

Livingstone

Outlook for Mid-market M&A in 2009

Livingstone investigates the potential for an improving UK M&A situation for owners of mid-market companies contemplating an exit in 2009

February 2009

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Introduction

The difficulties confronted by the financial markets across the globe have been intimately documented over the last 16 months. Its effects on the mergers and acquisitions (M&A) market has also been explored exhaustively, albeit with a pre-occupation with the virtual standstill in activity within the 'mega-deal' arena.

Of course, much smaller transactions dominate the M&A markets by volume - if not value - and the experience of this 'mid-market' (for the purposes of this article, deals with values of £10m to £100m) has been very different until relatively recently.

This article offers a quick and personal review of recent events in the mid-market and attempts to point to the potential areas of greatest opportunity over the course of 2009.

2008 in the mid-market

August 2007 heralded the dawning of the 'credit crunch' and a dramatic withdrawal of leveraged debt from many of the multi-billion deals that marked the high point of the most recent period of M&A deal-frenzy. The seizing up of the wholesale credit market for institutions lending into these large deals was immediate and absolute as the consequences of the US sub-prime crisis rippled across the global financial markets.

At the time, many in the mid-markets saw the credit crunch as specific to the mega-deal market. Even at its most ebullient, the mid-market struggled to obtain leverage debt multiples of 5x EBITDA (earnings before interest, tax, depreciation and amortization), and 3.5x to 4x was the norm. This compared to multiples of 7x or even 8x for much larger deals. The fact that credit was no longer available to the largest deals on these heady multiples felt very much like a much-needed correction and normalisation, rather than the start of a deep downward spiral.

The UK mid-market continued to tick over in late 2007, receiving a considerable filip by the decision of the UK Government to increase the capital gains tax burden on private company owners selling their businesses after 6 April 2008. This led to a significant rush to the exit door among unquoted company vendors in Q1 2008 as they sought to crystallize value at the lower prevailing 10% tax rate.

During the intense ensuing activity, mid-market advisors often felt as if they occupied a parallel universe. As global M&A markets melted down around them, they remained frantically pre-occupied with beating the April 2008 deadline. However, any complacency was soon dispelled in the early Summer as the UK leveraged debt community - populated by the same financial institutions that had been lending so aggressively to the mega-deal market and relied so totally on the wholesale credit markets - started to rapidly withdraw from lending to mid-market transactions.

Where did all the Debt go?

Those stalwarts of the UK mid-market lending community - HBOS and RBS - began scaling back their activities in early 2008, followed quickly behind by Barclays. Whilst professing to be open for business, the reality was that their terms of business were (and remain) penal and they had become highly selective about the deals they backed. Lloyds TSB and HSBC were left among the High Street banks to wave the flag, taking full advantage of their competitors' withdrawal. In quick succession, the new pretenders of the mid-market - the Icelandic and Irish banks - then also exited stage left in complete - and in some cases, terminal disarray. Clydesdale and Yorkshire Banks (both part of National Australia Bank) suddenly leapt to prominence as the last men standing in the mid-market. This is a position that they maintained until the end of 2008. Their appetite for deals in 2009 remains to be tested.

Throughout 2008, mid-market advisers struggled to close deals in the face of the apparent capriciousness of the debt markets. Leveraged debt teams at all the above institutions were mandated to find deals to back, but no-one could tell - least of all those very teams - whether their credit committees would sanction a specific deal until a few days before the deal was due to close.

As the major banks decide upon their 2009 allocations for mid-market leveraged lending, this uncertainty is likely to continue to dog deals well into the New Year. Banks are seeking to align themselves with acquirers and PE investors that they regard as strategically important to them. Advisers must therefore rise to the additional challenge of understanding how these new axes of influence can be exploited to their clients' advantage.

Who's Buying?

The last quarter of 2008 saw a significant fall-off in mid-market M&A activity, principally driven by the intensifying credit crisis and a pervading sense of uncertainty about what 2009 has in store for the global economy. Private Equity houses could not raise the debt required to fund their deals; trade buyers simply seemed reluctant to participate.

We do not expect the availability of acquisition debt to ease before the end of H1 2009 and for any subsequent improvement to be slow. However, overall, we do expect M&A activity to demonstrably start benefitting from PEs and trade buyers having readier access to credit by Q4 2009. PE investors in particular will be eager to deploy their capital over the next 12 months, with many looking to 2009 as a potentially excellent 'vintage' for new investments. They will however need to see the banks supporting these ambitions as there is still limited appetite amongst mid-market PEs for taking 100% of the initial funding risk to close a deal on the uneasy assumption a refinancing might follow in shortly afterwards.

Trade buyer activity in Q1 2009 is likely to focus on taking advantage of distressed - or just plain stressed - opportunities as they present themselves. As corporates remain skittish and reluctant to dip significantly into their existing banking facilities for acquisitions, most M&A activity will be seen at the lower end of the deal size market, in particular in the £10m to £25m arena.

The relative weakness of sterling against the dollar and euro is likely to bring opportunistic US and continental European buyers back to the deal table earlier than would otherwise be the case. For US buyers, UK acquisitions are 25% cheaper today than in mid-2008.

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Who's Selling?

Also looking to take advantage of the currency window above, UK groups may be tempted to rationalise their US and European portfolios by divesting assets there rather than in the UK. Corporate vendors are likely to play an important role in mid-market M&A 2009 as they reflect on the acquisitions they have made over the last five years, on their new strategic priorities, and those with higher levels of gearing look to bolster their balance sheets.

The PE community is unlikely to be a proactive seller in 2009 where houses have the luxury of holding on. However, some attractive exit opportunities will emerge from portfolio companies acquired in 2004 and 2005 or where the natural fund-raising cycle requires houses to crystallise value as evidence of past success.

The owner manager community will continue to provide the greatest volume of mid-market M&A opportunities. Private company owners frequently consider exiting for personal and practical reasons other than value maximisation: retirement, health, succession - or the need to be part of a larger group to fulfil a business's potential - all providing valid reasons for a sale.

As the credit markets start to recover, there will be a modest recovery in company valuations from the artificially depressed levels seen in Q4 2008. However, it is unlikely that valuations will experience a material rebound before 2010, and for vendors with a need to exit in the short term there may be limited benefit to delaying a sale process beyond Summer 2009, especially where the opportunity is likely to appeal to strategic buyers.

And What Should Vendors Expect?

Who's In or Out - Sectors

The difficulties faced by the property, retail, leisure and FMCG sectors are well understood and market fundamentals are unlikely to support optimal valuations other than for exceptional opportunities. Unsurprisingly, business owners operating in sectors offering the best protection from recession are in the strongest position to realise best value in 2009.

In the mid-market, these sectors are likely to include organisations with a significant reliance on public spending, ie. those serving the infrastructure, education and healthcare sectors. The oil and gas, power (in particular nuclear) and environmental arenas will continue to offer exciting opportunities as the structural globalisation of their markets maintains momentum behind M&A activity. Companies with exposure to the international Defence and Security markets will also be beneficiaries of acquirers' sharper focus in these sectors. Lastly, certain areas of the Industrial sector are likely to see an increased flow of deals, supported by cheap sterling, easier raw material prices, low interest rates and renewed interest in manufacturing among the investment communities.

Go Slow

M&A processes are taking up to nine months to complete in the current market, compared to around six months in 2007. Three key factors are driving this additional time burden: firstly, the nervousness with which acquirers are approaching new opportunities; secondly, the greater thoroughness of their due diligence; and finally the shift in the M&A market from a 'Seller's Market' to a 'Buyer's Market' has made it far harder for sellers or their advisers to force through aggressive timetables in auction-style processes.

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Plan well ahead of the sales process to limit delays on transactions.

The former factor is a reflection of acquirers' greater selectivity when offered a new acquisition opportunity. A combined sense among purchasers of having less financial firepower and no clarity of the macroeconomic outlook for 2009 is making them extremely 'picky' about the targets they will invest time in. The two latter factors are a function of a heightened level of risk-aversion and a need to see a specific acquisition's medium-term prospects verified to a much greater extent than would have been the case in a more optimistic 2007.

Be Prepared

The best way of limiting time delays on transactions - and therefore the distraction to and burden on a target company's management - is to plan well-ahead of the sale process commencing in earnest. In addition, whereas acquirers have been pre-occupied with financial due diligence in recent years, there will be a new emphasis on market and customer (or 'commercial') due diligence, as acquirers focus on a target's immediate prospects, specific market dynamics and competitive positioning. During 2009, better value for money may therefore be extracted from vendors commissioning commercial due diligence reports before contemplating vendor financial due diligence.

Bespoke is Best

Exceptional and desirable mid-market companies will still be capable of supporting the highly orchestrated competitive sale processes that have become de rigour in the mid-market in recent years. However, companies such as these are relatively few in number and the majority of sale processes in 2009 will need to become more accessible and constructive to attract the right purchasers and sustain a genuine level of competition.

This need not mean that the end result of an outstanding deal need be any different, but it will require a different cultural approach to be adopted to managing sale processes to ensure buyers' meaningful participation - rather than deterring them from getting involved at the outset.

Think Ahead

Taking into account the above factors, vendors committed to achieving an exit in 2009 should be taking action now in anticipation of marketing their businesses in June/July and closing the deal in November/December. Selecting advisers and anticipating the demands of the sale process is easily a four to five month process if it is to be done properly and the business taken to market with poise. Equally, sellers considering an exit in 2010 should be thinking well ahead and contemplating the need to start the preparation phase in August 2009.

As the PE market remains fitful in 2009, vendors must be more realistic about their options. Strategic acquirers with cash to spend now offer sellers a much more certain solution than the PEs. Those contemplating a sale to a management team must recognise that this route currently offers little or no valuation upside and may require sellers to provide a high level of ongoing commitment to the business in the form of a vendor loan. In addition, to maximise value such deals must deliver PEs and debt providers a 'perfect trinity' of a proven and high calibre management, revenue and profit growth in the face of recession and a robust order book or contractual visibility to support that growth.

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About Livingstone Partners LLP

Livingstone Partners is the leading investment banking boutique specialising in cross-border company sales, acquisitions and private equity transactions with deal values ranging from between £10m and £100m plus. With offices in the United Kingdom, continental Europe and the United States, Livingstone is the only mid-market M&A boutique with a international infrastructure capable of delivering immediate access to buyers, investors and opportunities across two continents

We deliver expert corporate finance advice and practical help to groups and companies from around the world concerning:

- Exit Strategy;
- Company Sales;
- Corporate Acquisitions;
- Management buy-outs & buy-ins;
- Capital Raising;
- Debt Restructuring; and
- Cross Border Deals.

Livingstone focuses on four core sectors and has dedicated teams operating in the Business Services, Consumer, Industrial and media:tech markets.

About the Author



Following graduation from Cambridge University and law school, Jeremy joined Clifford Chance, the international corporate law firm. Since qualifying as a lawyer in 1991 Jeremy has specialised in M&A in the public and private company arenas.

Jeremy joined Livingstone in 1993, he has led over 100 deals in a variety of sectors including defence and automotive engineering, printing and packaging, building products and consultancy.

Jeremy is primarily responsible for leading the firm's Business Services sector team, with a focus on the Consultancies and Facilities Services markets but is also active in Defence & Security industries. Jeremy has played an active role in developing Livingstone's international M&A capability.

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