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Trends in middle-market private company M&A/LBO activity

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General economic conditions, tight capital markets and a certain amount of post-Enron uncertainty influenced the relative lack of completed acquisitions in recent years. Many of these circumstances have been ameliorating over time allowing for an increase in 2004 in merger and acquisition activity for US-based, privately held middle-market companies. This return to normalised activity levels has led to general enthusiasm regarding potential deal volume in 2005.

The “middle-market” is one of those often-used corporate finance phrases that is virtually without a common meaning. In order to analyse current trends in leveraged acquisitions, we have focused on transactions involving privately held, domestic US targets with transaction values of less than \$1bn. Moreover, a portion of our comments are particularly relevant to the sub-\$150m deal environment.

Many statistical analyses support the fact that 2004 marked a return to more robust deal volumes. FactSet Mergerstat, for example, announced in January 2005 that the number of private company deal announcements climbed 24.4 percent in the US, making 2004 the most prolific year since 2000 [*Press Release, FactSet Mergerstat, LLC, FactSet Mergerstat's M&A Roundup in 2004 (Dec. 30, 2004)*]. Even adjusting for the number of mega mergers announced at the end of 2004, which materially influenced merger volume for the entire year, middle-market deal volumes similarly reflected larger activity levels.

As a starting point in reviewing financial trends in the leveraged transaction environment, the increasing availability of private equity and hedge fund capital in the middle-market continues to create buy side pressure. With the abundance of financial buyers, equity yield expectations had been driven down, allowing for buyout pricing

dynamics that remained favorable for the healthy seller. We continue to see new funds enter the middle-market and established funds able to raise significant amounts of new capital, particularly (and sometimes dramatically) if the established fund had a top quartile performance record in its most recent vintage fund.

While some have characterised 2004 as the year of the private equity buyer, strategic buyers also returned in force to the market. Today's strategic buyers with stabilised businesses and renewed appetites for growth are viable competitors to the private equity

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firms. What is perhaps a change from prior periods, however, is the fact that strategic buyers remain obligated to use cash as opposed to their stock in deals. We continue to see cash as the principal consideration for leveraged deals.

The need for cash in the current environment relates, in part, to the fundamental fact that sellers of privately held companies are often financial institutions and not individual owners or operators. On exiting their investment, these financial institutions have a need

to distribute the proceeds to their ultimate stakeholders, and holding or distributing the buyer's paper is often not a viable option. This fact, together with relative scepticism regarding the value of illiquid public securities, drives the almost absolute necessity for transactions to involve cash as the principal consideration. While stock-for-stock transactions are possible in the middle-market, few financial sellers desire to hold currencies other than cash. Many public company acquirers still will need to use cash as the currency of choice, at least until there are fundamental changes in expectations regarding public company valuations.

The most dynamic changes during the last several months have been the increased availability of debt financing for leveraged transactions. The most active debt providers have included second lien lenders, hedge funds and traditional mezzanine lenders. Overall liquidity in the capital markets at all levels, including the high yield market, continues to fuel the growth in a competitive lending environment. Throughout 2004, leverage multiples increased, evidencing a general willingness for debt providers to be more aggressive in pricing of middle-market leveraged transactions. Certainly we believe that 2005 should be characterised by a significant amount of available capital, up and down the balance sheet, to be available to put to work in leveraged transactions.

The economic structures for 2005 leveraged transactions should reflect increased purchase multiples, increased debt multiples and reduced yield expectations for purchasers reflecting a decent selling environment.

In the main, financially healthy companies are experiencing fully subscribed auctions. Some of our clients have characterised these auctions as “outlier markets” in which one or a handful of the bidders place valuations on the target that are significantly higher than what otherwise would be the market ►►

clearing price. Valuation dynamics that are intrinsic to individual potential purchasers often produce the “winning bid.”

Aggressive pricing carries with it the cost of potential covenant defaults and early financial difficulties. 2005 should continue to be a robust period for refinancings and distressed investing due, in part, to aggressive pricing techniques during a period of relative limited overall economic improvement.

Current trends in legal issues for leveraged transactions continue to involve governance and compliance issues arising in the post-Enron world. Fiduciaries for both targets and acquirers will continue to insist upon board level oversight of proposed acquisition activity as they remain sensitive to heightened levels of scrutiny regarding their deliberative process. This oversight will necessarily impose added due diligence and process scrutiny to any material transaction. Boards analysing strategic transactions, whether buyers or sellers, will generally require more deliberation, more expert involvement and more due diligence (both financial and operational).

Many private transactions involve related parties in one form or another. These related party transactions will draw particular scrutiny from independent board members, leading to the more frequent use of special committees and special committee advisers. Even during a period when fairness opinions are being intensively scrutinised in the public company context, we anticipate that more privately held companies may feel compelled to obtain fairness opinions, particularly in transactions involving related parties.

As an outgrowth of Section 404 of Sarbanes-Oxley, a fair amount of financial due diligence will continue to be focused in the area of internal controls over financial reporting. As the target’s business is absorbed into the buyer’s, internal control compliance will be at the forefront of the integration strategy. Systematic issues with a target’s existing financial reporting regime can become deal killers. Buyers will continue to retain third party advisers to assist them in this critical area.

The American Jobs Creation Act of 2004 (AJCA) and its deferred compensation

legislation is but another post-Enron piece of legislation that will materially impact the US leveraged deal environment. This legislation and the regulations to be issued by the Internal Revenue Service under Section 409A of the Internal Revenue Code will have significant ramifications on many forms of compensation devices typically used in middle-market transactions. The AJCA applies to a whole panoply of compensation devices from basic employment agreements to certain equity-based compensation arrangements and supplemental retirement plans. The penalties associated with missteps in this area are personal to the individual beneficiaries of the deferred compensation and, in certain circumstances, can result in penalty taxes of an additional 20 percent, plus interest.

So from where will some of the growth in 2005 come? Many analysts believe (and we agree) that mergers and acquisitions in the area of homeland security will continue to grow exponentially. One reason for the predicted growth is an increase in venture capital funding. Traditionally, venture capitalists have been attracted to technology-based companies, and much of the homeland security sector includes private companies with new technology related to a wide range of security-related products such as secure identification systems (e.g., using DNA-based technology), next-generation video surveillance, wiretapping and intelligence technology, highly-sophisticated chemical and biological weapon and counter terrorism detection systems, and other products related to protecting the nation’s borders, critical infrastructure, agriculture and a host of other points of concern.

A related area of growth will be in the area of federal government contracts, generally. In fact, the Homeland Security Act of 2002 was designed to make it easier for companies to contract with the federal government. Defense Secretary Donald Rumsfeld and Vice President Dick Cheney have been hailed on many occasions as the biggest proponents of private companies acquiring much of the work of the government. Because of these factors, many venture

capital firms are developing specialised products targeting private companies with the capacity to win such government contracts, which can often be lucrative. While publicly held companies will be competing for the same contracts, we will probably see an unprecedented number of privately held companies jumping on the government contract bandwagon, like Accenture did in 2004, when it was awarded a contract to develop high-tech border crossings to deter terrorists from entering the US and track foreign visitors. That contract is valued at up to \$10bn. Another strategy is for large companies (publicly or privately held) with current contracts with the federal government to affirmatively seek out and acquire smaller, more niche oriented private companies (think bio-security) that can make the potential bidder’s portfolio more attractive by offering an array of technologies. A recent example of this strategy is the acquisition last month by Lockheed Martin of STASYS Limited, a UK-based technology and consulting firm with expertise in network communications and defense interoperability. We believe that other significant players (particularly in the defense industry) will follow with similar type acquisitions. In a recent survey conducted by Grant Thornton LLP, 42 percent of government contactors say they have been approached to sell their company in the past year [*10th Annual Government Contractor Industry Survey*]. According to the same survey, there were 147 mergers of government service/technology companies in 2003, and 79 percent of those surveyed reported that the acquisition met or exceeded expectations.

With billions of dollars available for the taking (\$40bn in the homeland security budget to be exact), many private companies and their investors will want to do deals in an effort to win contracts with the government. In the past, these same companies would have never even considered this strategy. Today, the allure of these deals will attract financial buyers to search for such acquisition opportunities. ■

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