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Middle-Market Advisers Diversify Their Workload

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Photos of participants by Gerard Franciosa

The *high-level corporate scandals have spun off a considerable amount of valuation and other work for middle-market m&a pros who are prized for their independence. That has helped them weather the tough times in getting deals done for small and mid-sized buyers and sellers.*

M&A: *Is there any fallout on the middle market from the big-company financial and accounting scandals? Are due diligence investigations more intensive and are buyers looking into areas they passed over in the past? Are likely buyers simply afraid to commit to deals?*

Deutsch: There are a number of different controversies here. There are accounting controversies: issues related to special purpose entities, revenue recognition, financial disclosure, and the matter of "managed earnings." And there is an entirely different set of issues related to corporate governance controversies: the role of the board of directors, the composition of the board, the role of various board committees (the audit committee, in particular), CEO compensation, and insider stock sales.

We see the greatest impact on public and would-be public companies. But these scandals will certainly effect all companies, large and small. For example, we expect increased costs for audit and tax work, for insurance, and increased cost of credit. We also expect new questions regarding corporate responsibility vis-à-vis employee stock ownership plans and, possibly, new issues regarding the establishment of ESOPs.

Overall, these controversies have altered the relationships between many parties — between the company and its auditor, between the CEO and his or her board, and between the company and its public shareholders — hopefully for the better.

Robertson: As far as mergers and acquisitions in the middle market are concerned, I don't think that these events have had any significant impact. The prominence of these controversies relates to the size of these companies and their wide ownership. If there is any single impact, I think the turmoil possibly may lead to more corporate restructuring and divestitures, which is always good, from our standpoint, because it increases the number of deals that are coming out.

Restructuring is always going on, but now it is going on in an economically depressed environment. When stock prices and earnings are down, companies examine all of their businesses and decide what is core and what is not. That is primarily driven by the economic forces at play today. However, when you layer on top of that the type of controversial issues that have come out, it increases the pressure on management to solve the problems and increases the probability that there are going to be transactions of some kind.

Owsley: I think that the direct impact on the middle-market m&a environment is probably modest. I think that on a longer-term basis many of the issues that will be raised by boards will get into the whole corporate governance matter and that people will increasingly focus on those questions.

I think there will be a lot of concern about conflicts of interest. Some of those conflicts are going to be at the board and management levels. Companies like Enron have come under severe criticism for that and some professionals have come under criticism for that. I think that over a longer period of time that will play out in terms of boards and law firms seeking more non-conflicted advice from various professionals.

Fortunately, boutique firms like ours are virtually non-conflicted and this is good for us since we are probably going to be seeing more questions coming from the corporate governance arena with respect to conflicts. Some of these conflict issues may in turn lead to transactions or how one might consider structuring transactions in order to avoid shareholder suits or other criticisms.

Hurley: It is another blow to confidence that affects all of us. It may not have a direct impact on the seller of the business but it does have an impact on sellers looking at investing in the volatile public market as an alternative to holding on to the business.

It also affects the lenders that have already taken write-offs because of poor performance by borrowers, especially for executives at the senior levels of financial institutions that have been hurt by private equity losses.

I think all of that results in more second-guessing, hesitation, and scrubbing of every aspect of deals. It slows things down so that it does affect all of us one way or another. It is not a positive impact. Those who can and do make solid long-term investments right now will reap big rewards.

Deutsch: We've seen two definite changes. One is increased thoroughness in due diligence from all angles. The other is significantly more discussion regarding a transaction need for third-party validation in the form of fairness opinions, solvency opinions, etc.

M&A: *Middle-market intermediaries always have been active in areas like reconstructing balance sheets and P&L statements of private companies and have performed other functions on the financial front. Have you had to take on any new roles in the current market?*

Robertson: I really don't think we have because of the things that we have talked about. However, there are some other things that are changing the competitive landscape.

In terms of corporate finance and merger and acquisition work, a lot of that work was starting to go to the accounting firms. Almost all of the accounting firms had started various groups to provide corporate finance and various m&a advisory services, and they were encroaching further into deal negotiations and the roles traditionally played by investment bankers.

I think that Enron and the other situations have really caused the accountants to stop and re-examine what they are doing. Arthur Anderson is a case in point. Its accounting practice is diminishing rapidly and it has disbanded its corporate finance and m&a advisory activities. A lot of companies that were using it for corporate finance work have totally rethought the role of people from whom they will seek such services.

The question is whom they are going to use. I think that to some extent that is going to be a boost for those of us who specialize in various types of financing or financial advisory work. Business people will be more interested in advisers who really know what they are doing and are not conflicted in serving in that role.

The second thing is that the accounting issues are going to lead to further review of the valuations at the time of an acquisition and the establishment of goodwill, if any. That is going to require accounting and valuation expertise. Although there will be no amortization of goodwill, there will be an annual test for impairment of goodwill. That is going to create more demand for valuation services, which is what we do, and a company's accountant will be conflicted from

performing this service. We are not only involved in valuation at the time of the acquisition, but we will later determine whether these values have been maintained.

Deutsch: We have always had two sets of responsibilities — that is, responsibilities to two different constituencies. One has changed; the other hasn't. We have responsibilities to our clients and also responsibilities to transaction counter-parties.

Our responsibilities to our clients have always been to protect them, to advance their agendas, to maximize value for them, to manage their transactions to completion, to decline to complete transactions if something is not right. Those things haven't changed.

As for our responsibilities to counter-parties, I would put them in two basic realms. One is the realm of "disclosure" and the other, the realm of "fairness." In the world post-Enron, it is incumbent on us and our clients to be absolutely fully disclosive and for transactions to be above-reproach "fair."

It is one thing to be an advocate for our clients; it is another to be "unfair." We have always told our clients that they can't change the facts, but they can change how they shine light on them. In the "new" world, they must be careful to shine "light" on all relevant facts.

Owsley: Everybody is alluding to the increased scrutiny, including the need for opinions. That is probably going to lead to increased workloads for advisory firms. This doesn't equate to a change in role but it does equate to an increase in certain types of assignments.

A lot of litigation assignments should arise out of various questions on the appropriateness of transactions that may or may not render a company insolvent. That may have involved too much of insider taint, for example. A lot of things are going to require the services of the people in this room, primarily because of their experience in m&a and their experience in dealing with difficult corporate governance issues. So I see us being more involved in opinions, in examining forensically what happened in some cases, and in assisting law firm clients in connection with their work. That is going to be a growing part of the business for the next several years.

Hurley: Assessing risk has become more important. Whenever the decisions get more difficult, the role of the adviser takes a different turn. That means understanding your clients better than you otherwise would have needed to. It means giving them the right kind of framework for making their decisions. Managing expectations is critical for both sides of deals. Crafting an alignment of interests with strings attached for both parties has replaced the done-and-gone style.

For example, private equity firms owning companies in these times need different kinds of advice than family owners of privately held businesses. Professional sellers with IRR clocks ticking have bigger problems than old-line brand manufacturing companies that can wait for an upturn when the going is good economically.

Owsley: I think that it calls for advising boards as well as private equity sponsors. The financial adviser needs to establish a close rapport with the company's attorneys, as well, in order to give the board the right advice, rather than suggest the most expedient thing to do. Sometimes those are tough decisions.

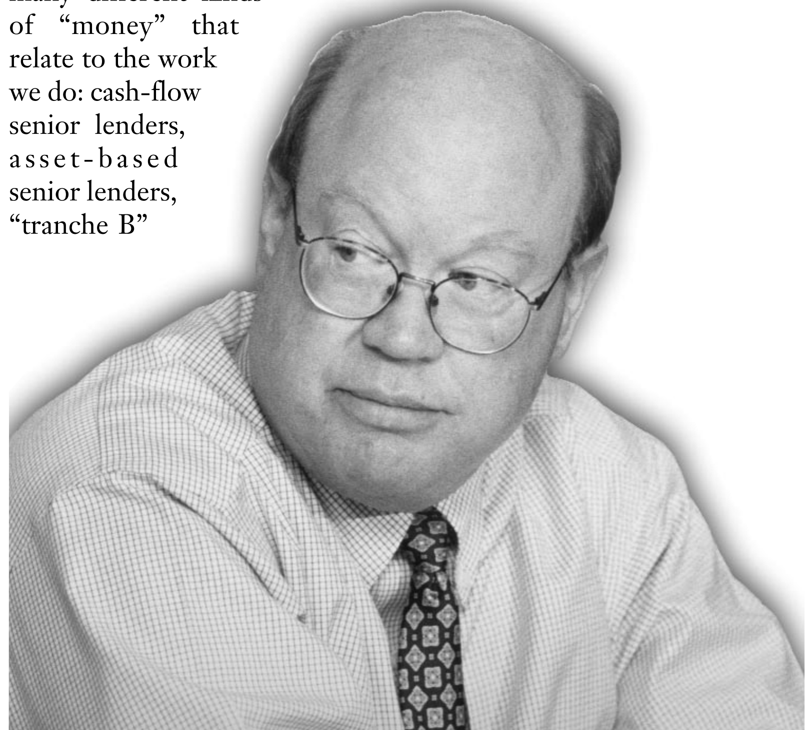
I think that as corporate governance comes increasingly under the microscope, there will be a greater premium on good advice and good opinions.

Deutsch: There also will be a premium on how good we are as investment bankers in vetting all of our clients' "red flags."

M&A: *Financing and credit have been tough for the last couple of years. Are they showing any signs of easing or are they getting tougher, partially because of the financial scandals?*

Deutsch: Financing sources for private equity buyers are twice as diligent and thorough in their underwriting process, meaning that their process takes longer. The irony here is that money is as cheap as it has been in decades. It's cheap if you can get it!

Of course, there are many different kinds of "money" that relate to the work we do: cash-flow senior lenders, asset-based senior lenders, "tranche B"



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lenders, sale-leaseback providers, etc. It is in cash-flow senior and mezzanine where we have seen the greatest increase in diligence and most challenging financing conditions.

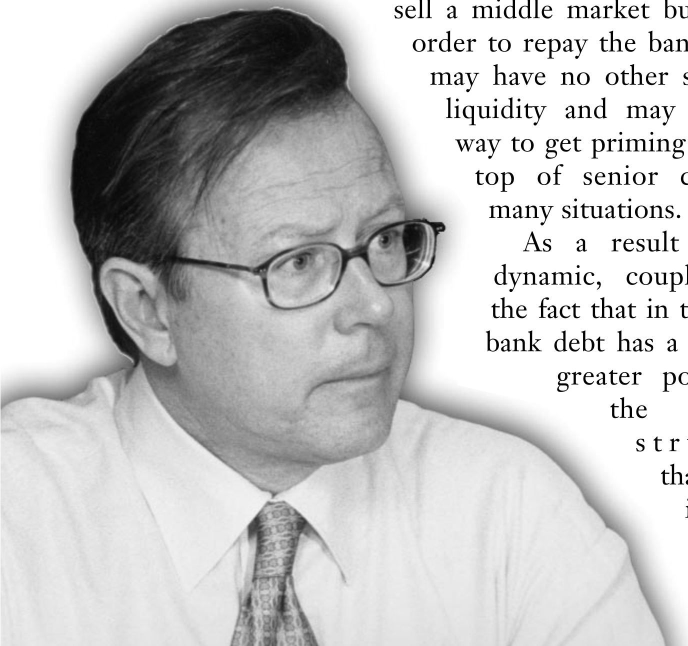
In this most challenging environment, asset-based lenders and sale-leaseback arrangers seem to be enjoying their day in the sun.

Robertson: I don't think that the scandals have really had any impact on credit for the m&a market per se. But when you talk about credit, the various sources have to be broken down. Bank financing has been tight for over two years. If anything, it may now be easing because the primary cause of the credit crunch was the demise of the e-commerce business, which left greater wounds on the banks than many of us initially realized.

As those loans have been written off and restructured, the banks are in better shape. They are still not lending at the multiples of cash flow that they were in the past, which means that the amount of money available on any particular acquisition is reduced. Therefore, the price is probably reduced because you can't dial in the equity and mezzanine and obtain the returns required to justify the price. So bank credit restrictions are still affecting prices of transactions.

Owsley: I have a slightly different perspective because we work, in large part, with distressed situations. I think that the current credit environment has increased the deal flow in our business as senior lenders and other lenders have decided to exit certain credits. That in turn precipitates a series of events which, in many cases, lead to the desire or even the necessity to sell a middle market business in order to repay the banks. They may have no other source of liquidity and may have no way to get priming loans on top of senior credit in many situations.

As a result of that dynamic, coupled with the fact that in this cycle, bank debt has a relatively greater portion of the capital structure than it did in the last cycle, the banks are calling the shots. Many of the banks are saying they would like out of the credit, so please sell the business for fair market value.



T. Patrick Hurley Jr.

Quite frankly, that is how many of these situations are being resolved today. It is the flip side of the availability of capital and the banks' reluctance to be lenders at large multiples of EBIT-DA that cause or precipitate the sale of many businesses.

M&A: *Have there been any problems at your end of the market in adjusting to the non-amortization of goodwill and elimination of pooling? How have your clients adjusted?*

Deutsch: The demise of pooling hasn't really affected our business. It has had much more of an impact on mergers of financial institutions, on the roll-up phenomenon, on companies with Tyco-type acquisition strategies and, in general, mergers predicated on an IPO exit.

Robertson: If anything, you may have an improved environment. It is really ironic that when you eliminate pooling and you have a purchase transaction using stock without the amortization of goodwill, you have the same EPS accounting as you had under pooling.

I don't think that we saw the whole picture initially because all of the accounting changes were not available at once. As the veils were lifted and we see the whole picture, it is probably a better environment today for public companies that want to use stock for acquisitions.

Deutsch: We've seen at least one structural change. For those acquirers that don't want to employ purchase accounting, there is an alternative to a pooling transaction: a recap, which is essentially a change-of-control transaction in the guise of a financing. We are seeing more recaps, in general. Financial buyers that might otherwise have bought something buyout-style are considering recaps to escape purchase accounting.

Robertson: As for the issue of goodwill impairment, we are just beginning to deal with this because most companies have until December of this year to adopt the new provisions, and some companies are still trying to decide how to handle it. In fact, one company I am familiar with was clearly headed toward establishing a revised amount of goodwill last January. Then it came face to face with obtaining a valuation, its accountants, who assisted on the initial acquisition, were clearly conflicted from performing the updated valuation.

A whole new demand for valuation work has arisen. All of us are looking for ways to do it on a cost-effective basis for our clients. The key, I think, is that buyers will be required when they book the acquisition to develop a set of projections

that justify the purchase price and goodwill. Then it becomes reasonably simple going forward to test your performance against the original projections. That is probably going to be the best way to test for impairment.

A lot of the process is making sure that the model for the base case of projections at the time of the acquisition was in good order. We are going to play a major part in that process with our clients.

M&A: *For the last couple of years, we have been hearing that it is a buyer's market, the buyer calls the shots, pricing is down, and sellers are reluctant to part with businesses at current prices. Is this the way you see the current environment?*

Robertson: I think it is unfair to characterize it as a buyer's market. I think you to have to look at the tiers of deals that are getting done. In distressed and bankruptcy situations there is a lot of activity because the creditors are saying, "No more of this management. We want these assets redeployed." So there is a lot of activity in terms of change of control in that sector of the market.

For those companies that aren't bankrupt but are not quality situations either, there is so much money in the hands of financial buyers that has to be put to work that these mediocre companies are getting more attention than they would have in a robust market. The higher-quality companies, which are under no pressure to sell, are riding out this market and are waiting for a better climate when they can get their price. They are waiting for the banks to increase their loans to cash flow multiples and for the equity markets to improve.

That is leading to another change in the market which involves companies that are still growing during this period and that need growth capital. They can't go to the public market. Therefore, you have the activity of private equity investments by financial buyers that are no longer insisting on control and are willing to take minority positions in well-managed public and private companies.

Deutsch: Saying it's a buyer's market is like saying it's raining. It may be raining in Manhattan but not in Westchester.

While we care about overall market indices, we care more about what is going on in our client's particular industry. We look at our clients and their roles in their industry. There are better-than-average companies in any given industry and there are poorer-than-average companies. The better-than-average companies tend to weather storms like these, while the poorer performers tend to have fewer options.

It is always difficult to generalize. There certainly has been pricing pressure, on multiples of EBIT-DA. But that has not necessarily resulted in all transactions being done at lower prices. In some cases, it has simply meant delayed transactions, particularly among quality companies that can afford to wait. Transactions in general are tougher to get done, but there are not necessarily changes in outcomes. The problem is that it might take you longer to get the outcome that you'd like.

There is more need than ever before for diplomacy in transactions. Your style of negotiating must change in this environment. You can no longer stand up and storm out the door; there are too many things to fight about in this environment. Everyone must be that much more diplomatic if they expect to get something done.

Owsley: A lot of this is in terms of perception and expectations. A lot of the seller's expectation, particularly for private companies, is that the values prevailing sometime in the past will prevail again shortly in the future. They should wait in terms of trying to achieve such robust valuations again. Time will tell whether those expectations are well founded.

I think that the valuations in the merger market are, to some degree, related to the future of the overall equity markets. I for one am probably not sanguine about valuations in the current market environment, for a lot of reasons. I think that we are probably in for somewhat of a sideways-to-down stock market trend. I could be very wrong. But if that is the case, the history in a variety of market environments is that over long periods of time, sellers' expectations do eventually come into line with market realities. So there may be more willing sellers at a future point in time if they adjust to lower price expectations.

Hurley: The middle market is where it was five years ago. We all thought it was fine then because public equities were booming. The overall market is what makes us feel blue. I think that everyone has accepted the notion that there is more volatility in all of our lives, whether it is holding a business asset or what can happen to any of us when we walk down the street every day. Some people are willing to wait another cycle, but that may be much longer than five quarters; it may be five years.

A lot of people who are not necessarily in need of a transaction but who would like to proceed should be aware that there still is a fairly active market today. If you are a seller and you have a quality company, there are a lot of people who will spend the time to take a close look at it. Every sector has been hard hit. But the least hard hit has been the $25 million to $50 million in value company where strategic buyers are able to rationalize a purchase of something that fills out a product line or opens a new market for leveraging their existing businesses. They are not going to go out and do something that is a company-changing event under today's conditions. So the bite-sized deals become more attractive.

We see people who are selling businesses for $35 million or $45 million and are getting just as good a relative price as they would have four or five years ago because they waited and they have strong results now. Who knows what they would get four or five years from now. We discourage people from generalizing and telling everyone to wait. That may not apply if someone has something that would be advantageous to sell now.

We represented a fellow of 72 who sold a company in a deal that closed this past spring. His lawyer was telling him to wait! It was silly for him because the price for the company was about 12 times operating earnings. So what good would it have done for him to wait another year when something may have occurred on the competitive front that would have made him wish he had accepted when he had someone who was interested in the firm?

Deutsch: I couldn't agree more — even in those situations where if you wait you might get a 5% better value in a year or two.

We should never forget that our job is to advise our clients with respect to value, not merely to manage their transactions. In many cases, clients forget that even if they have a bell-ringing number in mind and even if they can hit it by waiting some period of time — which might be years — the time value of money, and business risk, often make waiting a foolish choice.

Robertson: I think we all are saying that risk is becoming a greater part of our worlds. Our clients need to recognize the degree that risk is going to be influencing their decisions and to understand what is going on in the capital markets.

M&A: *I have noticed what seems to be a variation on PIPES in which private equity firms have acquired minority interests in acquirers to help them finance deals. Does this suggest an increase in popularity for PIPES or is this another kind of trend where financial buyers can put their money to work?*

Deutsch: I think the question is whether private equity firms, and others that formerly focused on controlling investments, are considering more finance-type investments. The answer is, yes, absolutely.

We are seeing more sharing of transactions among private equity firms, and we see many more private equity firms, at the margin, considering minority stakes, where they may control the board, etc.

Robertson: They are minority equity investments, whether into a public or private company. A financial buyer that heretofore may have required a control position now recognizes that the better-quality companies in a market like this are not going to pursue a change-in-control transaction because the valuations don't justify it. They are still interested in growth capital, and the financial buyers have come to realize that partnering with a good management team, which is exactly what they do in a controlled investment anyway, is better than giving the money back to their investors. This is why you are seeing a lot of financial buyers amending their charters to permit them to do minority investments.

Hurley: There are plenty of good investment opportunities in small public companies that have already upgraded their operations and management Just as Apollo was closing its last fund, it filed for a cash-in secondary on Rent- A-Center, and the earlier postponed IPO for Pacer International got done. So you have some winners out there and you see more private equity funds willing to make sort of blocking investments rather than control investments.

You are going to see those types of interests become routine. More of the private equity funds are supplying capital that would otherwise come from lenders or the public equity market. They are not limiting themselves to the traditional model of leveraged buyout funds anymore.

Deutsch: Of course, this will all come full circle. The limited partners who fund buyout firms will reconsider what investment styles they thought they had bought into. They may rethink their allocations for control investors versus minority investors.

Robertson: There is going to be a greater role for private minority equity because the size requirement for an IPO is growing, driven by aftermarket liquidity needs and research justification. Research coverage is harder to get with the shrinking population of analysts on the Street.

There is no sense in going public if you are not going to be fairly valued, which requires being followed by at least several analysts. So I think this gap is increasingly going to be bridged by private equity funds. I think you are going to see more and more of what have been control financial buyers coming up with new types of funds to provide this growing need for bridge equity.

Owsley: The other side of that is the issue of control and super majority provisions regarding boards. I have seen private equity firms take minority positions but quite a few of those situations involve certain structural securities, such as preferred shares with voting provisions, that allow the private equity firm to at least maintain the integrity of its investment.

In many cases, if the private equity firm holds restricted securities and things go amiss and is unable to influence events, I would think that its limited partners would be able to criticize it for those kinds of activities. So my experience

has been that many private equity firms have been very careful on the corporate governance side.

Hurley: One of the reasons that financial buyers are doing fewer deals is that they are trying to make up for portfolio problems with sweetened terms for themselves on recaps and other new investments. That keeps them for being as competitive as they ought to be; and in some cases, keeps them from doing deals that they should not let get away.

Owsley: I think there is an entirely different story on the private equity side. I think that the private equity lenders, the distressed junk players, and the mezzanine players think it is harder to make a buck in this environment. I think the people are seeing the effects of that.

I wouldn't be surprised if this cycle had relatively more modest rates of return than previous cycles have had.

Deutsch: Rate-of-return expectations have declined. In today's riskier business and financing environment, savvy acquirers are looking for ways to take less transaction risk by, for example, providing their own mezzanine capital. They'll accept overall lower returns for a safer structure.

Owsley: It is again reflected in the market. Historically, many of the private equity firms might have walked away from portfolio companies that were laggards on the theory that if they could focus on two or three big winners, the percentage gains on those would offset everything else.

Well now they are looking at their entire portfolio and trying to wrest gains or at least reduce losses from the laggards in their portfolio. So they are addressing all sorts of ways in which they might try to recoup some of their less successful investments.

M&A: *How creative does deal structuring have to be in the current environment, and what are some of the things that are being done to get deals done as far as deal structuring is concerned?*

Owsley: Warrants have always been a form of transaction structure in our business, and I see no cessation of them. Other examples include rights offerings, which are a different flavor of a warrant with a shorter maturity. Certainly, there have been discussions with respect to contingent payment rights and similar securities. Overall, though, I would say that most "gap-bridging" securities are in the form of warrants, which come in many flavors.

I don't think they are becoming increasingly common, but they are a constant in our business in terms of securities that are issued in connection with restructurings and in connection with transactions involving sellers that may have transitional issues.

M&A: *Are there any changes in the amount of the down payments that buyers pay?*

Robertson: I don't think we are seeing any changes in that area. However, it is hard to generalize because of situations where you have to do something creative.

Deutsch: We are seeing more sale/leaseback transactions today. If there is any element of a transaction's total financing package that has changed most, it is the use of this financing as "gap filler."

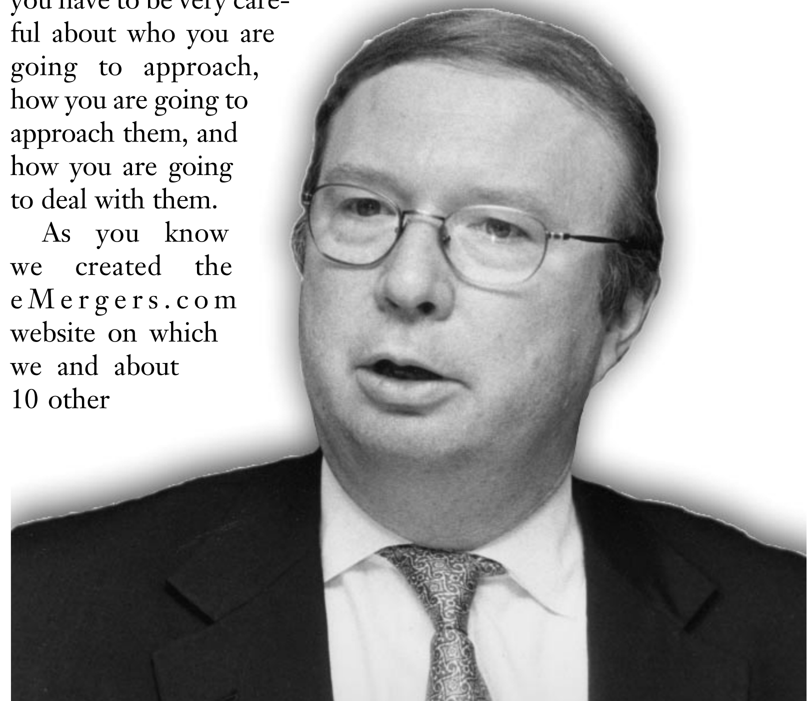
With regard to our corporate sale clients, we still reach for as much at closing as possible, as much in the form of installment payments as possible, as much in the form of contingent future payments as possible, as much real value in our clients' ongoing consulting agreements as possible. The actual mix varies by transaction.

M&A: *What is the climate on auctions and competitive bidding? Do you have to qualify one buyer and negotiate intensely or are you drumming up interest from multiple bidders?*

Robertson: It is deal-specific. But in general, I think you have to be more careful about whether you are going to go broadly or not.

I think that with quality companies where you know there is going to be broad interest, you can run an auction. With situations that have a much narrower field of interest, you have to be very careful about who you are going to approach, how you are going to approach them, and how you are going to deal with them.

As you know we created the eMergers.com website on which we and about 10 other



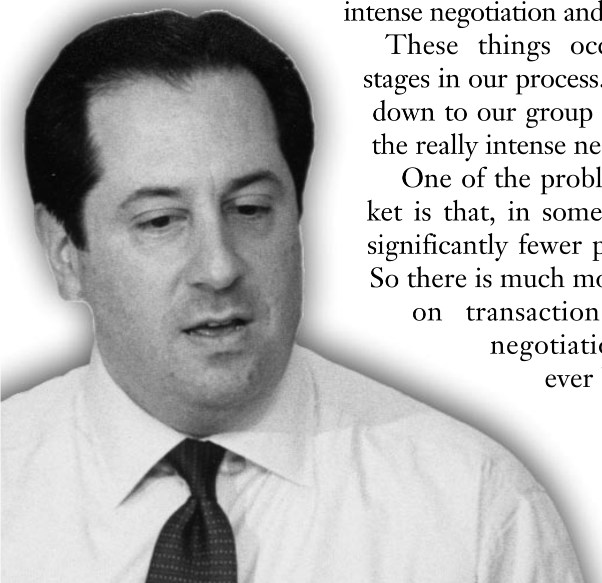
Henry F. Owsley

bankers post actual exclusive sale transactions. We are finding that the interest in the site has varied with the market. As this market has turned down, the level of interest in m&a activity has turned down and the number of hits we get on the site declines. I think that is largely a function of the fact that we are not refreshing the deals that are posted as frequently as we were or would like. I think that as the market picks up and we post more deals, the activity level will pick up.

Deutsch: The vast majority of our transactions are neither full-blown "auctions" nor one-on-one negotiated transactions. We generally advocate a targeted yet competitive process — part auction, if you will, but part intense negotiation and structuring.

These things occur at different stages in our process. It's when we get down to our group of "finalists" that the really intense negotiations begin.

One of the problems in this market is that, in some cases, there are significantly fewer potential bidders. So there is much more of a premium on transaction structure and negotiation skills than ever before.



David N. Deutsch

Owsley: We continue to see the need to keep the process competitive through closing, in many cases running parallel paths with more than one buyer with respect to definitive agreements. If certain of our clients are left in the lurch at the last minute, it would be devastating to them because they are in financial extremes. So we have to keep the process honest for a very long period of time.

You don't want to put yourself in the position where a buyer can retrade you at closing with no other alternative left. There may be many alternatives with respect to conventional m&a because the buyer or seller can always decide not to proceed. However, in our business, the seller frequently is required to proceed. Therefore, the competitive dynamic is highly important.

The insurance policy against retrading is strong due diligence and a no-surprises contract process. You have to get potential buyers that have the financial wherewithal, the ability to close, and the desire to close. In many cases, the best bid is not necessarily the highest nominal bid.

Hurley: We continue to respond to the personality and objectives of each of our clients. If the client is a professional seller that wants broad marketing of the company, that gets carried out. But if the client wants to talk to only a few or maybe even one bidder, we will help them do that and make sure that they get compensated for the exclusivity.

A number of our assignments recently have been the result of strategic buyers approaching our clients and saying, "Don't be concerned that the market rules of thumb indicate that your company isn't worth what it used to be. We believe it still has plenty of worth, and we want to buy it." Most successful business owners are very savvy and know exactly what they want from their advisers. ❐