

DEAL ECONOMY 2010: MIDMARKET DEAL TRENDS

BY BAZ HIRALAL

The post-lunch panel at The Deal Economy 2010 conference in New York City on Wednesday discussed the middle-market sector, where M&A has been on the rise.

Nathaniel Baker, a senior editor at The Deal, moderated the panel, which included Steve Deedy, a managing director at Alix Partners;

Ken Hanau, a managing partner at 3i U.S.; Jim Epstein, a partner with Pepper Hamilton LLP; and Randy Schwimmer, senior managing director and head of capital markets at Churchill Financial.

Baker began the panel by noting his recent feature story *Waiting to exhale* in The Deal magazine, which explores how dealmakers are cautiously optimistic but fearful that the continuing paucity of credit could derail any middle-market rebound before it gets properly started.

Baker then asked the panel a series of questions:

- Where is middle-market M&A dealflow, and what are some of the major issues affecting it?
- Will lenders stay focused on middle-market deals?
- What are the prospects for private equity investments and add-on acquisitions?
- Which industry sectors and regions will remain vibrant?
- Will cross-border and inbound investment continue?

Epstein addressed Baker's first question about middle-market M&A dealflow and some of the major issues affecting it. Epstein explained Pepper Hamilton splits midmarket into two categories: deals under and over \$100 million.

"Of course, there's more credit available for small deals. LBOs are difficult above the \$300 million to \$400 million mark, but at least valuation gaps are shrinking," Epstein continued.

3i U.S.'s Hanau responded, "We've come a long way since March. People were fearful, but we're seeing a thawing out of credit markets. There is still caution, but the mindset is around growth."

Deedy said of the downturn, "PE firms were tending to focus on making portfolio companies healthy, but we're seeing a

willingness to expand lately."

Baker followed up his question: "It sounds like there are plenty of buyers and sellers, and they're even willing to meet at a point in the middle. But where is debt financing these days?"

Churchill's Schwimmer responded, "There's definitely financing for small deals."

3i U.S.'s Hanau also offered a response, "There was so much liquidity on the sidelines. Valuations have not come off that much, and that's driven by the amount of capital on the sidelines that's waiting to be deployed."

Pepper Hamilton's Epstein explained PE is "still loathe to go to banks."

Schwimmer added, "People are still doing their credit homework. This isn't 2006."

Alix Partner's Deedy chimed in, "I agree there's a lot of money on the sidelines. Building products companies have been hit hard so it makes sense to go in there and get something on the cheap. But everyone's flocking to the same deals. Caution is also called for on future performance."

Baker turned the panel's attention to lending. He asked: Who are the new lenders, and what types of terms are they offering?

Schwimmer opined, "The identity of midmarket investors has changed. A lot of banks have gone out of the midmarket lending business, but small banks are being adventurous. We'll see where they are in two years. Golub is one of a few colleagues that's still active. And of course special dedicated funds have cropped up in the past six months." It's worth noting as a side note that CLOs have been a bit discouraging.

Epstein said another area of access to debt is seller financing. "I've been involved in a couple deals that were purely seller financing."

Hanau thinks we shouldn't be concerned too much: "Like Randy said, banks are coming to the market, and we'll see more of that."

Baker recalled that building materials were mentioned as an attractive sector for dealmaking. He followed the segue by asking, "Are there others?"

3i's Hanau responded, "Well, our main reason is to go for U.S. companies that are global, such as in technology or industrials, tech and somewhat in healthcare."

Deedy said, "Building materials,, I think is just an opportunistic sector. You should also look at the 'green' space." He also mentions that there's not a lot of money chasing retail because of the volatility.

Schwimmer suggested you should "ask yourself what is going to be the consumer model -- where will they buy and where will businesses sell? Business services is a big growth area. Of course, healthcare is a big area, but it's hard to figure what small companies focus on. Then there's the overhang of Obamacare."

Epstein noted that you can also "look at this from a transactions perspective. Look at the GE-Universal deal. On a much smaller scale, you will find a lot off opportunities to benefit from regarding corporate carve outs."

Baker asked if there is any concern about consumer spending?

Alix Partners' Deedy said the consumer is important, and "2010 probably won't be big for three reasons: 1) Personal savings rates will be high; 2) unemployment will be high, there's no hockey stick-type recovery to look out for; and 3) politically, things will be hard, throwing money at it will be difficult."

Hanau said, "We're definitely cautious, even though Asia is doing well."

Schwimmer responded that "it's fascinating to see some headlines, to see retail sales being up. Businesses are raising the optics of value."

"What about strategic acquirers?" Baker asked.

Hanau said they will come back. They have better looking balance sheets than financial buyers, meaning private equity.

Epstein pointed out, "Corporates can use stock as currency and the markets have been headed in the right direction."

Schwimmer added that "smaller companies are raising their hands and saying 'Hey we can't do this alone.' As a No. 3 or No. 4 player, they're reaching out. They're banding together, and it will be competitive."

Hanau also noted, "You can't cut your way to glory. You do cost cutting for one reason -- to grow."

(Corporate Dealmaker has a string of stories noting how strategics have been cutting costs, such as jobs, while acquiring companies at the same time.)

Baker asked, "Where is financing?"

Schwimmer responded with his own question: "Does anybody remember what happened to that \$280 billion deal pipeline? People love to have looming things over their heads, like '2012' (referring to the movie). There's a high yield boom. Deals will get financed somehow."

Hanau added, "Yeah, we're already talking dividends. This will work itself out."

Epstein said to "look for the extension concept. You hit a maturity date, but the company is performing." Banks will give some leeway.

Deedy talked about "kicking the can down the road. There will be money out there. Also, there is the end of covenant-lite deals. Companies will have to be run more tightly. Rates will be higher; covenants will be more restricted."

Epstein said, "I think banks are going to take a second look at whether they will call default."

Baker opened the floor to questions from the audience, and one member asked about emerging markets.

Hanau answered, "Look at Asia and Brazil, Eastern Europe. Money will chase growth, but with growth comes risk. China and India are also areas for opportunity." - *Baz Hiralal*

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