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Good deals will get done in middle-market M&A

By Dan Reid, National Managing Principal,Transaction Advisory Services

The most recent active mergers and acquisition period has caught most by surprise. Many believe that it is likely to lead to reduced activity in private equity M&A as a whole. While we expect to see some changes in the upper and mega-market private equity deals, we do not foresee a complete fall off in activity and we believe middle-market private equity activity will remain robust with certain changes expected. Here is a brief glimpse of what we see unfolding in the next few months:

1. Many of the larger private equity firms that rely on public debt markets or more esoteric financings, specifically high yield debt and other debt with covenant-lite or no-covenant features, will be most heavily impacted by the credit crunch. We would expect to see buyers going back to the table to figure out different financing structures or terms for their transactions. Recent examples of this include TXU or Home Depot. Specifically the Home Depot deal reportedly has been restructured to include the seller retaining more of the company, different financing sources and other new terms. While we believe most of the deals currently on the table will get done, you should expect to see some "re-drawing" of the terms to do so. Going forward, the larger deals will be structured so as to take into account the changed credit environment. We might see some decrease in multiples as sponsors are less able to rely on debt to reach the "edge of the envelope" in terms of putting together a winning bid.

2. The good news is that most middle-market deals rely more on traditional capital structures involving senior debt, more traditional mezzanine debt and sponsor equity. Since these types of debt are less impacted by the current credit crisis, middle-market deals will be less adversely impacted by the recent developments in the credit markets.

3. Traditional banks and lending sources still want to finance good deals. At the end of the day, this is the business they are in, and even in a tight lending market, they need to put their money to work. Therefore, look for traditional middle-market lending sources to continue to finance quality deals.

4. At the same time, buyers will focus on making sure their lending sources are on board early and kept in the loop so as to avoid last-minute surprises. The need to work closely with lenders increases as credit markets tighten. Banks will be more interested in the results of due diligence and will be more involved throughout the process. We have already seen lenders much more involved early on in the process on recent transactions. >

5. Middle-market deals tend to involve private companies; therefore, inherently these deals have a greater degree of flexibility when it comes to finding a way to structure the transactions. Look for increased use of seller notes, earn-outs and seller rollover equity as tools to bridge the gap between seller expectations and buyers' ability to finance the purchase price.

6. Private equity firms continue to raise capital from investors and that, coupled with the existing overhang, means that significant volumes of capital are available and need to be invested in M&A.

7. This recent period with high M&A activity levels is different from what we saw during the period of the late 1990s and early 2000s in terms of the quality of the underlying portfolio companies. Following that prior active period, many private equity firms found that they needed to devote significant amounts of time working on underperforming portfolio companies. However, having learned from this, most private equity companies seem to have kept their eyes on the ball as it relates to their portfolio companies and seem to have emerged from this active M&A period with a strong portfolio of companies. As a result, these private equity firms will be able to stay focused on an investment strategy without turning their efforts around or "fixing" existing portfolio companies.

8. Cross-border deals will continue to drive deal volume. United States private equity firms have an increasing interest in global outbound deals. Likewise, inbound money from India, China, Europe and elsewhere will add to the already competitive transaction environment.

9. Strategic buyers are becoming more active in the M&A arena. The emergence of strategic buyers, coupled with previously mentioned increased cross-border activity, will keep M&A activity levels high.

10. Private equity firms will not be able to turn to refinancings and recapitalizations as a means to achieve liquidity for their portfolio investments. Anytime we enter tighter credit markets, these alternatives become more difficult to structure. Without recapitalizations and in a less than frenzied IPO market, sales of portfolio companies may be the best way to achieve liquidity for a private equity firm. Thus companies that in the recent looser credit environment might have been recapitalized and held by a private equity firm, now might be put on the auction block. Perhaps we might experience an increase in the number of sponsor-to-sponsor deals.

As in all markets, even in a down market, good deals will get done.

Given the recent pace of deal flow, any of these factors that continue to support M&A activity will go a long way to maintaining robust middle-market activity, even if the pace slows down for other reasons – such as more selectivity in investing and tighter scrutiny by financing sources. All of this should mean that while we might not maintain the frenzied pace of the last couple of years, we do not expect to see any significant slowdown in middle-market M&A. ■

Cross-border mergers to play major role

By Harris Smith, West Region Managing Partner and Dan Reid, National Managing Principal, Transaction Advisory Services

Cross-border mergers, which have been a key driver of record worldwide merger volume, will continue to play a major role in boosting global M&A figures, according to a new study by Grant Thornton and the Association for Corporate Growth (ACG).

According to respondents to the ACG/Grant Thornton/ Eureka Private Equity survey of middle-market private equity and company dealmakers, 75 percent indicate that they have been involved in a cross-border transaction at least once and 74 percent say they are likely to be involved in a cross-border deal in the next 12 months as a buyer, seller, adviser or in some other role.

These findings are in line with the general upward trend noted by Thomson Financial's second quarter 2007 Mergers & Acquisitions Review released on July 2, 2007, which reports that cross-border M&A accounted for a record high [47 percent] of all deals conducted in the first six months of 2007.

We believe that the trend to a higher level of cross-border transactions is permanent and long term, and unlikely to be reversed by transitory speed bumps in the debt markets and other phenomena.

Why cross-border?

Historically we often thought of a cross-border strategy being driven primarily by corporations and private equity firms looking to diversify geographically, as they seek to establish manufacturing operations in places where they can produce goods less expensively. Now we are seeing a trend develop that places an emphasis on a desire to reach new consumer markets such as China and India, and the need to be close to existing customers who themselves have gone global. In addition, buyers are finding attractive acquisition candidates in many locations, sometimes available at more reasonable multiples.

Recently, key elements have fallen into place to make it more efficient for corporations and private equity firms, and the investment bankers with whom they work, to reach across borders to invest in, merge and acquire companies. Behind this phenomenon is a developing financial and technological infrastructure that facilitates business strategies which were not economically feasible less than a decade ago.

Developing regions

Developing countries, particularly the BRIC countries (Brazil, Russia, India and China), present unique opportunities to access growing new markets and to tap into an increasingly educated workforce at highly competitive rates. Although there remain significant players interested in investment in developing nations for their raw materials and relatively inexpensive labor force, more companies have targeted these nations for the expanding markets they represent.

Developed regions

Acquirers still find good reasons to consider acquisition opportunities in the more mature developed countries. Although the cost of production can be higher compared with developing regions, high per capita income continues to make them attractive markets in which to sell goods and services. The most interesting opportunities often result from strategic investments designed to enhance existing operations.

> "In the United Kingdom and the European Union, due diligence is more exhaustive than in the United States," says Dennis White, ACG Director and a partner in the Boston Corporate Practice of McDermott, Will & Emery LLP. "The European Union countries are generally less litigious societies, and in those countries it is presumed that the buyer has the responsibility to adequately kick the tires."

Due diligence

Due diligence is essential for any deal, but when the potential for risk increases in unfamiliar territory, special vigilance is warranted. Due diligence is more complex in cross-border deals. It requires treading lightly on cultural matters, such as the issue of pride and trust, while also getting the professional guidance necessary to understand investor ramifications of the legal framework and accepted business practices in the target country. Before investing in a target company, dealmakers must first invest the time to understand key aspects of the business environment, from unique business practices in day-to-day operations, to the workings of the legal system, human resource considerations and any practices necessary to maintain customers.

Once they have these answers, they must ask themselves if they are still willing or able to proceed given all existing factors. In the global market, challenges abound. Merger professionals must be sure to work with reputable service providers who understand both foreign and domestic business requirements. Clearly, the new global market offers tremendous opportunity. Gearing up for the challenge will mean asking all of the right questions and tapping all of the most appropriate experts.

> "Especially in the United States, a lot of private equity and corporate dollars are chasing fewer and fewer deals, forcing US dealmakers to look elsewhere to deploy capital," said Paul Stewart, ACG Chairman and Principal of PS Capital Partners. "Fortunately, cross-border investing has become increasingly easier to do as technology has made the world a smaller place, with many parties making use of electronic data rooms to facilitate deals...."

Cultural issues

At the end of the day, nothing can substitute for getting to know the people and customs of the country where you are looking to make a cross-border investment. While technology can significantly cut down on travel time and speed the flow of information, investors must spend the time "in country" so that they know what is driving people's actions and decisions.

For a copy of the white paper by Grant Thornton LLP's Harris Smith and Dan Reid on cross-border transactions, "Bridging the global, cross-border transaction gap: What more middle-market dealmakers need to know about global M&A," please visit: www.GrantThornton.com/PrivateEquity. ■

Key tips when doing cross-border transactions

- Spend time getting to know the target's country, including local customs and practices.
- Establish personal relationships with individuals who represent the culture you seek to understand.
- Make certain there is agreement on how transaction value will be determined.
- Allow for additional time and resources to reconstruct actual cash expenditures and verify receipts.
- Make certain that the principles you use to negotiate deals in your country will work under another country's laws.
- Be prepared for unexpected legal/regulatory changes.
- Understand and adhere to the Foreign Corrupt Practices Act (FCPA) or similar laws in your home jurisdiction.
- Adapt your approach to a deal to be mindful of local business practices.
- Understand what remedies are available to you in the event of a dispute.
- Understand the norms for performing due diligence in the target's region.
- Be prepared for vendor due diligence when participating in an auction process in many countries outside of the United States.
- Examine pensions and workforce issues closely in a cross-border transaction.

Mergers and acquisition trends

As we look into 2008 and beyond, we believe a number of trends will shape cross-border merger and acquisition activity including:

International regulatory, economic and judicial standards will converge
We are seeing this trend in European Union (and European Union-applicant) countries, as well as between the EU and NAFTA countries. Similarly, this trend is developing between EU and NAFTA countries and emerging markets, such as China and India. The opening to market forces of more world economies, the abolition of restrictive ownership clauses and nationalism, and the protection of investors through effective regulation and enforcement have combined to create global acquisition opportunities.

Accounting standards will need to be transparent across borders
The need for transparent accounting standards is pushing toward convergence of United States GAAP, International Financial Reporting Standards (IFRS) and "local country GAAP" (the term used for those countries that have not adopted IFRS and with different rules than United States GAAP). The continued blurring of country borders to define the areas in which a company operates, as well as the need for seamless financial reporting across multiple jurisdictions, is driving the call for uniform accounting standards that are transparent to investors and financing sources.

More specialized financing products will be developed to facilitate the ability to finance M&A in emerging markets
As more M&A takes place in other parts of the world, where cultural, religious or other traditions influence business practices, we will see increased demand for something other than traditional debt and financing products. We have already seen the rapid growth of Sharia-compliant financing products geared to the specific needs and requirements of Islamic communities. As cross-border M&A further penetrates developing markets in which adherence to local customs is more prevelent, sufficient demand will warrant tailoring of specific financing products geared to local, regional or national needs.

Dispute resolution mechanisms in emerging economies will continue to evolve towards established and acceptable standards
Companies involved in cross-border M&A will need to arrive at a level of certainty regarding the process and fairness for settling disputes. Too often we have seen situations in which the courts or other authorities have been willing to overlook the agreed-upon terms of a document essentially to rule in favor of the local party. In other instances, when the foreign investor does receive a favorable ruling, there has been no viable means of enforcing it. This environment attracts investors seeking to achieve higher-than-average returns in the short term to justify the risk they assume.

Globalization of middle-class consumer products will increase as more M&A is focused on serving the needs of new consumer markets
The shifting of the middle-market consumer base is likely to influence trends and development of consumer products geared toward new markets. As mentioned previously, China and India each have a "middle-class" roughly the size of the entire U.S. population. In China alone, the growth in the number of vehicles purchased over the next 30 years is expected to exceed the increase in the United States by almost four to one. With these kinds of consumer markets opening, we expect to see companies tailor designs and products to meet unique needs and tastes of burgeoning consumer markets. ■

Questions?
Please do not hesitate to call us for due diligence on your next deal or for insights on the best opportunities for investing. For more information on how you can benefit from Grant Thornton's private equity services, contact:

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