

Feature

A Grind

The data reflects how hard the past six months have been for dealmakers, though some see signs that M&A could start to pick up

By Avram Davis

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It was only six months, but the first half of 2009 likely took years off of the lives of most dealmakers. It doesn't matter how the data was sliced, by any measure the first half of the year represented a dismal stretch for M&A. Continued unrest in the credit markets, economic weakness, and a thick, hovering cloud of uncertainty conspired to blanket deal activity for the first six months of 2009.

Global M&A volume for the first six months, at \$941 billion, plummeted by more than 40% compared to last year, according to Thomson Reuters, with more than half of the activity confined to just three sectors — financials, materials and energy and power. Dealogic, meanwhile, painted an even uglier picture for the private equity space, registering an 82% drop in the volume of global buyouts. And Robert W. Baird gave the middle market little reason for cheer, documenting a more than 25% dropoff. As might be expected, the only good news could be found in the distressed space, which saw the default rate climb to 9.2% in June, as year-to-date corporate defaults totaled 119, according to Standard & Poor's.

The deal community, however, is not about to throw up their collective hands and walk away. Rather, most are keen to work within the new confines of the market to help companies and investors find and seal deals. And many pros note that periods of “creative

destruction” are critical for buyers to capitalize on dislocations, even if they have to rethink their approach.

For instance, many private equity investors are exploring structured minority stake deals as a way to put capital to work. Most traditional private equity firms would normally eschew these kinds of transactions, as control has always been paramount to most buyout strategies. But these aren't normal times. Lime Rock Partners, BC Partners, Mistral Equity Partners and Warburg Pincus were among those that sealed minority-stake deals in the first half of the year.

“It's an opportunity to make an investment in a good company,” Steven M. Dresner, president of Dresner Partners, says. “That's preferable to not making an investment at all.”

For the most part, these types of deals are balance-sheet plays, in which financial sponsors come in with equity to fill a hole that had previously been plugged with debt. Some structures can cushion buyers' risk, but by and large these transactions are more complex than the 2007-era buyouts.

Phil Curatilo, a principal of Key Principal Partners Corp., notes that the complexity involved can add a different layer of risk for investors new to these types of deals. “They think it will be like other acquisitions they've made, but then they get the legal docs, and they're blown away,” he says.

Meanwhile, deal pros are anticipating other changes to the market. **Matthew F. Herman**, a corporate partner at **Freshfields Bruckhaus Deringer LLP**, for instance, points to weakness in the dollar and notes that he wouldn't be surprised to see foreign buyers renew their interest in domestic assets. Particularly, he cites European-based corporate buyers and sovereign wealth funds as likely acquirers.

H. Hiter Harris III, co-founder and managing director of **Harris Williams & Co.**, agrees, saying he is expecting foreign acquisitions to increase during the second half of the year. "Sovereign wealth funds have stepped back a bit," he observes, "but I think it's a temporary situation."

Herman, however, is careful to note that these buyers will have to be confident about the long-term prospects of the US before they commit. "At the end of the day, you're buying a dollar-based revenue stream, and you have to deal with that after you buy the company," he says.

As it relates to domestic activity, most onlookers anticipate corporate-driven M&A will dominate the landscape. Those with clean balance sheets are expected to capitalize on the weakness of their peers to consolidate the marketplace.

This is especially true for growth sectors. The Obama administration's focus on health care, particularly health care technology, has not gone unnoticed. **Hyland Software**, for instance, acquired **Valco Data Systems** in the first week of July in a deal that bolsters and expands the services of the health information management company.

Meanwhile, the hit on performance is forcing corporate chiefs to reconsider which areas they want to focus on. **Phil Seefried**, chief executive of **Headwaters MB**, describes, "When there is so much volatility, companies look very closely at their business units. That is vastly different from the budget cycle from January to March."

The end result will likely see corporations skim out

the underperformers from their portfolios, translating into more dealflow for both strategic buyers and private equity firms.

Also, those with a taste for a turnaround should expect to see even more opportunities in the coming months and even years.

Andrew Vogel, managing director at **ZM Capital**, describes that in addition to structured equity transactions, the only other type of deal he is seeing today are distressed sales, "involving sellers who need to sell an asset pretty quickly." He adds that he doesn't foresee any slowdown in these types of transactions.

Milacron, **Tropicana Las Vegas Hotel and Casino**, **Greenbriar**, **Filene's Basement** and **Eddie Bauer** have all been sold out of bankruptcy recently.

When deal pros find a bottom to the market, few expect a sharp bounce will follow. Rather, both buyers and sellers will find ways to accommodate the uncertainty that clouds the marketplace. Earnout mechanisms will become more popular, seller financing will increase, and minority-stake transactions will increasingly become the investment of choice.

When it comes to actually finding the bottom, deal pros will largely be waiting for the lenders to come around. And while new BDCs or mezzanine funds certainly help, M&A pros more interested in the investment banks and other senior, cash-flow lenders. In the meantime, increased activity from the regional

banks — drawn to asset-based facilities — is one positive sign, and many private equity buyers have accepted the fact that deals are going to require a higher equity component.

To be sure, dealmaking today and for the foreseeable future will continue to be a grind. But some believe that they're seeing signs that the market is regaining its feet. **Brent Knudsen**, founder of PE firm **Partnership Capital Growth**, notes that over the past year, investors have used their time on the sidelines to establish a new gameplan. "People are just figuring it out now," he says. "But it takes a year for them to get it." **MA**

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