

BY THE NUMBERS

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Since the onset of the current financial crisis, the M&A market has slowed dramatically. One of the most important forces behind this has been the lack of financing at levels that had existed during the past few years. Because it is currently more difficult to obtain debt financing and debt has become more expensive, buyers have had to use additional equity to close transactions. According to Standard & Poor's, average equity contribution to leveraged buyouts rose to 42.6% in 2008 from 32.9% in 2007. As a result, buyers have had to lower the prices they are willing to pay sellers to receive an acceptable, albeit reduced, rate of return on their investments. Almost as important, certainty and confidence, the two "foundations" of M&A, are in short supply.

While valuations have declined, many sellers are more willing to accept lower purchase prices, as many are in distressed situations and are motivated by short-term liquidity needs and covenant default and other lender pressures. Sellers are concerned about tighter credit and that their ability to generate internal growth will be more difficult. Also, the press coverage and pervasiveness of the economic slowdown has caused sellers to accept that the world has changed. Moreover, with respect to non-core assets, cash constrained sellers are more likely to accept a decreased valuation as part of a divestiture of a lucrative subsidiary or division as a means to weather the economic storm in their core business. Therefore, some view M&A as a means of recapitalization, which has further driven down purchase prices. As companies continue to struggle, sellers will likely appreciate qualitative factors such as certainty of closing as much -- if not more than -- valuations, which may cause further decreases in purchase prices.

Before June 2007, M&A transaction levels were at or near all-time historic highs, due to massive global liquidity, liberal lending terms and strong activity by private equity firms that purchased \$495 billion of U.S. assets in 2007. Then the credit markets began to tighten significantly with debt financing becoming much more difficult to obtain. Even if debt was available, the cost of obtaining

it was much higher. In the fourth quarter of 2008, the average all-in spread for BB/BB- institutional loans was LIBOR plus 467 basis points, compared with LIBOR plus 172 basis points in the second quarter of 2007. This in turn led to a large reduction in private equity activity and the virtual disappearance of large leveraged buyouts. According to Thomson One Banker, U.S. M&A volume during 2008 versus 2007 based on deal value decreased 38% and the number of deals during that period declined 18%. Private equity-sponsored deals declined more on a relative basis in 2008, resulting in increased market share for strategic buyer deals. The decrease in the fourth quarter of 2008 versus 2007 was even more dramatic, with U.S. M&A volume based on deal value declining 54% and the number of deals declining 30%. Standard & Poor's estimates that U.S. new-issue leveraged loan volume decreased from approximately \$511 billion in 2007 to \$148 billion in 2008. These statistics are even more startling when you factor in that the 10 largest deals in the second half of 2008 accounted for more than 40% of the domestic M&A activity. On the global M&A level, the fourth quarter of 2008 saw a 36% decline from fourth quarter 2007 totals.

While overall activity declined in 2008, transactions above \$500 million showed the greatest decrease on a relative basis when compared with deals of a smaller size. This decrease is particularly acute when one eliminates the sales of distressed financial institutions, which accounted for a great portion of these larger size deals. Furthermore, median transaction valuations in 2008 decreased from 2007 levels. Yet they still remain above the 10-year average, because the middle market has been somewhat more stable and resilient. Even the middle market, though, has recently shown significant declines in activity.

Significantly reduced valuations in many recent M&A transactions, due in large part to the sustained difficulties in the credit markets, has resulted in an increase in all-cash or stock-for-stock transactions, especially during the fourth quarter of 2008. According to Standard

& Poor's, in the fourth quarter of 2008, average debt multiples of highly leveraged loans fell to 3.1 times from 5.2 times in the second quarter of 2007. Further, average equity contribution to leveraged buyouts rose to 42.7% in the second half of 2008, from 32.5% in the first half of 2007. With financing being sparse and only available under restrictive terms, equity has become a more predominant form of consideration in M&A transactions. The reduced leverage and increased equity contributions adversely affect transaction size and investor returns, and will continue to do so. As a means of offsetting these adverse consequences, acquirers are paying lower multiples.

With many companies struggling to remain solvent, many sellers have been more willing to accept lower purchase prices in order to keep their companies from going bankrupt. This has allowed for buyers to purchase distressed companies at attractive prices and has amplified the use of decreased valuations and increased equity when funding the transactions. Not surprisingly, hostile M&A bids have increased to 24% from 8% of overall domestic M&A activity from 2007 to 2008.

The decrease in purchase prices when coupled with the increase in equity contributions can be viewed as a mixed blessing for buyers. Although they now have the ability to buy distressed companies "on the cheap," the lack of available leverage means that buyers

must put up their own cash as equity in order to fund the deals. This change with respect to how deals are currently being financed has shifted more of the risk of the investment being successful to the buyers and therefore acts to further exacerbate the decreases in purchase price we are presently seeing.

Given the recent significant changes in the M&A market and the overall volatility of the economy, valuations have become difficult for buyers and sellers to determine. However, this does not mean that no deals are getting consummated. Although many sellers still appear to have what are now unrealistic valuations, this mindset may slowly change, as sellers will likely become more focused on certainty of closing and in turn accept a lesser valuation. As companies continue to struggle economically and search for new ownership by better capitalized entities, an increased number of sellers may become more amenable to accepting lower purchase prices. As such, depressed valuations in conjunction with increased equity-based transactions are being used by various buyers in order to make their returns more acceptable and it is likely this trend will continue in the near future.

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