

## The Usual Suspects Plague the Middle Market

### Roundtable Participants

**Greg Benning**  
Managing Director  
Adams, Harkness & Hill

**Stephen Blum**  
Managing Director  
Burnham Securities

**Oliver D. Cromwell**  
Senior Managing Director  
Bentley Associates

**Allyson F. DeMatteo**  
Managing Director  
SSG Capital Advisors

**David N. Deutsch**  
President  
David N. Deutsch & Co.

**Michael S. Goldman**  
Managing Director  
TM Capital

**T. Patrick Hurley**  
Managing Director  
MidMarket Capital Advisors

**Henry F. Owsley**  
Partner  
Gordian Group

**Karl A. Palasz**  
Vice President  
William Blair & Co.

**Russell Warren**  
President  
The TransAction Group

*Photos of participants by  
Dan Nelken*

**M**id-sized and private companies are in a frame of mind to seize on their prospects for buying and selling but in general continue to hold back.

Dealmakers serving the mid-market point to such long-running disincentives as the uncertain economy, reduced M&A pricing, and tough credit. But a few areas of strength — buying by private equity-owned companies and interest in distressed company bargains — offer glimmers of hope for conversion of interest into actual transactions.

**M&A:** Are you finding any increased interest and follow-up actions among mid-sized and private companies about being buyers? Are they seeing this as a good time to bring in acquisitions given the calmness of the market and reduced prices on a historical basis? If this is the case, what types of deals are they looking for?

**Cromwell:** In general we are not seeing an increase in companies looking for acquisitions at this point. On the corporate strategic buyer side, there are still some companies that are making some acquisitions. However, we see a far larger number of those buyers doing what I call “lowball” bidding to see if they can purchase something very inexpensively. But I don’t see a significant increase in general middle-market activity from companies.

However, on the financial sponsor side, these potential buyers are feeling more pressure to make acquisitions because a number of these funds have not made many investments during the recent past due to poor market conditions. They now have a shorter time fuse to start doing deals due to the limited remaining life of their funds.

**Palasz:** From a macro standpoint, we are seeing a bit more activity, but not necessarily a groundswell. However, within certain pockets, there has certainly been some pickup. For example, in several sectors in the software industry, especially health care IT, we are seeing more interest from acquirers looking at acquisition opportunities on a “make” versus “buy” basis.



**Greg Benning**

**DeMatteo:** In the distressed market where we operate we are seeing interest by strategic buyers who are being opportunistic. They are buying at lower multiples now, if they have the financing to do that.

**Owsley:** Also on the distressed side we are seeing a number of companies taking advantage of companies in bankruptcy to acquire assets at prices that they find attractive and to significantly expand their businesses. This occurs obviously in sectors that are distressed, such as steel, in chemicals such as fertilizers, and in certain food industries. We see several companies that are taking advantage of the current restructuring environment to advance their objectives.

**Goldman:** Since the first of the year we have seen a pickup in mid-sized acquirers coming back to the marketplace. We believe this reflects pent-up demand from acquirers that have been out of the market for some time due to market conditions and need to pursue strategic aims that cannot be deferred indefinitely.

We just closed an acquisition for a mid-sized strategic acquirer that needed to move forward into a new product area, and could only achieve this goal through an acquisition. So we are definitely seeing an increase in acquisition activity that is driven by the strategic needs of buyers.

**Warren:** We are seeing a pickup, and the one group that stands out are the mid-sized portfolio companies of private equity groups. Most of the private equity groups have strategic plans for growing those portfolio companies and that often includes acquisitions, if they have the opportunity and favorable pricing.

They have been kind of out of the market because of operational issues for a couple of years. I think they are getting their portfolio companies back to solid operations so they can focus on growth again.

**Blum:** The falloff in merger and acquisition activity after the late '90s happened mostly at the high end. Among non-headline deals, both the decline in activity and the recent pickup have been far more moderate.

There has been some uptick in areas such as tactical product extensions. The corporate clock keeps ticking, and after a while corporate buyers begin to feel some pressure to meet their strategic goals via acquisitions. But there is another phenomenon out there: Because of the tough times in the last two or three years, there are now quite a few NOL buyers out there. Some are investment firms and some are strategic buyers. The NOL has become a potentially useful acquisition element.

**Hurley:** We have not noticed any pickup with independent privately held companies unless a compelling one-time opportunity pops up. But there has been some noticeable action on the part of recap companies where professional investors are now in the picture and the CEO, who has gotten a substantial amount of money out of the business, is responding to encouragement for pumping growth.

The CEO might not have put additional family capital at risk but will use someone else's nickel. Those CEOs know where the diamonds in the rough are. They are out doing a little bit of cherry picking, if at all possible. In general, caution prevails and there is reluctance in this environment.

**Deutsch:** We see a number of forces and countervailing forces. Most companies now are generally inwardly, strategically focused. Smart companies recognize that mission number one is survival through the recession. That said, most companies, particularly public ones, still require growth.

We find that many companies are at least talking about consolidating their market positions in their industries, possibly through acquisitions. However, they are more inclined to pick up the pieces of fallen competitors than they are to pay great big premiums. We see a much more methodical pace of acquisitions. There is no longer a rat race to buy. There is no longer the sense that if you don't bid quick and big, you will lose. There is more interest in traditional, mature, economically resilient, and financeable targets.

**Benning:** When clients ask us if there's a trend line to the m&a market today, we say that the trend is something that you can tightly characterize as scattered: There are examples of everything. The activity level, while perceived as down tremendously, is at 1995-1996 levels, which were

fairly active years as far as deal flow goes. We expect it to stay at that level and we think that the market has only slowed down relative to its peak.

When you look at private companies and sub-\$500 million public companies, we characterize the activity levels at a higher level similar to 1997-1998 aggregate volumes, and more active than the broader market.

We've seen particular pickup in asset purchases and divestitures. Technology, telecomm, and health care are all areas where companies that have trouble tapping into the funding market or have built business plans that never really achieved scale are starting to sell off key assets. We think that continues to be a great opportunity for corporate development by small and mid-sized companies.

**M&A:** *Historically, private companies have had two choices for liquidity — sell or go public — and now the recap has been added. Has the weakness in the IPO market had any impact on surfacing companies for sale?*

**Benning:** When you look at the supply of companies that are going to be considering a sale, a lot of them are smaller companies that already came public in 1999 or 2000. There are a significant number of companies that are below the thresholds that institutional investors have for establishing new positions. If you look at what it takes to go public these days and you consider the float requirements and the market cap requirements, two-thirds of the Nasdaq falls below the \$150 million market cap, which is where these investors begin to buy in.

The downsizing and regulatory restructuring of Wall Street make it more difficult for broker-dealers to be sponsors of small public companies and to bring smaller companies public. We think that is going to drive a lot of these companies that are public and have good operating results to look to the m&a market, especially companies that need liquidity and can't effectively tap the equities market.

Moreover, the costs of being public have risen. A lot of private companies are looking at being out there in a post-Sarbanes-Oxley world and saying, "No thanks. None of that for me." So from our perspective, the IPO market has some new structural barriers that weren't there a few years ago and are going to drive more people toward recaps or m&a.

**Deutsch:** There are healthy aspects to many of these market changes; one relates to the IPO environment.

In the past, many small companies that were destined for the Nasdaq viewed an IPO as an integral part of their business plan and being public as a panacea. Many now realize that going public is not an end unto itself. It is one of many possible "gateways" to future financing and liquidity.

**Cromwell:** With regard to choosing between an IPO and



**Oliver Cromwell**

the sale of a company, we see more sale candidates due to Sarbanes-Oxley, and to the need for greater critical mass. We believe that the Sarbanes-Oxley impact is going to be very profound on that IPO versus sale decision. Even when the IPO market does return, a lot of companies will be taking a very long hard look at both the cost and the liabilities that are going to be involved in being public. It is still early in the process of implementing Sarbanes-Oxley, but all indications so far suggest that it is very onerous in terms of both the cost and the liability.

Two or three years ago during the Internet bubble, we would see a number of early-stage companies that considered themselves to be like the Internet companies that did IPOs. Some of these earlier-stage companies would talk to us with a certain illusion that they could go public. Now that the Internet bubble has exploded, these earlier-stage companies recognize that unless they get to a much larger critical mass, they won't be ready for an IPO. We don't have many companies coming to us these days and asking about the IPO alternative. A lot of those companies have decided that the only real exit strategy is a sale, since they will take too long to become large enough to justify an IPO.

**Warren:** A number of middle-market companies never had a realistic shot at being an IPO anyway. The good news for those folks is that even if there is no IPO window, there are some alternatives in the way they sell their businesses.

I am surprised that we keep finding entrepreneurs who think their choice is to either sell the business or keep it, without realizing that the recap market provides a very interesting middle ground. They can get a couple of bites at the apple, which is particularly nice in this kind of a rising



**Stephen Blum**

market, and there are some things that can be tailored for them.

**Owsley:** There is also an increased number of public companies that are in the middle market that are considering their alternatives in terms of going private and how they should finance in this environment and so forth. One of the critical issues is that financing has been a bit of a challenge for some of these companies. For example, last year we formed a strategic relationship with Allied Capital, which is a \$3 billion provider of mezzanine financing and other private equity products. The company is seeing a significant increase in the number of inquiries in this area. So I think that over the next year we are, indeed, going to be seeing alternatives to IPOs and alternatives to full-blown mergers in terms of the recaps.

An interesting byproduct of the change in the IPO market is a structural change in the private equity market. In the past there was a business model for a number of private equity firms, particularly in what we call “venture capital,” to pursue companies that would ultimately roll out a product line and could be taken public. That model is seriously flawed, if not dead at this point in time.

Private equity firms that have capital are now pursuing other avenues, including the restructuring area and other ways to put their money to work. Some of the historical private equity formulas are being modified in recognition of the fact that the once popular IPO exit strategy is not available today and may not be available for some time to come.

**Deutsch:** We are seeing more inquiry not only about

recapitalizations but ESOPs, which are, in a sense, tax-advantaged recaps. And there is more discussion about various creative forms of exit — things such as strategic mergers with already-public companies. Acquirers like Clayton Dubilier have pursued this strategy, considering it to be an acquisition and a partial exit at the same time.

One of the things that drives the choice among alternatives is timeframe to exit. Whether it’s a quick sale or a more gradual exit like an ESOP or a recap depends largely on our client’s preferences.

**Goldman:** We see a direct reaction to the soft IPO market in the increasing backlog of sell-side business that we are handling. We are going to market shortly with a company that is growing rapidly in an attractive industry. Three years ago, this company would undoubtedly have been an IPO candidate. The owners now believe they will maximize value in a sale transaction — and that is what they are having us pursue.

**Hurley:** There were probably two to three dozen high-quality companies sold in each of the last two years that would have gone public if there had been a market, but there needs to be at least an upward trend in the overall market and economy.

I think there will be an IPO market and that there is a five-year period for a generational change in the view of IPOs. In the short term there is no question that the companies that are professionally owned are going to drive more m&a because people will be looking for exits.

The decision by Merck to pull Medco from being an IPO and to spin it off continues to drive up numbers for divestitures. So right now we have “divestiture days” that everyone is living with. At the same time Texas Pacific and Leonard Green have done a transaction that just went into registration, MEMC Electronic Materials, that could be as big a winner as Weight Watchers was for Artal. That will make private equity firms remember how rewarding an IPO can be. Three years from now we will see some of the big divestitures recently done turn into IPOs.

**Blum:** At the low end of the middle market, the absence of IPOs is not having as big an impact as it is at the high end of the market. Folks at the low end always have had fewer choices. With respect to the sectors that are affected, the absence of the IPO window is especially hard on the growth and technology sectors. A lot of the old-line sectors don’t go to the IPO window very often anyway.

**Owsley:** With respect to an IPO versus a sale, in the restructuring world after a bankruptcy it can effect an IPO by restructuring the company through what is known as an “internal reorganization.” That gives the creditors common stock and other securities or perhaps the ability

to sell them in some combination into the public markets.

In this environment, a lot of creditor groups are electing to do an internal reorganization and not sell in the merger market. They are taking the view that maybe they can hold onto the stock, preserve the merger premium for a later date, and a year or two from now turn around and sell it at a higher price. One example was Chiquita, where the creditors did in fact make such a decision.

**M&A:** *How do you describe the current environment on deal financing? Tighter or looser than a year ago? What kind of hoops are lenders or other financing sources making you jump through in terms of quality, price, covenants, and things of that nature?*

**Palasz:** We are seeing a clear “Tale of Two Deals” structure in the senior lending market today: larger, high-quality, blue-chip companies on one hand, and then everybody else.

We are seeing senior lenders becoming more aggressive on higher-quality and bigger transactions in the \$100 million to \$150 million range and beyond. At that higher end of the middle market, we are seeing the lending multiples tick up with much more competition among lenders. Conversely, we are not seeing much improvement in lending multiples for the rest of the middle market deal universe, i.e., smaller deals and those that have some hair on them.

**DeMatteo:** The credit market is extremely tight for those companies with special situations that have any kind of a story to tell. Asset-based financing is still very conservative and the cash flow lending is just nonexistent if the company doesn’t show consistent profitability.

Financial buyers have been very active in auctions but they are not able to come up with financing to make it anywhere near worth their while. They are looking at all-equity transactions and are not able to be competitive with the strategic buyers in these auctions.

**Deutsch:** Those lenders that are lending are being careful about collateral eligibility, appraisals, and the characterization of appraisals, such as fair market value, orderly liquidation value, or auction value.

**Owsley:** We are seeing collateral scrutiny from several major secured lenders that were caught in the cycle with respect to losses in liquidations and are being very conservative in lending formulas. They are sort of giving you a double hair cut. First, they are cutting back on the availability formulas and then they are putting in a block that you must have “X” amount of additional availability just to make sure that they don’t get caught. They may be willing to lift that a little bit in connection with the debt financing or cash collateral availability in a bankruptcy, but otherwise we are seeing a tight situation.



**David N. Deutsch**

In terms of the mezzanine market, it varies on a case-by-case basis. We work extensively with Allied in this area and there are a number of things that can get financed, although the leverage multiples are clearly down from where they were three years ago.

**Deutsch:** The mezzanine market is strong. While less relevant to the smaller middle market, the public high-yield bond market is absolutely white hot. Various indexes had average rates of return on high-yield debt in the 13% to 14% range one year ago; those numbers are now 9% to 10%.

**Benning:** There are so few large deals and so few “AAA” deals out there that when one of them comes to market, there is a real feeding frenzy at the senior lender level. The presence of the asset-backed lenders like GE Capital or Merrill clubbing together with a Bank of America in a senior facility is another trend in which we have seen a hybrid of traditional lenders and asset-based lenders coming together. That was the case in a recent venture-backed recap that we did of a health care services company.

**Owsley:** When you get down into the sub-\$25 million EBITDA space and you are out of the institutional finance group and into the middle-market lending group, the conservatism steps up to another level. You are dealing with lenders who are primarily regular-way commercial lenders who aren’t doing a lot of acquisition finance. If you don’t have collateral, the cash flow-based lending market for sub-\$25 million EBITDA just isn’t there.



**Allyson F. DeMatteo**

**Hurley:** I think you have two separate groups with senior lenders. You have some that won't play at all but would consider themselves to still be in the market. You are hard pressed to get still 2 1/4 to 2 1/2 times term in senior debt. Or you can look at the LaSalle, Wachovia, GE, and the hedge-fund types that are now pushing 3 1/2 fairly often.

**Goldman:** We have definitely seen expansion in available financing as a multiple of EBITDA from the senior lenders we've arranged financings with over the last six months. To me it feels like 1992 after the tightness of 1990 and 1991. Yes, there is improvement in the multiples but there is still a way to go, and that is just the reality of the market at this stage of the credit cycle.

**Deutsch:** The EBITDA that you are looking at isn't merely the latest 12 months as of the moment of closing. People are now truly looking prospectively and truly considering downside scenarios, including how much additional cash investment may be necessary if the company takes a double dip.

**M&A:** *Where do the financial buyers fit into that situation? Are they your bidders of first choice when you have a company for sale? Are they fallback buyers? And in view of the financing and structuring situation, why bother doing a straightforward acquisition when you can do a recap?*

**Blum:** The line is totally blurred between recaps and what used to be called leveraged buyouts. I find them impossi-

ble to distinguish. Nowadays, most investment firms cover the gamut.

**Cromwell:** Each week at our Bentley group meeting, we bring in a private equity fund as a guest speaker to tell us about their fund. An interesting "barometer" is how many phone calls I get from people who want to be guest speakers, as well as what they say when they make their presentations. In general, I am getting far more calls to come to Bentley and they are all talking about wanting to do the more deals, since many funds have gone long periods without making investments.

We find particularly interesting is the range of responses when we ask how many deals that a specific fund done lately. The answers have been all over the lot. Some funds can point to a half-dozen deals they have done in the past six months, often putting more equity into deals or paying higher prices if necessary. Others funds have just not been willing to stretch, and have not done any deals.

Some funds may dig into a "troubled situation," while others will avoid those deals requiring more active involvement by the private equity fund. Some of the private equity firms are staffed with professionals who are financially oriented with Wall Street backgrounds and are used to sitting on boards, and often they don't want to "roll-up their sleeves" on some of these troubled-company situations. Yet, other funds have in their stable of professionals or on their advisory board a group of executives who are ready to participate in a much more proactive way on a troubled deal.

So we see a bifurcated market that includes good deals and good companies that are getting bid up in price at the one end of the market. When one of these rarer good deals comes along, a lot of the private equity funds jump in and bid up the price. These funds have got to pay higher prices to get the better companies. For the troubled companies at the other end of the spectrum, the private equity fund has to decide if it is ready to play a more active role. To do so, the fund must have the operational — not just financial — expertise.

**Blum:** Two key variables distinguishing financial buyers from strategic buyers have been speed and flexibility. A strategic buyer might pay our client a higher multiple. But the options for structuring that deal are usually narrower. If we deal with a financial buyer, we can often provide our client with more structuring choices. Yes, the price may be lower, but we will often end up doing it faster and more flexibly.

**Warren:** Each seller has its singular set of needs. We try to make sure that we understand what the seller's real motivations are and what it wants out of a transaction. A lot of entrepreneurs want to continue to own and operate their businesses and diversify their own holdings at the same

time. I think that this recent economic period has shown them that it is not smart to have everything in one place.

With private equity groups we find that there is more flexibility than with strategic buyers. They can tailor something a little more to the owner's liking in terms of how much it will get to participate going forward and what freedom it will have. The financial players also can put the money in to aggressively grow that business if it has a good upside potential.

**Owsley:** I couldn't agree more that financial buyers provide additional arrows for your quiver, particularly in our neck of the woods in terms of restructurings because in many cases you have to tailor a solution to the problem at hand. Strategic buyers are quite frequently still willing to pay more, and that is clearly a trade-off to consider.

Earlier we were noting that some people are doing deals and some people aren't and there is a disconnect in the private equity role that we continue to see. Some people are saying that because they are private equity firms, they demand a 35% rate of return — just because. Well, in this market environment it is really hard for me to see consistently being able to get a 35% rate of return, because we are equitizing more deals, leverage multiples are going down, and unless you really rub those cards hard, it is going to be hard to change the joker into the ace of spades.

Some people's expectations are just not going to be met. I think what is going to happen is that all of the liquidity currently available in the private equity market will dwindle to some extent over the next five years. I think that now is a great time to be a seller into the private equity market. I see that dynamic changing down the road.

**Deutsch:** The private equity community only gets more and more mature and more and more moneyed. Increasingly, private equity firms look an awful lot like strategic buyers, if they are not truly strategic buyers already by virtue of the size of certain of their industry platforms. What that means, in many cases, is that their investment horizons are lengthening and their rate-of-return expectations are, in fact, diminishing, to fall more in line with those of traditional strategic buyers.

If we are representing a seller and there are two buyers — one strategic and one financial — the choice always comes down to the nature and degree of each one's interest. That may have to do with what they do or don't have in their portfolio. It has to do with their willingness to pay up, which itself is always a function of things like synergies. And, in this market in particular, our choice of acquirer has a lot to do with probability of closure. Certain financial buyers are a lot less attractive in this environment because they have a lot less ability to finance their transactions than other financial sponsors who are



**Michael S. Goldman**

willing to over-equitize a deal or bridge themselves.

**Goldman:** There is often a difference between what people say and what they do. We have certainly seen that with private equity buyers. While they may state a desired rate of return, when we have a larger opportunity that is of superior quality, we see them stepping up to multiples that equal those of the strategic buyers.

The real differential has been at the smaller end of the market, with strategic buyers outbidding the financial buyers. But we think that overall, financial buyers have already reduced their return criteria, especially for the higher-end transactions.

**Deutsch:** Many of them have privately told us that they would be happy to realize high-teens rates of return.

**Warren:** In many cases, there are far fewer strategic buyers than it first appears. By the time you get down to what their synergistic opportunities really are, their degree of interest, and what else is on their plate, a financial buyer can in many ways be as competitive as many strategic buyers.

**Deutsch:** If, in fact, those potential strategic buyers are inwardly focused in this environment, forget it. They are simply not making acquisitions.

**M&A:** *That brings us to Sarbanes-Oxley and the probability that a lot of small, mid-cap companies may not want to disclose what is required, and they would be selling clients. But is this*



**T. Patrick Hurley**

*affecting the dealmaking process? Do your public clients require more due diligence to make sure that they don't wind up with any post-deal backlash? Have any of the deals tanked because of this? Are buyers demanding in the reps and warranties that there be no skeletons in the closet?*

**Blum:** Having spent 26 years in the accounting profession before joining Burnham, it's clear to me that Sarbanes-Oxley is turning the competition upside down. The accounting firms that remain in the m&a business operate on a much smaller scale than they used. Also, they are less likely to be at the high end of the m&a marketplace. Just an intriguing aside.

**Benning:** We are a full service broker-dealer so we have a very active institutional research and sales training operation. We provide research on about 250 public companies. When we talk to our public company CEO clients, it is absolutely the number one source of agitation for them. In the early '90s, I used to be able to meet with a CEO in a regulated industry like banking, inadvertently push what some called "their R-Button," and hear literally 30 minutes of real anxieties, issues, and uncertainties. It is déjà vu all over again as far as that goes.

When they look at the new cost structure of being public — and they all just paid their D&O premiums — they are even more upset. With the bills that they are getting from their accountants, the bills that they are getting from their lawyers, the scrutiny that is being placed on the audit committee and on the compensation committee, the

complaints that they are getting from their directors, and the difficulty that they are having attracting new directors, they are actively considering their options.

Last year at our investor conference we asked all of the public company CEOs if they wanted to be public or private. Two-thirds of them said they'd be private tomorrow if they could. My guess is that number will be up materially this year.

So it definitely drives sell-side interest in getting away from all of that—not having to certify financial statements, not having to be on the line for all of that undefined liability. The cost structure of being public when you go sub-\$100 million of market cap is real money in terms of the market cap of the companies. The litigation profile is going to drive sell-side deal flow also.

On the buy side, the pressures on due diligence are very real. If you look at the due diligence process in a transaction involving a public buyer today, I would say it is 30% to 50% longer than it was pre-Sarbanes-Oxley. The aggressiveness on the reps and warranties is very tangible.

The other place that it is creating issues is in some financial sponsor deals. They are trying to not get into a deal structure that isn't going to be acceptable in a public-company context after the fact in terms of management loans and options and how you set up the board with independent directors.

**Deutsch:** There are many more shareholder class-action suits. Ultimately, they pit company management against their board and their shareholders. It's no surprise that there are many more going-private transactions, particularly among smaller public companies.

**Goldman:** We are in the midst of a going-private transaction led by a major shareholder of a public company. It is always hard to precisely analyze the motivations of the acquirer. But I would say that 75% of the motivation behind this particular deal is not just Sarbanes-Oxley but all of the other expensive aspects of being public. A micro-cap public company just can't justify those expenses.

**Owsley:** As a director of a company that is looking at Sarbanes-Oxley requirements, I can tell you that it is a painful exercise. But I think there has been more smoke than fire so far about going private and that people are thinking more seriously about it after having signed the Sarbanes-Oxley reps four to six weeks ago. I think that this is going to accelerate this year.

There is also something else that we are seeing from our neck of the woods. Because financial statements may change in their importance as companies approach the zone of insolvency, companies that are nearing distressed levels are finding additional pressure being put on boards in order to make sure that they are solvent. If they are not,



the audit committees and the boards may face responsibility for promulgating less-than-accurate financial statements.

**M&A:** *Specifically, with distressed companies, are buyers taking more of an interest in them and willing to play in the Chapter 11 process, if necessary? Have we set any criteria on how they should be priced? Are topping fees becoming a problem?*

**DeMatteo:** We are able to market these companies as multiples of pro forma cash flows. We do have buyers willing to take a look on that basis. We also are seeing that financial buyers that previously wouldn't touch a distressed company are willing to get involved in that process. But they still may not be the winners at the end of the day because they don't have the tolerance or the speed to get through that process quickly enough or the flexibility or the financing.

So strategic buyers still are usually the winners at the end of the day in most of these situations in the lower middle market, especially where we don't have time for financing contingencies.

Topping fees are an issue. We have struggled with that in many districts and everyone has to lobby to get them to stimulate the bidding. When you have to justify it, you just say, "Look judge, if we don't have this stalking horse we may not be able to sell the company and that is drawing value from the estate."

**Owsley:** In terms of the strategic buyers, I don't think that there is a fundamental shift. Leading strategic buyers will take a look at distressed companies in their universe and take advantage of the opportunities. In the steel business, for example, Nucor bought Birmingham and in the chemicals business Koch bought a number of assets from Farmland.

Within the financial universe, more people have come into the distressed area as financial buyers simply because the number of opportunities there are greater than in other areas right now. They can take advantage of perceived price imbalances and so forth.

I view the topping-fee issue as not a whole lot of new news. We have always had judges, creditors, committees, whoever, raise questions about stalking-horse fees. We

*We see a much more methodical pace of acquisitions. There is no longer a rat race to buy.*

have always had to provide justification for them. Scrutiny may be higher on those kinds of things today than they were in the past but scrutiny today in bankruptcy courts is generally higher on a number of issues. So this is not anything out of the ordinary. You have to provide both logical and statistical justification that says



**Henry F. Owsley**

"this fee is in line for the following reasons."

**Deutsch:** It might be helpful to categorize various kinds of distress. First, there is good company/bad balance sheet, a fundamentally good company with something awry in capital structure. Second, there's the slightly troubled fixer-upper for which there is markedly greater interest now. Third is the deeply troubled company for which there may only be interest from professional turn-around investors. And fourth, there is the dead company that just doesn't know it yet, for which there shouldn't be any interest!

We see the greatest change in interest in the slightly troubled companies. Many private equity firms and others that wouldn't have touched trouble in the past will consider a mildly troubled situation today, if they think they can fix it.

**Benning:** What we see is a bunch of new companies with promising product lines that are starting to get some sales traction but their infrastructures are way beyond the size of the company in this economic environment. They thought they were going to have \$100 million in sales but they have reached only \$25 million in sales. But they have an attractive product for a strategic acquirer. They will sometimes look at a prepackaged bankruptcy or Chapter 11 process as a way of cleaning things up and leaving behind a lot of residual issues that they don't want to deal with.



**Russell Warren**

**Cromwell:** I think that category of “repairable companies” is drawing increased interest. Some of this interest is driven by the fact that there just aren’t many good companies available to be acquired. The private equity funds don’t have as much choice as they did in the past. If they want to invest in something or buy something, they may have to more seriously consider that category of company.

**Deutsch:** It is the general perception that you may avoid an auction if you consider slightly troubled companies.

**Goldman:** One reason I think that this has been a poor m&a market over the last few years is that sellers and companies with strong profitability have not viewed this as an opportune moment to maximize value. As a result, much of the deal action has been on the distressed side. I think the volume of activity in the distressed sector has reduced some of the stigma that was once attached both to filing for bankruptcy and to acquiring a business and assets through the bankruptcy process.

**Warren:** I think that the financial buyers operating in the troubled company sector are another example of the specialization. A lot of special skills and knowledge are required, and they either get it by working with turnaround firms or they have the expertise in-house. That gives them distinctiveness and is a way to acquire something with less competition and at a bargain price if they are willing to take the risks and put up with the challenges that it takes to generate a return.

**M&A:** *What, in your opinion, is it going to take to restore a level of activity in which we have a substantial, solid market with a lot more deals?*

**Palasz:** It is difficult, if not impossible, to say that one thing is most important in driving an increase in deal activity. Most of the factors are linked in terms of a firming of the economy. I believe an economic pickup will help drive some more accessible financing, and the combination of those two things is interrelated with the stock market firming up.

I think we have all seen the deal market experience a bit of “a perfect storm.” We in the m&a business had a lot of different factors hitting us at once, including conservative lending markets, a bear market in public equities, and a general economic slowdown. These three factors have brought m&a activity levels down on a macro basis, albeit only to 1996 or 1997 levels, which is still fairly high on a historical basis. We probably need to see a number of factors move together over time for the overall m&a market to return to much higher levels. That is perhaps 12 to 18 months out, but we at William Blair are beginning to see it.

**DeMatteo:** In the distressed sector we are not complaining about deal flow. We are pretty happy about the way things are coming in and are bullish that they will remain that way even if the economy starts to turn and interest rates go up. Companies that have been treading water are going to have trouble meeting their debt payments and financing demands will come back stronger.

**Owsley:** We are also heavily involved in non-distressed and complex deals as well. I think that one of the reasons why we are not seeing as much deal flow in conventional m&a is because of a disconnect between buyer and seller expectations and a disconnect between equity and debt expectations. Part of it is due to the economy and part to financing.

Right now we don’t know if we are going to have inflation or deflation. The Fed keeps flip-flopping depending on which paper I pick up and which week it is. So until people’s expectations get in some form of consistent zone on whether there will be economic growth and what the interest rate assumptions are and what the equity expectations will be, you are going to have buyer and seller disconnects. You are going to have other inconsistencies that are just going to cause more impediments to getting deals done. Once that straightens itself out, I think you are going to see a lot of deal flow.

**Goldman:** Over time, the best predictor of volume in the m&a middle market has been the confidence of acquirers, whether strategic acquirers or financial acquirers. When

that confidence is restored, the quality sell-side deals will return to the market.

The key to building acquirer confidence is the performance of their own companies; as their companies become stronger, they are much more inclined to move forward. Other factors include the performance of acquirers' stocks in the market, the availability of financing, and the overall level of m&a activity that they are seeing in their industry, because there is a "me too" aspect to the m&a business.

Once acquirers see a solid pickup in their own business in both revenues and the bottom line, that inevitably builds their interest in making acquisitions. As we've seen in previous cycles, once the acquirers are ready to step up, the supply quickly reloads and sellers become available.

**Warren:** We are advising sellers that own nice companies that are growing relatively well in this period that it is probably to their advantage to go earlier than later. Right now there is a dearth of good sellers out there who are willing to step forward. If they do, they attract the attention of the many buyers that are really eager to get deals done. So these sellers will benefit from the imbalance of supply and demand. Each company has a window of opportunity.

**Blum:** But we also need a stock market with some continuing momentum, not just resting at a new level but showing some upward optimism. There are signs that this is happening. Second, we need a prolonged absence of bad news. Somebody used that wonderful phrase, "a perfect storm." You know, we really do need clear weather for a while. I'd also like to point something out about interest rates: One of these days a whole lot of buyers are going to look up and realize that today's interest-rate nirvana is going to end. When they do, just watch how deal announcements surge!

The key in terms of the buy side is the public buyer. Financial buyers are not the problem, although they are constrained by tough lending terms. Public buyers, particularly those that have been using their stock as their acquisition currency, are key.

**Hurley:** We focus on privately held companies with owners who only sell once. They need sustainable optimism so that they believe that they will be able to match what they are currently earning. I don't see any problem with the price disparity at the moment for high-quality companies, but the alternative investments are not great.

The real issue is when someone says, "If I sold my company two years ago, imagine how much of it would I have lost in the last two years in the stock market." So you can put your money to work for a low, single-digit interest rate in a tax-free market. Or you can put it in the public



**Karl A. Palasz**

markets and think about how much you are willing to lose. I think when people believe that they will be able to match what they are doing with their operating company investment today, they will be ready and willing to go to the market.

**Deutsch:** When I ask myself what it will take to restore a healthy m&a environment, I wonder if the previous several years of m&a activity were healthy, or unhealthy, and from whose point of view. It was healthy from an investment banker's point of view, perhaps, but not from all companies' points of view.

From an investment banker's point of view, a better m&a environment depends on acquirer confidence and deal machinery. What makes people have greater confidence? Generally, a greater degree of economic health and growth, a sense of good inflation rather than fears of deflation, and Corporate America's ability to focus on the future rather than now. Now is war, now is current business problems, now is low public equity valuations. As far as deal machinery is concerned, it is having the banks fully back in the game as well as having private equity firms and mezzanine funds fully back in the saddle and less focused on portfolio problems.

**Benning:** I know the feeling today is that the market is slow, but I think that when we look back at 2003, with the benefit of some time, we will recognize that middle-market activity levels are actually fairly high relative to longer-term averages. As buyers and sellers address their sense of expectations, so are intermediaries, like m&a

bankers. The Street has clearly been going through a lot of downsizing to get back to the right size for 1995-1996-1997 activity levels.

From our perspective, there is no shortage of demand on the buy side. Corporate development officers and financial sponsors all want to see deal flow. And by historic standards, they are still paying pretty decent multiples. Right now there are lots of divestitures, lots of asset sales, lots of distressed deals, lots of buyer-initiated dialogues. When we talk about a return to a “normal” m&a market, the players missing today are the fence-sitters — companies that don’t need to sell today but need to do it sometime in the next five years. For those peo-

*People who move sooner are probably going to be glad that they did several years from now.*

ple, the keys will be less volatility and negative headlines, increased ability to forecast their own business, and a resulting higher level of confidence.

Setting aside the time value of money, people that move earlier are going to do better than the ones that hang back because the multiples today are still relatively high by historic standards. Financial buyers are paying five to six times EBITDA and strategics are buying above that. A lot of deals are still getting done at the upper end of the multiples range. People who move sooner are probably going to be glad that they did several years from now.

**Cromwell:** The environment is still not great in the middle market for m&a, but I do see some improvements in three areas: macro trends, deal supply/demand pricing dynamics, and momentum. First, in the macro area, the issue of

Iraq appears to have been resolved. It was a dreadful overhang in so many different ways. Second, there are improved economic and corporate results recently, and that bodes well for a better m&a market.

As for deal dynamics, on the supply side it is still going to take a little more time for the sellers to understand that the prices that they might have received three or four years ago are not available in the foreseeable future. Although it is taking them longer to recognize the new reality on valuations, I do sense that with the passage of time that their price expectations are slowly lowering to match buyers’ pricing.

On the demand side, I am beginning to sense that people are willing to step up a bit more and raise their prices. This trend is emanating more from the private equity funds than from corporations. Corporations don’t have the seven-to-10-year fund life of the private equity funds, and so I see the corporate buyers stepping up more slowly than the private equity funds. Overall, these deal dynamics of supply and demand mean that the bid and asking prices are getting closer, which is good for the m&a market.

The last issue is momentum. As people start to see more deals getting done, it will force both strategic and financial buyers to worry that they might have missed the bottom of the market and that they should move sooner rather than later. This momentum factor should begin soon after the above two factors begin to increase deal activity.

Overall, the improvements in the macro issues, the deal dynamics, and momentum will all lead to a better market. Although the m&a market is still not perfectly robust, I see positive signs in all of these areas to make me optimistic about an upward trend during the next couple of years. □