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Deals in a Downturn
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The ongoing Clear Channel Communications saga offers a stark illustration of just how the world of mergers and acquisitions has changed. The story goes back to late 2006, when private equity firms, Bain Capital and Thomas H. Lee Partners (THL), agreed to purchase the firm for \$39.20 per share. In March of 2008, with the transaction yet to be completed, Bain and THL filed suit against six banks who had committed to finance the deal, alleging that they had reneged on their commitment. "It seems clear that lenders' remorse set in when credit markets worsened," the companies said in a release.

Clearly, the market for private equity deals has changed. However, for savvy acquirers, particularly strategic buyers, this shift means a better chance of unearthing great buys. "If you kept your powder dry, there are a lot of good opportunities," says Steven Bernard, a Chicago-based director of mergers and acquisitions analysis with Robert W. Baird & Co.

A case in point is the acquisition by Arrow Electronics, Inc., of the Asia-Pacific components distribution business of Achieva Ltd. "We want to be a bigger, more significant player in rapidly growing markets like Asia Pac," says Paul Reilly, senior vice president and chief financial officer with the Melville, NY-based distributor. The Achieva acquisition, along with seven others over the past few years, is integral to that strategy.

To undertake these acquisitions, Reilly and his team first strengthened Arrow's balance sheet. The company completed a second offering in 2004, receiving about \$300 million. Strong annual earnings – net income almost doubled between 2004 and 2007, jumping from \$208 to \$408 million – and positive cash flow for the past five years, also have bolstered the company's equity base.

Focusing on the basics also helped, Reilly says. Employees made sure that customers were complying with credit terms, set up electronic payment systems, more closely monitored inventory – inventory values actually dipped by about one percent between 2006 and 2007, even as sales grew from \$14 to \$16 billion – and aligned compensation to reward better balance sheet management. As a result, Arrow's balance sheet currently sports about \$450 million in cash, and the company can call on \$1.4 billion in untapped credit facilities. "We can afford to be aggressive, take advantage of our competitors' weaknesses, and get companies that come on the market," says Reilly. "We can use our strength to be opportunistic."

The Achieva acquisition is a sign of the times. Even as overall M&A has tumbled since the start of the year, strategic deals, while down, haven't fallen as far. "We're now seeing strategic buyers that may have been squeezed by private equity before," says Bernard.

The total value of global mergers and acquisitions hit \$652.6 billion in the first quarter of 2008, reports Dealogic. That's a drop of 41 percent from the first quarter of 2007, and a decline of 44 percent from the fourth quarter of 2007. Strategic deals, or those done to bring together two operations that complement each other, sustained a less dramatic drop, Dealogic reports. The overall volume of \$567 billion in the first quarter of 2008 was off 2007's first quarter total by about one-third, while the number of deals actually rose by about 8 percent.

In the U.S., the number of mergers and acquisitions totaled 866 for January 2008, a dip of about five percent from the 912 deals done in January 2007, according to the February 2008 M&A Market Analysis by Robert W. Baird & Co. The total value of the deals dropped more dramatically, declining from \$92 to 59 billion, according to the report.

Hed: The Usual Suspects:

It's not difficult to identify the culprits behind the M&A downturn. The slowing economy, along with lower stock prices have spooked potential acquirers, says Bernard. Moreover, tighter credit has made it more difficult for some acquirers to get funding. A year ago, many private equity buyers could borrow against a deal's projected cash flows, with few restrictions. That funding has dried up, as more banks are writing off billions in assets, he adds.

The availability of debt financing will be the key factor affecting merger and acquisition activity in 2008, according to the 2008 M&A Marketplace Survey, conducted by KPMG and The Deal. Nearly two-thirds of the tax or M&A experts responding cited it as a factor.

One earlier casualty of this financing shift was Atlanta-based The Home Depot, which last year sold its wholesale unit, HD Supply. Early in August, the company announced that it was discussing with the private equity buyers, Bain Capital Partners, The Carlyle Group and Clayton, Dubilier & Rice, restructuring the deal and possibly reducing the sale price of \$10.325 billion. Later that month, the deal was completed for \$8.5 billion, with The Home Depot also guaranteeing \$1 billion in debt financing.

Even when banks are willing to lend, many are looking for greater equity commitments from the participants in the deals, says David Braun, founder and chief executive officer with Capstone, a Washington D.C.-based M&A advisory firm. Similarly, a greater number of larger deals – say, those that are well into nine figures – are being syndicated, based on surveys Capstone has done with its clients, Braun says.

That said, for some companies, the downturn actually is a “driving force,” in pursuing deals, says Kevin Dempsey, executive vice president with Summa Financial Group, an M&A consulting firm based in San Jose. A management team may decide that to remain competitive, it actually needs to boost the company's offerings. “If you want to acquire market share, get key employees, or move into a new geography, those synergies are more important than the background noise,” of the economy, Dempsey says.

“We would expect the market for strategic deals to percolate along,” adds Gerald Adolph, senior vice president with consulting firm Booz Allen Hamilton, McLean, Virg.

Consider the acquisition by Brambles, Ltd., a worldwide provider of storage and handling logistics based in Sydney, Australia, of LeanLogistics for \$45 million (U.S.) in cash. LeanLogistics, based in Holland, Mich., provides the technology Brambles’ U.S. division, CHEP, requires to keep growing, says Brian Beattie, senior vice president of marketing and business development. With the economy languishing, companies need to attack on all fronts to meet their profitability goals: cutting costs, and expanding sales of products and services, in both existing and new markets, he says. The acquisition enables CHEP to expand its service offering to existing customers.

In plotting its acquisition strategy, CHEP’s management team analyzed business models closely related to its core operation of renting pallets and containers to consumer products companies. These firms use the containers to transport goods from factories to distribution centers and beyond. Because rental rates vary with the starting and ending points of each trip, CHEP’s customers report the movement of their pallets to CHEP. So, CHEP’s information system knows that, for instance, Company A is sending 24 pallets of shampoo from Chicago to Denver on a specific day. It also can find out if another company needs to send 24 pallets of, say, laundry detergent, from Denver back to the Windy City the next day.

This information was key, as it allowed CHEP to offer a new service: linking deliveries, such as those in the example above, to more efficiently deploy carriers and drivers. However, CHEP first needed a robust transportation management system, or TMS. That’s where LeanLogistics came into the picture. “They’re the brains behind the whole movement,” Beattie says. LeanLogistics’ web-based system tracks which vehicles are available, and when. Moreover, their seven years in the industry lent a degree of credibility that CHEP had yet to establish, Beattie notes.

As both the Arrow and CHEP acquisitions suggest, mergers and acquisitions increasingly cross borders. According to Dealogic, for the first quarter of 2008, cross-border deals amounted to \$249 billion, or 38 percent of the total of \$653 billion. “We see this as a permanent shift,” notes Murray Beach, Boston-based managing director with TM Capital Corp. More companies are operating internationally, and advances in communication, as well as in capital markets around the globe, make cross-border deals easier to complete.

Hed: Baby Boomers and M&A:

Another broader trend impacting the M&A market is demographic. A small, but noticeable, number of baby boomers who have built up companies now are looking at succession planning. Of course, many baby-boomers will continue on the job or will pass their firms on to their kids. However, “we’re still seeing people who want to retire and sell their companies,” says Dempsey.

In March, Sanders Morris Harris Group, Inc. (SMH), a Houston-based financial services firm, announced that it had completed the acquisition of Leonetti & Associates, Inc., a

wealth management firm in Buffalo Grove, Ill. The acquisition offers SMH a well-run wealth management operation; that business also tends to be less volatile than investment banking, says Stephen Cordill, president of the asset and wealth management division of SMH.

The deal also “was a factor of the age wave,” says Cordill. Mike Leonetti, 52, spent 25 years building his eponymous firm and was looking ahead. As he got older, potential and existing clients wanted to know where the firm is headed, and who would be handling their money, he says. The partnership lets him keep running his firm as part of SMH, while knowing that both his clients and employees have a future with the new company.

The deal also is part of a broader consolidation going on with in the financial services sector, says Cordill. Tax and M&A professionals expect banking and financial services to rank first and second, respectively, in merger and acquisition activity in 2008, according to the 2008 M&A Marketplace Survey by KPMG and the Deal.

Hed: Right-sizing Creates Opportunities:

The declining economy also is prompting some executives to right-size their lines of business and divest tangential operations, says Adolph. “Another driver that we expect to see more of is portfolio cleanup.” The flip side of this, of course, is that other companies can acquire the divested pieces.

Divestiture often gets overlooked when the economy is rolling along, Adolph notes. When times are good, selling a chunk of a business often means gaining extra cash that might make the company an acquisition target. When things get tougher, however, the focused use of cash becomes more important.

This appears to have come into play in the decision by Weyerhaeuser Company to sell its container-board business unit to International Paper for about \$6 billion in cash. In the March 2008 announcement, Weyerhaeuser chair and CEO, Steven Rogel, noted that the divestiture would enable the company to focus on the “the trees and the land,” where it can bring its “unique expertise.”

On the other side of the table, the acquisition expands International Paper’s geographic presence and diversifies its customer base, said Carol Roberts, senior vice president of IP’s packaging business.

A few industries may be less affected by the drop in merger activity. The software industry is one, says David Sommer, publisher of SoftwareCEO, which is part of the Computing Technology Industry Association, or CompTIA. “We’re seeing a lot of activity in M&A in 2008,” Sommer says. Mergers and acquisitions in the software industry totaled \$268 billion in 2007, according to an annual report by SoftwareCEO that was released in March.

The activity is likely to continue, Sommer notes. For starters, many of the deals are strategic; the acquirer often wants to gain a new technology or complementary product.

In addition, company valuations tend to be lower for merger or acquisition deals than for initial public offerings (IPO). In many IPOs, companies are valued at six to ten times revenue; that compares with about 2.5 to three times revenue in a merger or acquisition. When money gets tighter, merger and acquisition activity tends to pick up, Sommer reports.

In March, TWL Corp., a provider of workplace learning solutions, such as videos and simulation tools, purchased Divergent Entertainment Inc. “We’re one of the last obvious candidates to be acquiring companies, because we’ve been insolvent the last nine years,” says Dennis Cagan, chair, chief executive officer and president of Dallas-based TWL. The company’s revenue and profits topped \$100 million and \$20 million, respectively, in 1995. By 2004, after management and ownership changes, revenue had dropped to about \$22 million, and the company was losing about \$9 million.

Cagan’s first job when he came on board in April of 2006 was to stabilize the company. Although revenue dropped by about seven percent, to \$24 million for fiscal 2007, the net loss was cut by about 30 percent, to \$15 million. Now, the turnaround has begun to take hold, allowing TWL to absorb an acquisition. Moreover, strengthening the company’s market share requires both organic and external growth, and the DEI acquisition extends TWL’s offerings of computer simulation tools, Cagan says. The deal was structured as a three-year payout of up to \$16 million. This conserves cash, while providing an upside incentive to the seller. “Right now, we don’t have a tail wind. We’re fighting every step of the way,” Cagan says. Leveraging the acquisition will help the company gain momentum, he adds.

Keys to Success:

While strategic acquirers may have more options now than they did a year or two ago, that alone doesn’t guarantee a worthwhile transaction. A recently released study of 500 deals around the globe occurring during 2000 to 2004 by KPMG International and the University of Chicago Graduate School of Business analyzes several factors that influence the long-term success of deals.

For starters, acquisitions made by companies with low price/earnings (P/E) ratios were more likely to be successful. Acquirers whose P/E ratios were in the lowest quartile of the study participants saw an average gain in their stock prices of 42 percent after two years. Conversely, acquirers with P/E ratios in the highest quartile gained just .8 percent after two years. One possible reason: managers of companies with lower P/E ratios may be less tempted to participate in riskier deals, given that they can’t use over-valued stock.

Similarly, targeting companies with lower P/E ratios also enhanced return. When target companies’ P/E ratios were in the lowest quartile, their acquirers saw stock price increase an average of 34 percent after two years. Conversely, acquiring companies who purchased companies with P/E ratios in the highest quartile gained only 5.5 percent after

two years. The study authors theorize that targets with lower P/E ratios are more likely to be fairly priced.

Successful acquirers also are less likely to spread themselves too thin. The stock prices of companies that completed one or two deals in the prior year gained 18.3 percent, on average, after two years. However, the stocks of companies that completed ten or more acquisitions actually dropped by 8.3 percent after two years.