

### ***"Deal" or "No Deal"?***

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Being part of an investment banking boutique focused on small mergers and acquisitions provides an interesting view on today's marketplace for strategic transactions. These smaller deals (defined here as between \$10 million and \$100 million in value) generally get very little attention from the major banks and financial institutions or from the financial press. The fee potential for Wall Street and the impact on industry sectors have typically been too low to be of much interest. However, these smaller deals have always represented the vast majority of the number of transactions consummated and can be a good indicator of the vitality and innovation occurring in our economy as well as buyer confidence in the future, seller receptivity to market valuations and the availability of credit (both for distressed sellers and eager buyers).

Most of these small deals represent financial exits by entrepreneurs and their backers and the next step in their corporate evolutions. In general, there comes a time when a small firm realizes it needs greater size, higher efficiencies and broader distribution to grow and compete outside of its original niche. In an economy like today's, the advantages of scale are even more important as subscale companies seek improved access to credit and less nervous customers. In addition, with increasing taxes and regulation likely in the near term, having the scale to spread such overhead costs should become increasingly important.

...Media & Entertainment and Telecom represent 12.5% and 7.9%, respectively, of deal activity year to date by deal value. This is strong performance ... but in a very dismal year ...

So if small M&A deal flow is a good barometer of the economy, where are we exactly? In the last ten years, the number of small deals has gone from a low of 4,004 in the post-Internet/telecom bubble recession year of 2002, to a high of 7,294 in the nirvana LBO deal year of 2007, to a dismal 1,597 deals year to date<sup>1</sup> (2,626 on an annualized basis). The current deal rate when annualized is roughly two-thirds of the rate of the worst year in the last decade and roughly a third of the peak year 2007 rate. The impact has been even greater on larger acquisitions which are at only roughly one fifth of their 2007 peak rate due to the lack of credit for large acquisitions. If one excludes hot sectors like healthcare, energy, and metals/mining the view looks even bleaker. These three sectors alone represent 48.1% of globally announced deals year to

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<sup>1</sup> Thomson Financial, announced transactions globally between \$10 - \$100 million



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date by deal value. Our industries of focus, Media & Entertainment and Telecommunications, however represent 12.5% and 7.9%, respectively, of deal activity year to date by deal value. This is a strong performance relative to other industries, but in a very dismal year.

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It should also be noted that while year to date announcements are still paltry by historical standards the activity has in fact picked up considerably from the first quarter of 2009 where the annualized rate was less than half that of 2002. The recent pronounced uptick in the public equity markets is clearly having a positive effect.

Deal Size	10-Yr Low 2002	10-Yr Hi 2007	Annualized 2009 YTD	2009 YTD vs. 2002	2009 YTD Vs. 2007
\$10-\$100 Million	4,004	7,294	2,626	66%	36%
\$100-\$500 Million	1,540	2,879	932	61%	32%
\$500 - \$1 Billion	295	706	191	65%	27%
Over \$1 Billion	322	861	179	56%	21%

So, what do we expect going forward? We believe there are many small companies and Boards of Directors searching for safe havens in these challenging times, a nice comfortable home at a stable parent company, but have previously been turned off by the abysmal equity valuations. Many of these small firms are finding growth and even working capital hard to fund. Interest rates remain low, but banks continue to shepherd capital for their larger and safer clients. Many smaller firms have thus been all but abandoned by their banks with liquidity and even solvency a growing risk. As a result of the economy and this lack of credit, the one booming area of M&A, as reported in today's Wall Street Journal, is distressed takeovers, with \$84.4 billion worth of deals to date or roughly double the rate of 2008.

... [with] improving valuations, we would expect the rate of M&A deal announcements to continue to accelerate, especially for the smaller and easily financed deal sizes ...

As we bounce off this recessionary bottom and hopefully sustain a rally, some of the pressures to sale or merge may diminish, but the ultimate need to seek scale and financial exits will not go away. If not for absolute economic survival, prudence will suggest to many smaller firms that they at least be open to inquiries from suitors. With those inquiries increasingly, if still slowly, being based on improving valuations, we would expect the rate of M&A deal announcements to continue to accelerate, especially for the smaller and easily financed deal sizes.



... why not more deal flow? The answer is two fold: valuation expectations and fundamental performance....

One might also expect that the larger strategic buyers, having suffered major hits to their growth, profitability and stock prices, would be eager buyers at these lower valuations. If your investors, and in fact your entire corporate structure, is based on growing at say 6% and you are now growing at 2%, or not at all, there is only one sure fire way to quickly boost growth and that is by acquisitions. This assumes, of course, that the larger companies have the cash and/or borrowing capacity to consummate deals. In fact, quite a few of the larger companies, such as Apple, Cisco, Google and TimeWarner have very strong balance sheets and plenty of cash for acquisitions. Some have even issued debt or equity for the purpose of building acquisition war chests. There are also several private equity firms sitting on billions of recently raised funds very focused on exploiting these valuations. From our perspective, this “side line” cash and growth imperative have led to a lot of window shopping this year by the better positioned strategic and financial buyers.

... “You can't always get what you want, but if you try sometime, you just might find... you get what you need!” ....

So, if the buyers are looking and the sellers are at least talking, why not more deal flow? The answer is two fold: valuation expectations and fundamental performance. It is only natural that the founders, investors and management of small companies would be reluctant to sell when there is “blood in the street”, but now that the blood letting is abating and the street sweepers are out, the valuation gap between buyers and sellers should continue to close. Of course if the recent improvement in equity values sharply reverses itself all bets could be off, but for now the valuation news is moving in the right direction for sellers and still attractive to buyers versus historical multiples. All else being equal, this should result in continued increases in announced deal flow.

The other factor effecting buyer appetite is the financial performance of the target. In a recession, the target's financial performance will most likely have taken a hit and perhaps a meaningful one given the lack of scale and credit mentioned above. While easily accretive transactions are the holy grail for buyers, there has also been a sort of carpe diem interest in taking advantage of this market dislocation to gain market share and add key technologies, customers and people. Still, the underlying business has to prove sustainable and a true value to its core customer base, but with that value proposition established and some judicious pro forma adjustments for revenue synergies and cost savings, deals are starting to come together. As Dan Flatley, a banking partner of mine years ago, use to remind clients in tough



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markets "You can't always get what you want, but if you try sometime, you just might find... you get what you need!" (the Rolling Stones). For buyers, I would also add the advice of Rahm Emanuel: "You never want a serious crisis to go to waste."

If more buyers and sellers follow this advice, as we think they will, years from now we would expect the corporate and financial worlds to look back on the 2009 vintage deals as having generated particularly strong corporate franchises and above average investor returns.

"Deal" or "No Deal"? we say "Deal"!

By Hoyt Davidson  
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