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THE LENDING ENVIRONMENT

M&A Outlook: Sellers to Emerge

Bargains Await Those with Available Cash

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Many of the so-called "experts" who were writing market forecast articles a year ago probably wish that they could remove all traces of those writings from the Internet. Even Warren Buffett has had his share of bad days in the current market environment.

Granted, difficult times create unique opportunities for those in the turnaround field. However, this market is very different from the economic downturns of the past, and the market opportunities are different as well. With that in mind, here's what many advisors and observers foresee for the 2009/2010 outlook.

What's for Sale, Who's Buying?

Despite the gloomy marketplace of the current economy, sellers may begin to emerge this year. Mergersunleashed.com said recently that an "aging baby boomer/business owner factor" is an interesting unknown that could tip either way. Many firms have enjoyed record growth over the past few years after persuading their "aging" owners to keep their hand in everyday management longer than they might have otherwise. In the current, more difficult economy and with the possibility of increased capital gains rates, these owners may choose to get out now or, conversely, decide to hang on until the market outlook improves.

Distressed companies are also on the auction block — which often draws the interest of strategic buyers. Unfortunately, many companies are going bankrupt because their lenders are more interested in removing problematic assets from their balance sheets than they are in staying the course with borrowers.

Even though strategic buyers have cash on hand and may be getting ready to re-enter the marketplace, they need financing for their deals, as do private-equity firms. Although money is waiting on the sidelines, the tightening of the debt markets has caused many to fund transactions solely with cash equity, which impacts returns and lessens deal flow.

Even though there are bargains to be had, what remains to be seen is whether buyers choose to expend the additional cash required to maintain these businesses until market conditions stabilize.

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Any Bright Spots?

These days, "hot" sectors and "hot" geographic pockets are relative terms. In most parts of the United States today, the words to remember are healthcare, healthcare, and healthcare. For many firms, it's the only industry in which they can get deals done.

On an international level, recent pharmaceutical deals involving Merck/Schering Plough and Pfizer/Wyeth accounted for about $115 billion during the first few months of 2009. More consolidation can be expected as pharmaceutical companies react to the possible impact of the Obama administration's commitment to revamp the healthcare system, as well as internal issues, such as upcoming patent expirations and the need to improve drug development pipelines. Some analysts believe that pharmaceutical firms must take a longer term view, driven by events in a three- to five-year window, in considering acquisitions that can expand their pipelines, improve their geographic and therapeutic reach, and diversify their revenues.

In other segments of the healthcare industry, current multiples are making some deals almost irresistible, although still at levels below those of the same period a year ago. The major constraint is cash. Reports indicate that companies have sold noncore assets to raise capital either for ongoing operations or to make strategic acquisitions, even though these acquisitions are smaller than previously seen.

Smaller is not necessarily worse, though, as industry observers note that these middle market deals are focused and opportunistic, and motivated by the need to capture greater market share, replenish revenue, and consolidate fragmented markets.

Where's the Money?

Although private-equity firms have cash, the lower return on investment (ROI) created by lagging bank lending makes investments much less attractive. The *Dow Jones Review* recently reported that buyout firms are shifting to such strategies as all-equity deals, reducing ownership stakes, and asking for seller financing — all related to the need to find more unconventional ways to put their money to work productively.

An even larger issue is the uncertainty about how long the economy will remain weak, based on still-increasing job losses, a stagnant stock market, and a rising default rate. Private-equity executives expect ongoing weakness for the time being, particularly in consumer sectors, such as entertainment, media, and retail.

Naturally, these same factors create opportunities for distressed debt firms and turnaround professionals, but these opportunities often have a short fuse.

Here's an example of how this situation impacted a manufacturing company tied to the housing industry. In its heyday, the company had annual revenues of up to $80 million. In 2008, the company believed it had a deal with a private equity firm and a bank, each of which

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would contribute $5.5 million to take out the existing bank debt and shore up operations.

When the credit markets seized up, however, the new bank backed off the deal, and was followed shortly thereafter by the private- equity firm, leaving the company with its existing bank debt. The company had not "right-sized" during the same period, nor had it concentrated enough on sales because of its focus on the deal.

At the same time, its dealers were unable to obtain financing, and consumer demand shriveled, leaving dealers with inventory they could not sell. The upshot was that the company could not meet its obligations to the bank and found it necessary to sell its assets to a competitor. It was not a satisfactory conclusion for a company that was more than 25 years old and whose owner was left with nothing but a paid-off bank note.

Another example was a 20-year-old family-owned manufacturing company that had been lulled into a false sense of security by its success over the years. That success had blinded the company to its weaknesses in sales and operations, which were exacerbated by the owner and the bank not being as diligent as they should have been in monitoring business performance.

Even though the company called in a restructuring firm, it was too late. The company owed $5 million and was forced to sell its assets for $1 million.

The lesson is that the waiting game does not usually work in a company's favor. Success may mask underlying weaknesses, which are then detected too late to save the business.

Lessons to Learn

The very nature of capitalism is that there will be failures, and as these examples demonstrate, positive economic periods often hide systemic weaknesses, keeping companies propped up beyond their underlying capabilities.

This has been compounded in the past by a presumption on the part of businesses that if a private-equity firm showed interest in a company, banks would follow on the basis of the private-equity firm's due diligence. More companies now understand that all players are wise to perform their own due diligence — including a business' management — to get an objective view of a company's strengths and weaknesses and to make whatever corrections are necessary to maintain profitable operations, with or without a deal.

Private-equity firms do have cash, but it's still on the sidelines. However, they will not wait forever. Their investors have adjusted their expectations on returns, and eventually more and more of this cash will come into play. Similarly, strategic buyers are taking a wait-and-see approach, enjoying the luxury of cherry-picking for the best opportunities available.

Lowered end-user demand is already leading to consolidation within a number of industries, often through asset sales, offering huge bargains for companies and investors that have enough cash on hand. Many observers believe an uptick in investment activity may occur in late 2009 as banks re-enter the lending market to start making money.

In the meantime, there are other interesting observations to be made. First, as Buffett said recently, albeit speaking of consumer attitudes: people are afraid and confused. Fear is contagious, and people get fearful quickly. When they are fearful and confused, they don't regain confidence for some time and need clear messages to adjust their attitudes and behaviors.

On the plus side, these troubled times could lead to one of the largest entrepreneurial spurts the U.S. has seen in some time, as laid-off executives and managers start their own businesses and foreign investors begin to pick up some of the bargains that are on the table.

Who will be the earliest winners as the economy starts to pick up steam? For buyers, valuations are more favorable than they've been in more than 15 years, and competition is shrinking for the deals. In addition, there are a number of talented managers on the street looking for opportunities, many for the first time in years. For sellers, the key is to go back to basics and identify and shore up weaknesses in sales, marketing, and operations.

Solid companies in stronger industries probably will rebound the fastest. The wisest business owners are those who continue to do the blocking and tackling necessary to stay strong and keep their eyes open for opportunities. But they also should stay in touch with their bankers and other lenders. There's a lot of competition for lenders' attention right now. CR

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