

*Todd D. Peter, Evarts Capital*

## **M&A Forecast – Partly Sunny Today, Mixture of Sun and Clouds for Next 3 Years**

### ***Timing Issues in Selling A Company – 2010-2012***

In 2005 we admonished private owners (correctly we might add!) to “Catch the Wave” and sell in the 2005-2007 period. We admit no prediction of the calamity that followed in 2008-2009, but feel it appropriate to update our views on the M&A market for mid market private companies in the coming 2-3 years.

Unlike 2005, the picture is much more complex and subtle and we are counseling owners that capturing the trophy deal will take a close eye on the weather. The most distinctive characteristic of the deal market is a remarkable study in contrasts between clouds and sunshine. Carefully selecting the right time and approach to the market is critically important to a wonderful outing and avoiding lingering thunderstorms.

#### ***Deal Market Forecast – If You Can.....***

***.....Grab the Good Weather Today***

***Demand for good deals greatly exceeds today's supply***

***Supply of equity capital is enormous***

***Economy is showing solid rebound and near term strength***

***Companies showing strong performance are in a good position to sell now.***

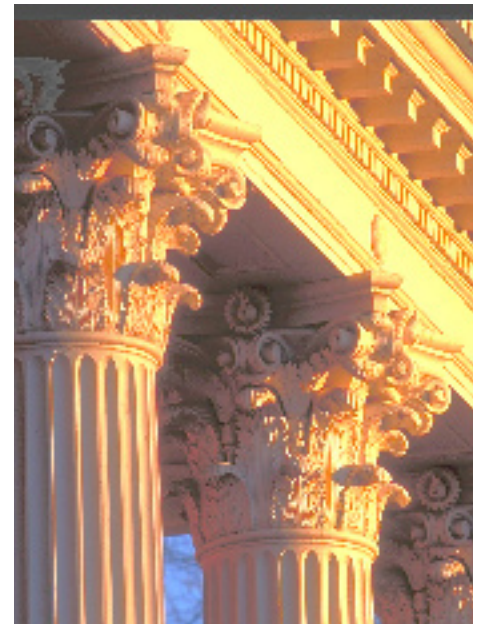
Although company specific factors account for ~80% of company's value, timing can add that icing on the cake. We summarize the key “deal timing” variables and our assessment of each in this article.

### **Deal Supply**

Most private businesses come to market as the owner approaches retirement. It is widely reported that private business only successfully transfer to a second generation in about 30% of cases. The market for exits for the last 2 years has been terrible and exits, if any, have been forced ones in distressed circumstances.

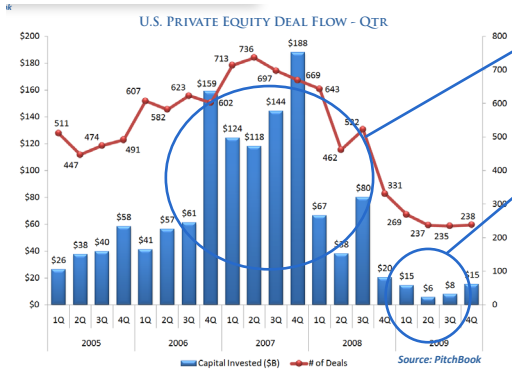
The “retiring population” (and presumably the retiring business owner population) with the long anticipated baby boomer peak is hitting stride beginning in 2011.

Private equity firms and the companies they own have become a significant part of the middle market. The fundamental nature of a PE fund requires sales/exits of their holdings after a 3-7 year holding period.



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The 2003/04 crops (investments) faced the same dismal exit prospects in 2008/09 and together with the 2005-2007 vintage will be coming to market in droves in 2010-2012.

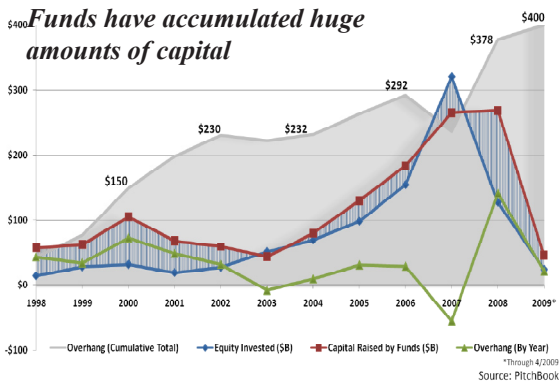
Thus while the dearth of deals in 2008-2009 has left the market eager for some good product to come to market, the supply will begin to surge as 2010/11 financial performance firms, the boomers begin to hit the exit button and overripe PE portfolios seek exits. Supply is the first of the bifurcated signals in the market. Companies ready for market today face a extremely favorable supply demand balance that will gradually diminish and move more to the buyers favor.

## Deal Demand

The demand for lower and mid market acquisitions is driven by three groups of buyers. First is the traditional exit path of a private company, the strategic corporate buyer. During the crash corporate buyers curtailed M&A spending to preserve cash and liquidity to weather the recession. Two years of cost cutting and consolidation have pretty much run the course, and with stabilizing and growing demand corporations flush with accumulated cash and reborn banking support are looking again for growth and have reentered the M&A playing field.

The private equity(PE) marketplace for mid market companies grew to over 50% of the mid market in the peak years with ever more capital focused on the middle market. During the recession the funds spent their time dealing with restructuring their investments and reacting to collapse of the lending markets. At present, despite lingering trepidation in some portfolio companies, the funds have enormous amounts of cash available to commit to new platforms. This huge capital overhang has PE sponsors chasing deals hard, committing “excess” amounts of equity to deals to get them closed despite the less than exuberant participation of the banking industry.

In contrast, PE returns to limited partner investors (LPs) have suffered with the cyclical bloodbath, deferred exits, and a number of outright deal failures due to over-leverage and the recession. Additionally, LPs face portfolio allocation issues due to the plunge in public markets, and are pulling back from new commitments and in some cases trying to wiggle out of existing ones. PE Funds in a capital raising mode are struggling to arrange new capital commitments.



In the 2005-07 period (see red line on fund raise graph) LPs committed huge amounts of capital to alternative investments including private equity. The “asset diversification thesis” has lost some of its shine and this influx driven by increased portfolio allocation percentages is likely to reverse. This factor added to public market declines and many pension funds now transitioning to net outflows, will increase PE fund raising challenges. There are some indications that sovereign capital will replace the pension/insurance capital as the mainstay of LP participants but this is likely a few years off and will impact only the large cap PE funds in the next 5 years.

Again on the PE front, a bifurcated signal. A huge supply of capital available today, but likely a reduced flow feeding the PE machine over the next few years.

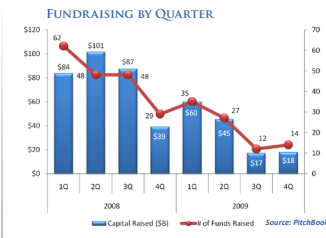
In the lower end of the mid market, typically deals under \$15 million, a key element of demand are the displaced senior executives from corporate life that are now out seeking to acquire an entrepreneurial business. These buyers are often supported by the smaller private equity groups or friends and colleagues. While recession has seen a new crop of displaced executives looking for deals, this “50” year old population is significantly smaller than the boomer group before them that built demand from this segment.

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## Capital Supply & Cost

The price a buyer is willing to pay for a company is driven by their cost of capital. The lower the cost of capital, or expected return, the higher price a buyer can pay. Lower cost of capital increases deal prices.

In 2010 the supply of capital is again a study in contrasts. The banking industry has rebounded from the pessimism and virtual death in 2009 but overall remain somewhat skeptical of new deals. Lending ratios are improving but at lower multiples than in 2006/07. Cash flow lending is returning with reports of moderate leverage particularly for deals over \$5M in EBITDA. In lower mid market deals many traditional banks have developed an almost obsessional focus on tangible capital collateral. The bank lending market is a downside to current deal activity but should gradually improve as banks right themselves and return to their core business of lending money.



**Recent fund raising challenges are likely more severe than average but indicative of a long term trend**

Additionally, the private capital markets are beginning to spawn a number of new non-bank lenders in the to fill the gap left by the traditional banks. This is some relief especially for larger mid market deals but nothing like the hedge fund lending euphoria of 2007.

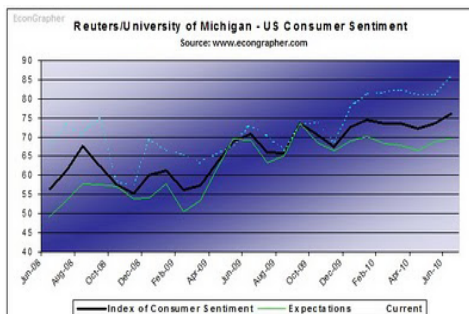
The private equity funds are motivated to put capital to work and are committing to higher equity capitalization of deals. Many funds are using “equity” to fund the equity portion and a “mezzanine” portion of a deal with expectations of refinancing later or reluctantly accepting a lower blended return as better than idle cash. This factor plus the LP factors discussed earlier generally indicate a higher cost of capital.

The private entrepreneurial buyer have taken a punishing blow to their personal retirement funds and as a result are conserving their capital tightly and are ever more price frugal then before.

Capital supply today is unquestionably lower than compared to the flush years of 2006/2007. The combination of plentiful equity and scarce debt capital are at present somewhat offsetting, except for the smaller entrepreneur deals. The trends in both equity and debt capital supply argue for similar offsets in supply levels over time. Thus the heady days of 2006/07 do appear to be a peak in capital supply and deal pricing. For the next 3-5 years the overall supply of capital, with a shifting mix, is likely to remain stable and supportive of transactions but fundamentally at lower multiples than 2006/07.

## Economy

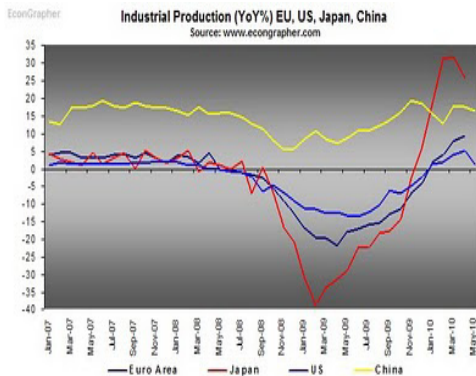
The consensus of most economists and their forecasts calls for moderate growth and recovery from the horrendous years of 2008-2009. We see this in almost all our client contacts across the Midwest where most businesses are reporting solid growth from the bottom of the abyss. Few have returned to pre-recession levels of sales but progress is steady. Unemployment remains high as pre-recession levels of output have not been reached and virtually every CEO has a superb short term memory of the painful and deep cuts required in the last 2-3 years and wants no part of overshooting rehiring. Despite this consumer are showing some sign of life.



There are a great number of pundits, politicians, and purveyors of an oncoming apocalypse driven by the huge governmental deficits (in the US and abroad) and still rather tenuous state of the real estate and banking industry. We expect slow and gradual improvement as world economies improve and some combination of managerial judgment and regulation damps the excesses that sent the real estate and financial services industry into a tulip(Mortgage security) mania and frenzy in 2006 and 2007. Resolving the overhang of boomers Social Security and Medicare liabilities will require politically painful and generally non-stimulative actions ( higher taxes, reduced spending, reduced benefits, or excessive governmental borrowing).

The world economy will be increasingly influenced by two macro trends. First is the aging of the boomers in the US. US consumers are world champion spenders and a large population segment is aging up out of the peak spending years of 45-60 and being replaced with a much smaller group. This relative lack of spending will damp US consumption especially in the housing arena. Offsetting this damper somewhat (but not in housing) will be the transfer payments from Social Security and Medicare that will be a net “spend” stimulating consumption.

Second is the booming growth in India and China. With nearly 40% of the worlds population, these two economies with the requisite bumps and overheated booms, will be driving world economic growth. From a global perspective the Asian boom will more than offset the US moderation in share of world wide consumption.



The interplay of these consumption dynamics, global capital flows, exchange rates, and trade imbalances will prove to be the key to understanding economic cycles in the next 10 years.

What it all means in the next 2-3 years for M&A is certainly less dramatic. We expect and are seeing increased activity by Indian and Chinese firms to deploy capital, access capabilities and establish physical market presence in the US. We expect the outsourcing to Asia trend to moderate as wage differentials narrow a little, as local (Asian) demand grows reducing export sales' allure, as transportation costs (oil) remain high and (eventually) as the Chinese Yuan reaches higher valuation levels. These trends will support relative strength in the US manufacturing sector.

The present macro economic conditions again mirror the ying yang nature of todays market, with near term improvements but significant longer term uncertainties especially relative to domestic US growth. Services and anything consumed by baby boomers will enjoy relative prosperity and manufacturing will stabilize from the wrenching double hit of globalization and the great recession.

## Company Specific Factors

A company's financial performance and industry factors are the most significant drivers of value. The normalized cash flow performance of the company will have the largest impact on company value. Healthy companies are seeing returns to pre-recession profitability and cashflow even though sales are still below peak. Once a return to normal has been demonstrated the stigma of the recession will be washed from the sale process.

Industry characteristics and growth prospects will impact value. A company outperforming its industry growth rates will be able to attain superior valuations even when broader metrics may be less favorable.

A company may find that their industry sector is highly sought after. This is particularly true in 2010. Industries in particular demand include business services, health care and health related services in any segment removed from direct reimbursement risks, environmentally greenish/energy industries, education, and consumer products isolated from big box pressures.

## Summary

**If your company performance is back on track, or never fell off, it is a FALLACY that the “time to sell” will clearly improve over the next few years and that you should kick the process out a few years.**

**Conditions today for many mid market deals (for all the reasons discussed above) are likely to be as favorable to sellers as we can expect for the next 2-3 years.**

**Sellers looking to come to market should carefully gauge the availability of capital for THEIR deal and seek to establish a deal process that focuses attention with key buyers.**

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