



## **Stuck in the middle** **February 20, 2008**

**by James D'Aquila**

In these dreary markets for equity and debt, the inevitable question remains: What's ahead for M&A, particularly among midmarket companies?

The short answer is, if the past is any guide, the midmarket should hold up relatively well.

There's no question that the megadeals (\$1.5 billion plus) are generally off the table for a while. Prices and terms got out of balance as compared to a scant 12 months ago, when the market was awash with available debt for all transactions.

Now, we're seeing a different game. Large banks have been left stranded with several billions of deal-related debt that they are waiting to unload, which makes this avenue for capital access a dismal shadow of itself. Likewise, the funds that at one time would be the likely buyers of this paper are asking for reduced leverage, more realistic (read: lower) Ebitda multiples and higher spreads in pricing, and greater equity, along with more protective covenants, in contrast to the recent past, when offerings were decidedly covenant-lite. A sharply reduced LIBOR rate also has investors thinking twice and, even though spreads to indexes are widening, people are not wild about the credit markets. Couple this with a questionable outlook for future growth in corporate profits and a near collapse in the credit spread derivatives market, and it is very difficult, if not impossible, to efficiently borrow sums above \$1.5 billion.

But in the world of midmarket companies, defined as those of \$1 billion or below, M&A activity is apt to play out differently. The percentage decline following the dot-com shootout in 2002 among midcap M&A was a slight 11%, as compared with over 51% that year for larger transactions. And there were more than 400 transactions in the \$500 million to \$100 million range alone, or 86% of the total. This number rose to about 600 last year, a gain of almost 70%, while the midcap deal category as a whole rose 65%.

This year, no doubt, will be another tough one, except that there are some favorable signs buttressing the outlook. One is the initial public offering market, which continues to be highly sluggish: Some recent notable offerings have been pulled because of low valuations, weak after-market performance and general market apathy as investors focus on current portfolio components. Low liquidity among smaller companies, and a weak economy that is putting a financial squeeze on them, are also likely to spur smaller, family-oriented businesses to seek better heeled partners.

The fact is, midmarket deals as a group never commanded the awesome leverage ratios that their giant counterparts attracted, and the financial institutions that provided the financing are not among those swept up in the subprime, CDO and CLO troubles. They certainly are exhibiting more caution and require more hand holding, but the funds remain available, if at slightly higher spreads and tighter terms.

It is true that when you have price and credit adjustments there will likely be a lag between seller's willingness to pay and buyer's expectations. Having said this, we have a tremendous amount of capital on the sidelines. Now, no fewer than 72 SPACs are seeking to raise an

estimated \$72 billion in capital in addition to their already sizeable war chest, while private equity firms, having raised about \$602 billion since 2002, have remaining availability of unspent funds totaling \$266 billion. Not to mention the untold amounts available from hedge funds for the midmarket deal business.

The funds will be invested, one would suspect, with great care, and deals will undoubtedly take longer to get. We also may have lost about one-half to three-quarters of leverage on Ebitda, but with equity in the marketplace and the expected returns lowered slightly by equity firms, the odds nonetheless favor a robust market.

As for more specifics on leverage, transactions before were getting done somewhat irregularly at 6 and 7 times (and sometimes greater) leverage. Now we are probably at 4-1/2 to 5-1/2 times, with only a uniquely strong and healthy company commanding 6 times or above. And balance sheets are likely to be comprised of between 35% and 40% equity,

Financing remains key, and on the sell side it's clear that a good part of a banker's effort is spent on making sure the financing remains available. We're not talking about stapling the financing or seeking bridge commitments. Neither has really been a necessary feature of the below-\$750 million market. The focus in the midmarket range, particularly today, is making sure that the leverage providers are in step with the purchaser along the way. Sell-side advisers will need to spend a greater portion of their energy working with the lenders, as opposed to just the equity sources, to make sure financing will be there at the closing.

At the same time, there is a whole new class of lenders who are attracted to or have been reinvigorated by the current market. This is especially true of nonregulated investors, such as business development corporations, SBICs and the aforementioned SPACs. Many of the nonregulated investors remain committed to this market, and many others were waiting for some rationalization of the debt markets, and now that the heat in the transaction market has come down, they are looking for opportunities to participate. At 7 times leverage, they were not interested, but at 5 times it has become a more interesting sector. And, in fact, these firms are now taking market position away from more traditional providers who previously supplied the financing.

Especially interesting is that the appetite for such transactions has not waned among limited partners of private equity firms. True, they are being a bit more cautious and questioning; however, they are still eager to put their money to work. The evidence indicates that despite market conditions, new private equity investment funds continue to form, and those with superior track records continue to attract LPs, perhaps with a view that chaos creates opportunity.

Middle- or small-cap market companies remain actively involved in growth and consolidation. This is especially true in subspecialty areas where, despite the hesitation being exhibited by consumers, companies continue to provide unique services or products that escape the larger corporations in their industries. Investors and strategic buyers have, in the last three years, invested more than \$9 billion in a wide variety of specialty retailers ranging from natural foods to personal care to unique offerings for man's best friend.

Companies offering products and services to the bridal market are no longer local, family affairs, but increasingly expanding national chains. Sports apparel is no longer a mom-and-pop business, and even specialty sports equipment makers are breaking out of that mold. Health clubs, once a disenchanting breed because of their fickle customers, now attract diehard members intent on sustaining their health and bodies in a society which puts premiums on both. Even industrial firms and technology companies that have developed niche products and capabilities are proving to be sought-after properties among businesses looking to fill out their product lines or venture into related fields.

And underscoring all this is the continuing desire by midcap managers and owners who, after years of struggle and building, are seeing an increasing degree of personal liquidity and estate protection.

The midcap M&A market of the past two years will not be the same in 2008 but is likely to maintain its intensity and activity. The data indicates that over the past decade the only years the midcap deal market turned down was following the excesses of the Internet era of 2000, but even then, the \$500 million-and-under transactions held their own. The excesses of 2007, if they can be called that, were functions of broad liquidity in capital markets attracted in the main to megadeals, with the pricing and daring in the midcap venue increasing only slightly. It's perhaps a sign of the times that the larger transactions have slowed and the bulge bracket M&A firms are now beginning to turn their attention to midcaps, which, I dare say, they will just as quickly spurn once the megatransactions beckon again.

Those boutique and other investment banks who have consistently mined the midcap market, however, possess a better understanding of the buyers and sellers in this complex marketplace, and the factors that will contribute to sustained interest in what is a growth field, as 2008 gets under way, even if it has been a bumpy start.

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