



INSIGHT

The Day the Earth Stood Still

When the financial markets collapsed in 2008, mergers and acquisitions ground to a halt.

by William S. Hanneman

In the Fall of 2008, the earth's rotation ground to a stop, at least with regard to the world of mergers and acquisitions. Markets essentially confronted the reality that the credit foundation for the surge of buyout activity over the past several years was built of sand. Wall Street firms collapsed, banks faltered and some failed, and, in response, the federal government scrambled to roll out a veritable alphabet soup of support programs—TARP, TALF, TABS, ASSP, CPP, MLP, and more—all with the hope of stemming the carnage. In the midst of the turmoil, our consumption-oriented society stepped back a couple of paces. Financial activity creaked to a virtual halt.

Uncertainty and fear supplanted the optimism that underscored the financial surge, as everyone (bankers, business owners, and government officials) had little choice but to sit tight until the smoke cleared and it was possible to evaluate actual conditions and potential next steps. That smoke is only now dissipating, and what has emerged should be of interest to every business owner.

THE ENVIRONMENT

Without a doubt, 2009 was the worst mergers and acquisitions environment in memory. As can be seen from the accompanying chart, the dollar value of transactions hit a 12-year low, as did the role of LBO's.

In most cases, a sufficiently similar view of future business prospects is a prerequisite to a transaction, as it provides the basis for buyers and sellers to agree on price. In a weak economic environment beset with uncertainty, business owners, whether they were large corporations, individuals, or private equity firms, tightened their focus on survival and forswore new business combinations. Those that did seek buyout opportunities frequently found that the gap between the bid and ask was far wider than normal.

Nevertheless, the forces of creative de-

struction in a free economy cannot be forestalled indefinitely. A long restructuring process of squeezing excess human and physical capital capacity from the system is underway in an effort to adapt the means of production to today's demand reality. Owners of debt-laden businesses learned (or re-learned) the harsh lesson that leverage cuts both ways. Many businesses survived the bruising and many others perished, or will in time.

As might be expected, a principal strategy in this environment is to retire capacity and enhance productivity through industry consolidation. Strategically minded corporate buyers armed with cash have taken the lead. Acquisition of distressed assets from firms either already in or confronting bankruptcy/receivership, constituted a significant share of 2009 deal volume.

Another segment where palpable activity was found is in businesses based on enhancing the productivity and efficiency of other businesses. The chart on the following page reflects an industry breakdown of 2009 private equity M&A activity relative to 2008. While deal volume was a meager 23% of the prior year, there was proportionally greater interest in business products and services, information technology, and a grab bag of industries lumped in the "other" category. Less desire-

able were consumer products, healthcare and financial service firms.

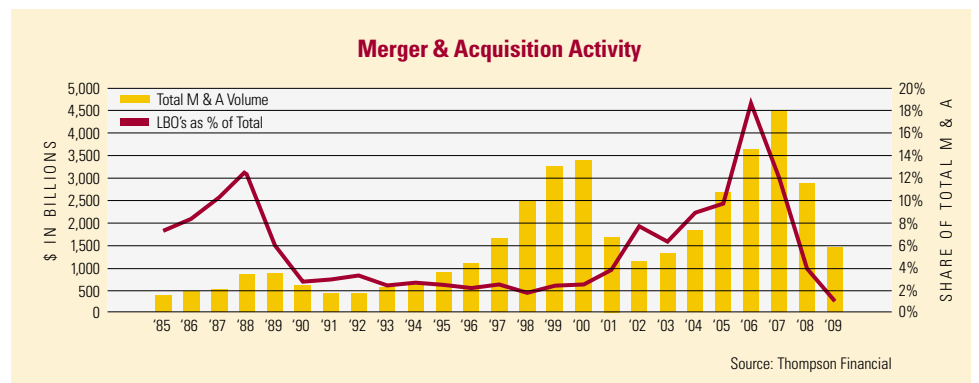
NEAR FUTURE

Our observation is that three themes are likely to dominate M&A activity in the near term: recapitalization of over-leveraged balance sheets, continued consolidation of industries to drive productivity, and liquidity transactions in industries as their futures become discernible.

First of all, there are many good businesses that are buried beneath the wrong capital structure. Lenders and owners have been able to defer the eventual economic reality, but we are seeing these situations only now coming to the fore. These businesses will change hands or alter ownership structure in transactions that right-size the balance sheet to current circumstances.

There is much capacity that has yet to be rationalized as evidenced by low industrial utilization rates across a number of sectors. Times like this give great impetus to learning to do more with less, often much less. As such, the wave of creative destruction that will reconfigure many industries has just begun to run its course.

Existing businesses, both large and small, are the tools best suited for this job. Private equity will play a role in the process in cases



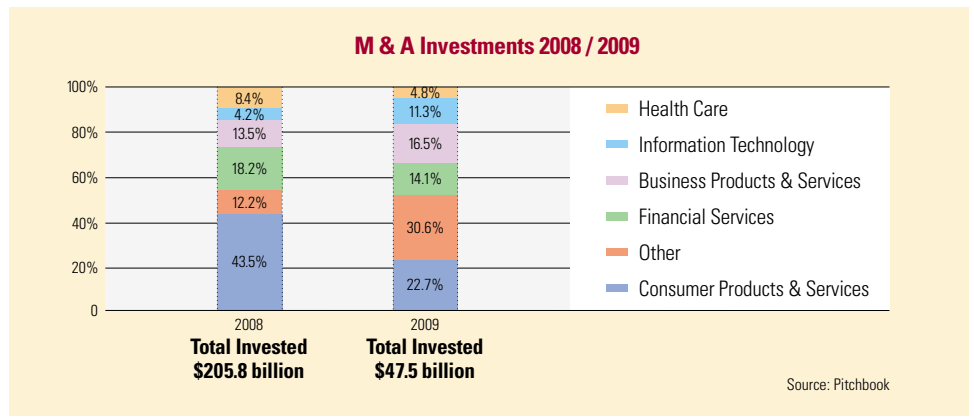
where capital can facilitate rationalization.

At the same time, both corporate and financial investors have an inexorable appetite for investment in stable businesses (e.g., food and beverage products and certain business services) and even more for businesses that exhibit prospects for healthy growth (e.g. healthcare, alternative energy, IT services, and government contracting).

Private equity firms, largely sidelined over the past 18 months, are increasingly poised to put capital to work. As discussed in the nearby IN\$IGHT article, the improving credit markets and a less murky view of the future is unzipping private equity purses to pursue growth businesses and to back quality management teams in consolidation strategies.

VALUE GAP CLOSING

In many instances, the gap between sellers and buyers concerning the seminal component of any deal, value, has not been resolved. Sellers look at the recent stock market rebound and renewed economic growth and hope it's a sign that the "good ol' days" are back and presage a return of the lofty business values achieved at the pinnacle of the cycle in 2007. In most industry sectors, buyers and their lenders, on the other hand, are more cautious, as economic and earnings visibility remains hazy. This valuation disconnect



persisted throughout 2009 and led to creative deal structures designed to bridge the value gap. These mechanisms, including earn-outs, significant residual equity positions for sellers, or multiple-stage closings, have become much more common. But, in sectors that demonstrate growth and stability, the "good ol' days" appear to be back. Because of the mismatch of capital available for investment and a dearth of good companies, competition is driving higher pricing.

In the final analysis, the value gap will close and deal activity will pick up for two reasons. First, businessmen and investors, in general, are beginning to understand the

realities of the economy and what the future might hold. The second factor is the inevitability of time. Private businesses are owned by people, and those people age. Most private businesses are not transitioned from one generation to the next. Instead, sales of businesses are the mechanism to generate liquidity to foster wealth diversification. Many business owners would have already taken that step but for the environment of the last two years. The need to monetize wealth accumulated in privately held businesses can be delayed, but not eliminated. ❖

Private Equity Update: The Tale of Two Cities

PE firms are developing new strategies, and private-business owners should take note.

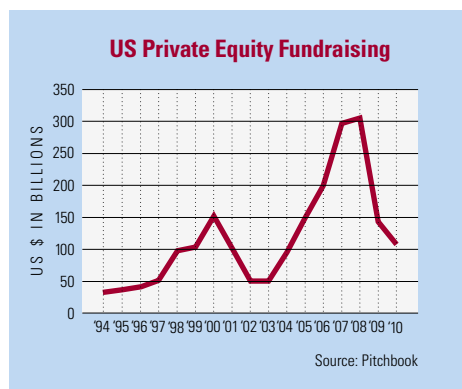
by Mark D. Working

Private equity firms are in a bind. The industry has been built on the twin pillars of control and leverage. Investment returns have traditionally come from a leveraged purchase of a business, followed by modest business growth, and then application of the cash flows to deleverage the balance sheet, culminating in the re-sale of the business to harvest the value. Returns from this formula have recently become more difficult to cultivate. As a result, private equity firms are changing their business models. For private business owners, these changes are potentially meaningful and should stimulate a fresh look at the prospects for taking on a partner and revitalizing the balance sheet.

THE CURRENT STATE OF THE PRIVATE EQUITY UNIVERSE

The four highest fund-raising years ever for the private equity industry were 2005, 2006, 2007, and 2008. Fund raising dropped off the table in 2009.

Armed with ample reserves and compliant lenders, private equity-led buyout transactions ballooned in the 2006-2008 period, peaking in 2007 at almost 25% of all mergers and acquisitions activity, followed by a crash



in 2009 to the lowest volume in 10 years.

During the robust years of 2006-2008, financial leverage applied to transactions reached its zenith, thereby diluting the usage of the equity raised, leaving an unprecedented glut of undrawn private equity firepower.

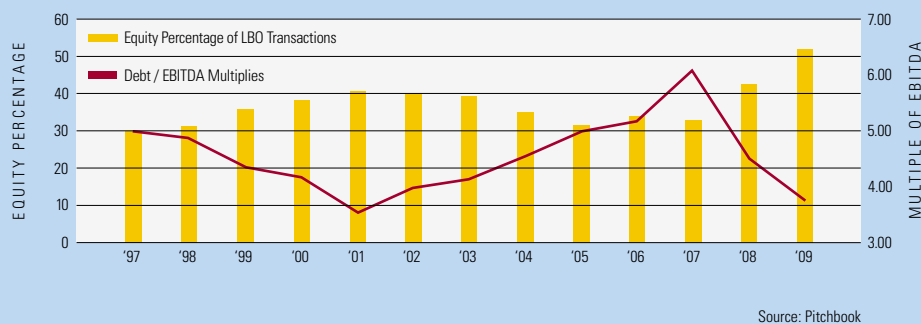
The industry's chief problem is relentless pressure to put money to work in an environment where attractive investments are scarce. There is simply a smaller universe of target businesses, particularly in cyclical industries where demand and earnings have waned. The compulsion to invest in spite of the absence of

compelling opportunities is driven by the basic structure of private equity funds. Investors don't actually invest in a fund; they commit to provide funds on demand for a fixed period of time, typically four to five years. If sponsors are unable to put that capital to work during that time, the commitments lapse. Sponsors draw a management fee based on total commitments, drawn and undrawn. Once the initial investment period expires, fees are solely predicated on actual invested dollars, valued at market. Failure to find a home for committed funds within this initial period can have a negative effect on the sponsor firm. In addition to suffering questions about the value of the firm's proprietary deal flow, erosion of firm revenue may thereby jeopardize its ability to find and close new opportunities and manage its existing portfolio.

The second challenge is the fateful combination of imprudently high leverage employed on investments in the peak years and continuing economic malaise. These are the key ingredients to an extended period of disappointing investment returns.

A third problem—"if I call, will they answer"—was front and center for private equity

Equity Contribution and Leverage Ratio (LBO Transactions)



firms just a year ago, but seems to have faded with time. Back then, there was genuine concern that some fund investors might default on their capital call commitments in spite of the punitive consequences of defaulting. Failure to meet a capital call typically results in the loss of interests in prior fund investments. Investment market stabilization, together with a rebound in the value of institutional equity portfolios, has resolved this fear for the most part.

THE TALE OF TWO CITIES

Because private equity and American business and industry are so tightly intertwined, the forces of creative destruction unleashed by the financial crisis continue to take a heavy toll on private equity investments. For a fund that competed aggressively for opportunities during the buyout boom and is now shackled by underperforming portfolio companies, there is a magnified urgency to put new money to work in an effort to average out losses. The firm also has to be concerned that, depending on the condition of its portfolio, investors who have lost confidence in the investment strategy have no real downside to defaulting on future capital calls, potentially putting the firm out of business.

Those funds with a long-term track record over multiple funds are better situated to withstand diminished returns in their current portfolios, but still face mounting pressure and competing objectives. As with the pitcher about to face mighty Casey late in an important baseball game, he hears from his

coach, “don’t give him anything to hit, but don’t walk him.” The private equity firms hear from their investors that they want prudence, but wonder why they are paying fees when no investments appear. Many private equity firms have little to show for themselves in the last 18 months.

The bottom line is that there is a great desire to put a lot of money to work.

REDEFINING INVESTMENT STRATEGIES

As with all industries, private equity fund managers have been reevaluating their business models. For quite some time, the dominant private equity formula for success has been to acquire controlling interests in stable, but modestly growing businesses, then add substantial financial leverage in the process, and, finally, permit the passage of time. With modest growth, the business works down its acquisition debt. The growth leads to increased enterprise value as well as a greater proportion of that value accruing to equity. A sale of the business at a later date delivers an attractive return on equity to the firm and its investors.

A recent study by the Boston Consulting Group comes to the conclusion that private equity firms have earned the greatest returns as the result of “operational value creation”, not financial leverage. Making good strategic business decisions trumps the effect of financial leverage and with a lower degree of risk. Fundamentally, the private equity industry understands this and is adjusting. Although banks and the public bond market are loosen-

ing up and providing acquisition financing again, we’ve noticed a change in approach by private equity firms.

- More private equity firms are using operating partners, former or current managers of businesses, to assist in evaluating companies and business strategies;
- Due diligence is directed towards operational improvements and business strategy; and
- Investment is going into companies as well as to owners of companies.

This latter trend suggests a slight movement towards the venture capital model in which capital is employed to achieve operational goals.

Private equity firms are more concerned now with becoming involved with winning strategies and management and less concerned with control. A successful business that can benefit from some additional capital will attract minority equity as a partner.

WHAT THIS MEANS TO THE PRIVATE COMPANY OWNER

Whether we are observing a trend or simply a temporary technique to widen the net for investment opportunities will play itself out over time. In the interim, private companies can avail themselves of a capital partner that will provide funding for both ownership liquidity and growth without adding overwhelming leverage.

Recognize that private equity firms have an objective of delivering an investment return to their investors. The value proposition must be clear and clearly articulated. Due diligence will include a greater scrutiny of operating plans prior to making the investment and, after closing, pressure to achieve objectives.

Choosing a partner is a more complex decision than selling a business. First impressions might not yield an accurate assessment. While selling is often mostly a function of price, taking on a partner is a more personal decision. It is important to understand the fund’s history, its current and future status, and the personalities of the principals under different conditions. An advisor who specializes in this market can be very valuable. ♦

Predicting Future Interest Rates

Rates will be going up and vulnerable business owners should get prepared.

by Michael T. Newsome

Interest rates are nearly as low as they can be, as illustrated in the chart on the following page. The Federal Reserve has signaled that it will attempt to quickly withdraw liquidity from the credit market at the first sign of inflation. The question does not seem to be whether or not rates will rise, but rather when and by how much.

Users of senior debt have enjoyed nirvana since 2000. With the support of the Fed’s efforts to drive down rates, businesses have funded the expansion of long-term assets with variable-rate debt, in the predominately floating-rate bank market. Staying at the short end of the curve has been a winning strategy and made interest rate risk management a less

important endeavor. As a consequence, the focus has been on credit spread, rather than the long-term, all-in cost.

However, the interest rate risk currently being borne by businesses is potentially catastrophic. Whereas companies have been hit hard on the revenue line since 2007, interest-rate movements could increase credit expense

several fold. The double-whammy of eroding EBITDA and higher debt service obligations could create a difficult set of hurdles for borrowers with above-average leverage. It is incumbent upon business managers to take seriously the job of insuring against that outcome.

As illustrated in the nearby yield curve chart, one-month Libor has declined 500 basis points since the eve of the financial crisis in June of 2007. At 32 basis points, as of April 15th, there is little room to move lower.

In addition, the shape of the yield curve has changed markedly in the last 30 months as short-term rates have fallen relative to long-term rates. The gap between one-month Libor and the 10-year swap rate now exceeds 380 basis points. This is compared to a 44 basis point differential in 2007.

FUTURE INTEREST RATES

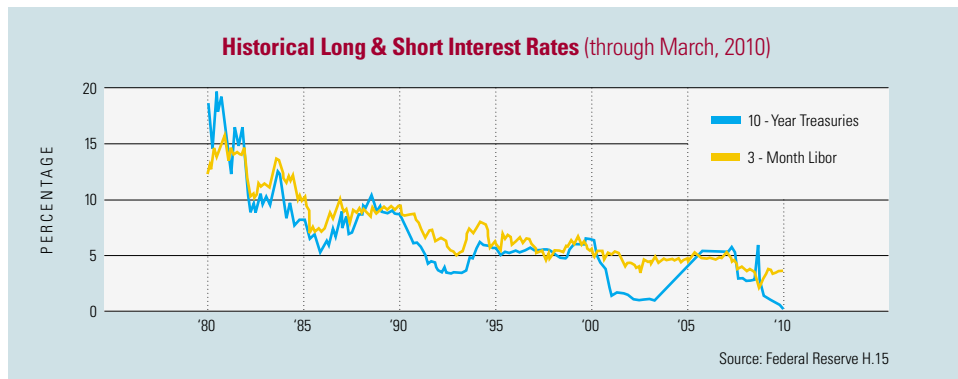
The "\$64,000" question is, how long will rates remain at these levels? We are certainly not in the business of predicting interest rates, regardless of this article's title, but the current slope of the yield curve is generally indicative of an expectation of rising rates as we look out beyond 2010. If business owners have learned anything over the past three years, it should be that change can occur rapidly, often unpredictably.

INTEREST RATE RISK MANAGEMENT

Knowing that it makes sense to hedge against rising interest rates is one thing. Implementing the optimal strategy is another. In our view, interest rate risk mitigation should be approached from the insurance perspective – protection against a potentially catastrophic risk to the quality and stability of the cash flow stream and the corresponding value of the business. Obviously, insurance has a cost. So, how much interest rate protection is needed, and for how long, has cost implications.

Managing interest rate risk revolves around the concept of "duration," which may be broadly (and inartfully) defined as the weighted-average time to reprice the assets and liabilities of a business. As an example, a slump in the value of the dollar might result in higher interest rates, but might also boost businesses engaged in the export market. An importer, on the other hand, might think about that quite differently. Businesses that have their assets constantly repriced are not as concerned about the impact of inflation or deflation on their business, whereas companies that have long-duration assets and/or long-dated cost or revenue elements (e.g., manufacturing plants, long-dated real estate leases, long-term pricing contracts) could experience a much greater impact. The point of this is that an appropriate interest rate strategy for one business might not be well suited to another.

No company with variable rate debt can afford to ignore its exposure to interest rate fluctuations. An effective interest rate strategy enables a business to better manage its exposure to unpredictable interest rate condi-



tions on the underlying business.

Banks are a prime source of expertise, as interest rate risk is central to their business, but there are advantages to consulting an independent expert who can help you fairly evaluate the amount and duration of insurance that is needed, the timing of implementation, and the cost tradeoffs of utilizing different tools:

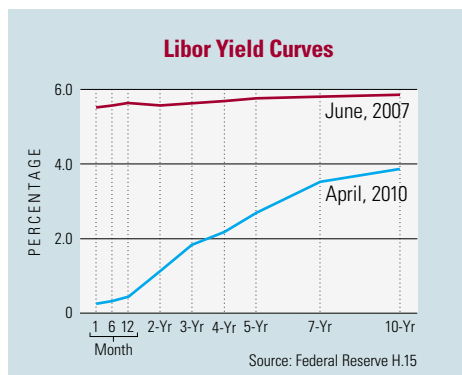
- The best alternative. Swap providers are in the business to make money. To that end, bankers often push long-dated swap or collar contracts, with lucrative embedded fees, rather than rate caps or other option-based hedging strategies that provide adequate protection at a lower cost. Banks generally

expect the same spread on a swap or collar, which embody some credit risk based on the client's obligation to make payments if rates fall. With an option-based hedge, there is no credit exposure, which means the client can consider providers other than its credit bank[s].

- Real-time information. Breaking economic news can significantly move derivative market pricing in a matter of minutes. Since there can be material intra-day movements, comparing multiple proposals over a several day period can be meaningless. An advisor with access to real-time market data is best able to find the most favorable alternative.

- Pricing transparency. A swap quote includes imbedded profits for the provider. An independent advisor can quantify the economics of various providers, so alternatives are fairly compared.

The starting point is quantification of interest rate exposure and the potential impact if left unhedged. Because rates are dynamic, regular review and adjustment is necessary. Now, we would argue, is the time to initiate a careful interest rate risk review with the objective of developing and executing a management strategy customized to your business. Waiting is simply a decision to bear the risk. ♦



ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to ZacharyScott.com.

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