But for the companies we work with at the low end of the middle market—companies with \$10 to \$100 million in sales that are seeking loans of \$5 to \$50 million—our goal is to have a long-term relationship. Lenders at this end of the market have little incentive to try to sell out of a position or to try to create acceleration or enforcement actions."

Ben Levin, principal of Insight Venture Partners, a VC firm in New York, pointed out that lending sources have become more sophisticated in how they look at the software, technology

enabled service and Internet businesses in which his firm specializes. "At the same time, as a class, technology companies have matured," he said. "A lot of software businesses, for example, have successfully transitioned to on demand models that provide highly visible and recurring revenue and profit streams. This model has made it easier for providers of debt capital to understand these types of businesses. Additionally, because the public markets have been less receptive to technology businesses for several years, you now see larger private companies in the space that have learned to grow profitably and with capital efficiency and can support leverage."

Despite this higher level of sophistication among lenders, some may still be flirting with disaster by going "downstream" to take on deals. At the lower end of the market more risk is involved due to less cash flow being available to service the debt. Whereas \$10 million of EBITDA used to be the hurdle for attracting a willing lender, now companies with \$5 million in EBITDA or lower are able to find financing to support deals. The lower \$5 million EBITDA hurdle is a direct by-product of lenders seeking out ground they feel will be less competitive.

Highly leveraged deals, of course, leave little room for error and the question remains of how hedge funds and similar alternative lenders will behave if a market downturn occurs. "I think the trend toward using a lot of leverage will continue until there are some high profile blow-ups," said Lemelman.

## KEY VARIABLES TO MONITOR

The possibility that lenders may turn more conservative if a few highly leveraged companies default on their loans is just one risk that could negatively impact the favorable environment for M&A deals. Some macroeconomic factors are already cause for concern, including the rise in the three-month London Interbank Offered Rate (LIBOR), which has increased 200 basis points since the beginning of 2006. This has already brought some cooling in the second lien market. A flat stock market or a slowing of economic growth may also cause the M&A market to cool. Though interest rates and the cost of debt have risen, this has yet to lead to higher default rates. Default rates for corporate high-yield bonds are at their lowest level, 1.09% in almost 20 years, according to Standard & Poors. However, the results of a poll done in June by the Turnaround Management Association show that its members foresee debt default rates increasing in the near term for underperforming highly leveraged companies. Ninety percent of the respondents expect that rude awakening by the end of 2007.

But for companies at the lower end of the middle market, Bowman believes they are somewhat insulated from any potential credit market crunch. "The deals at the lower end of the market are not financed by banks," said Bowman, "so when the Fed tightens up capital availability, that will affect the larger M&A market more than it will the smaller M&A activity. Funding sources will be more selective about the deals they finance and the multiples they pay, but you won't have a drying up of capital that you will experience in the broader capital market. Liquidity won't dry up; it will just get more expensive." The follow-on effects of the credit cycle's potential downturn

will include a drop in deal volume, lower purchase price, lower multiples in the private equity deals and new opportunities for strategic buyers.

## STRATEGIC BUYERS RETURN TO M&A PARTY

In fact, corporations, whose appetite for deals is supported by 16 consecutive quarters of double-digit percentage increases in annualized earnings, are returning in force to the M&A markets after years of sitting on the sidelines. As of Q2 2006, cash and cash equivalents represented 7.27% or \$633 billion dollars, of market value of the S&P 500. The initial use of cash started in Q4' 2004 with buybacks, but with an excess of \$600 billion sitting on their balance sheets, America's large corporations are eager to harness the possibilities for innovation that mid-market companies offer.

Also keeping the M&A party rolling are foreign strategic buyers. Cross-border activity is on the rise; Canada, Great Britain and Western Europe account for the bulk of foreign acquisitions in the U.S., with China coming on strong. Over the last 24 months, there were 361 US targets acquired by foreign buyers in the \$10-\$100M EV range, pointing to a strong middle market focus by foreign acquirers.

## EXIT BACKLOG

One factor that is worth paying attention to as we look to the future is the huge exit backlog of 1,912 private venture backed companies in the U.S., Europe and Israel. Of these venture-backed companies, 882 reside in the U.S., with an average of \$43 million invested in each company, according to Thomson Financial. These companies have not received financing in several years and are maturing from a venture capital perspective.

Assuming the 2005 rate of 356 M&A exits and 56 IPO exits continues, the backlog represents an exit inventory of approximately two years for U.S. venture capital firms. Such a high supply of companies seeking to exit could sway the current supply and demand equation in favor of buyers.

On the other hand, it is quite possible that VCs are becoming more comfortable with the idea of holding onto companies longer. "A lot of companies still have a nice run in front of them with rapid growth and profitability," said Steve Ricci, a senior partner at Flagship Ventures, a VC firm in Cambridge, MA. "You may not be able to take it public, but you don't want to get off the train yet. A lot of companies fall into this bucket and their owners/investors are going to have to hold them for a longer period of time unless it's in the private equity world, where one owner sells to another owner. That has happened somewhat in the VC world, but not a lot." Conversely, in the private equity world, "secondary buyouts," which are sales between private equity shops, exceeded \$11 billion in 2005 and are expected to be an attractive exit route for investors in 2006 and beyond.

Ricci highlighted another factor that could impact the M&A market, at least for tech firms. "For communications or software companies, it's a consolidating world, so there aren't

as many logical buyers as there might have been four or five years ago," Ricci said.

On the other hand, Ricci believes that the IPO market may pick up a little in the year ahead. "One factor in this is that companies have grown more," he said. "They've had an extra few years and certainly there are some very good companies out there."

Ben Levin said that despite this year's lukewarm IPO environment, "the market is always attracted to businesses that are growing and profitable. Even in the tepid market, we've seen quality companies get out."

## POTENTIAL CHANGES TO SOX

The stiff regulation posed by Sarbanes-Oxley Act is one of the reasons behind the tepid IPO market of the past few years. "SOX is partly responsible for closing the IPO market because it's so radically more expensive to go public and to meet SOX requirements as a public company," said Bob Fleming. "It's a hurdle that's much higher, so it makes VCs and directors a bit jittery. It has put a damper on things."

This concern makes this summer's announcement of the formation of the Commission on Capital Markets Regulation something worth keeping an eye on. This independent, non-partisan group of U.S. business, financial, investor and corporate governance, legal, accounting and academic leaders plans to conduct a major study of how to improve the competitiveness of the U.S. public capital markets. They will issue recommendations regarding specific changes in regulation and legislation in November. According to news reports, the Sarbanes-Oxley Act is a primary focus for Commission members, who are concerned that the U.S. capital markets are losing their global dominance because of SOX. Any movement to make the legislation less onerous would surely be a boost to the IPO market.

## AIMING FOR AIM?

Another exit strategy to keep an eye on in the months ahead is the possibility of going public on London's Alternative Investment Market (AIM). AIM has seen a significant rise in the number of admissions in the recent past and as of August included 1,613 members, according to the London Stock Exchange. A recent Mirus survey of deal professionals found that, while over 50% of respondents believed NASDAQ will continue to be the dominant exchange, 70% of respondents

expect to see more firms switching from NASDAQ to AIM. In all cases, respondents agreed that AIM is bound to grow. As of August, 35 US companies have listed on AIM.

According to our survey, service providers believe that company size is the most important criterion prompting them to advise their clients toward an AIM listing. The average market capitalization for an AIM company is \$95 million, compared to a NASDAQ company's average of \$1.2 billion. According to Steve O'Leary, senior managing director at Jefferies Broadview, an investment banking firm in New York, companies should not pursue a NASDAQ listing unless they have long-term visibility to achieve at least a half billion dollars of market capitalization.

For many companies, AIM has served as a fund-raising venue rather than a liquidity venue. As Bob Fleming noted, "AIM is changing very rapidly. Right now it's absolutely a viable alternative for capital fund raising but there are pluses and minuses with getting genuine liquidity. Using it as a fund-raising event is fine, but the risk with that is that it's not clear how people are going to view that later in an M&A situation or a follow-on round situation."

Steve Ricci said he knows a number of companies that have considered AIM but doesn't know any who acted on it. "I think it's a lack of familiarity and experience with that market," he said "If they have a good property, they would rather hang on to it. If you sell 20% of your company on AIM, does that make it difficult to sell the whole thing three years later? When people look at NASDAQ, they know that eventually it could absorb all the float of the company, but it's not clear AIM will do that."

## BE ALERT FOR CHANGE

Company owners and investors have many reasons to be enthusiastic about today's M&A market conditions. We expect these favorable M&A conditions to persist, due to the abundance of private equity and debt capital and the return of increasingly active corporate acquirers. But as this article points out, there are also a number of issues that call for vigilance in the months ahead.

In today's global market, the environment you need to monitor includes developments here in the United States but also events abroad, such as the continuing emergence of AIM and other alternative exit venues. It's a lot to keep track of, but the effort should pay off in terms of steering your company toward achieving a well-timed exit.

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*Peter Alternative is a partner at Mirus Capital Advisors, Inc. Research for this article was done by Mirus interns Nishant Garg and Christoph Schadinger. Mirus is a middle-market investment bank that specializes in advising companies in strategic mergers and acquisitions. By combining a proven process, industry and transactional expertise, creative thought, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Mirus is a registered broker-dealer and NASD/SIPC Member. For more information, visit [www.merger.com](http://www.merger.com).*



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