



INSIGHT

The Perfect Storm: The M & A Market Today

Cheap credit, economic prosperity, and market liquidity are driving mergers and acquisition activity.

by William S. Hanneman

The M&A market is the strongest it's been since the bursting of the bubble at the beginning of the decade. Historically cheap credit and relaxed credit standards, coupled with the expectation of continued economic prosperity and tremendous amounts of liquidity in the market have greatly accelerated the pace of M&A activity.

As illustrated in the chart, 2005 was the most active year in the M&A market since 2000. The total dollar value of M&A transactions in the U.S. reached nearly \$1.2 trillion in 2005, nearly a third more than was recorded in 2004. This pace is the highest since the end of the last decade.

This rate of activity looks to continue. In the first quarter of 2006, middle market dealmakers announced 969 transactions representing \$63 billion in aggregate deal value as compared to the 2005 quarterly totals of 1,068 deal announcements and US \$63.2 billion in aggregate deal value. U.S. based private equity firms completed approximately 225 of those transactions for a disclosed total of approximately \$42 billion. Those figures are slightly ahead of the first quarter of 2005 when 221 acquisitions were completed for a total value of approximately \$40 billion.

VALUATIONS ARE STRONG

Not only has the pace of activity stepped up, the valuation of middle market companies has crested a new high with average purchase multiples for leveraged buyout transactions with less than \$50 MM in EBITDA reaching up to 8.5 X EBITDA. This is a full two and a half turns (X EBITDA) higher than was recorded in 2001. Although purchase multiples vary from industry-to-industry and from company-to-company, this trend mirrors our experience in the Pacific Northwest.

THE PERFECT STORM

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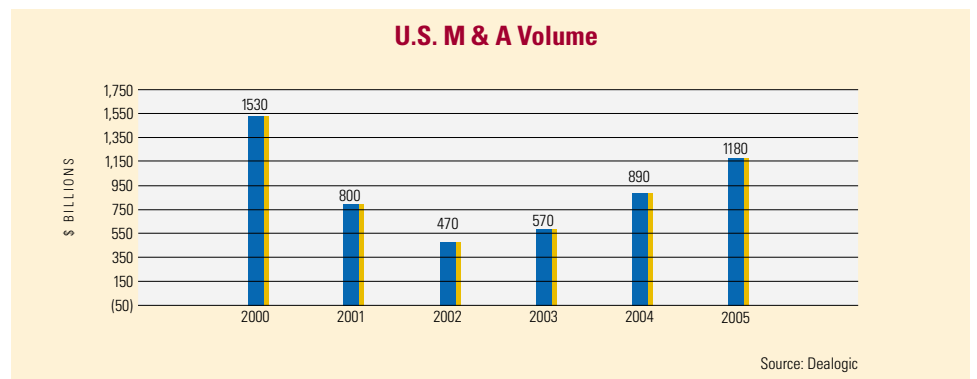
these resources in an effort to improve their competitive position, productivity, and scale. Corporate buyers are joined by growing numbers of private equity and hedge funds, all looking for deals. And, the credit markets are very accommodative—all coming together to create the perfect storm.

CORPORATE CASH FLOW

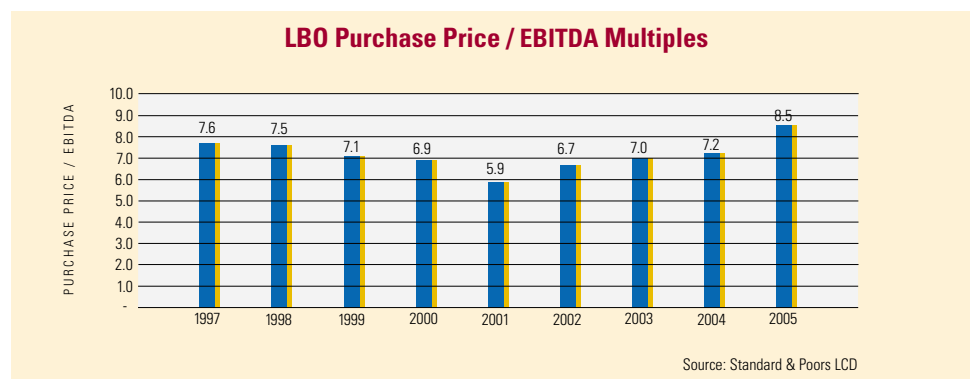
Unrelenting cost cutting and a revival of pricing power have resulted in corporate America generating massive piles of cash. Pre-tax manufacturing profits have almost quadrupled since 2001, while profits of all companies have doubled to \$1.2 trillion. Industrial companies

(continued p. 2)

2005 was the most active year in the M&A market since 2000.



The valuation of middle market companies continues an upward trend.



now have cash and cash equivalents of more than 7% of the companies' total stock market value, the highest percentage in nearly 20 years.

In addition to acquiring businesses, companies last year used their cash hoards to purchase a record amount of their own shares, totaling some \$325 billion, a 64% increase over 2004. There is no let up in sight. A recent survey of CFOs of mid-size and large U.S. manufacturing companies found that nearly three out of four expect their company's revenues to increase in the coming year—and nearly half (46 percent) predict higher profit margins.

AVAILABILITY OF CREDIT

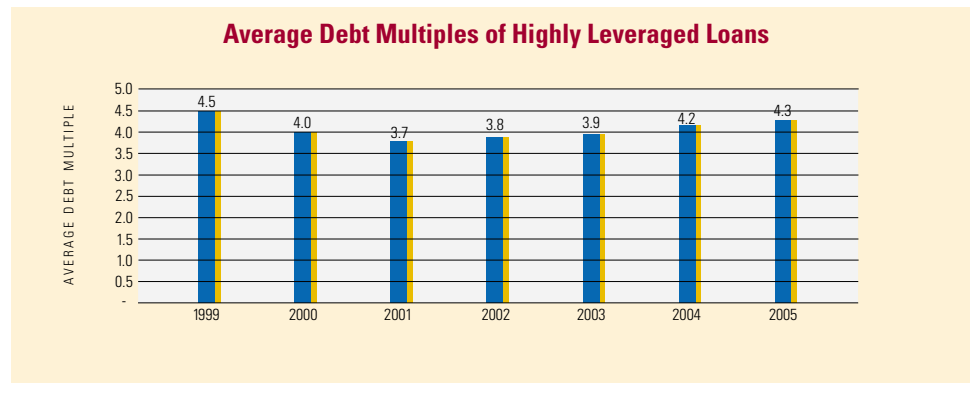
While financial theory says that investment decisions should be separate from financing decisions, it is unmistakable that the current pace of activity and lofty valuations are being driven by the availability of credit.

Credit standards are as loose as they have been in a decade. This view is supported by the quarterly Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices that has recently reported the most banks loosening credit standards than any time in the past 10 years. Banks are willing to aggressively extend credit because their portfolios are relatively clean. Default rates are at their lowest level in years and continue to decline.

Today's credit market is characterized by low credit spreads, lenient credit structures, and covenants that are quite loose or entirely absent. Standard & Poor's reports that bank debt multiples have steadily increased from an average of 3.7 X EBITDA in 2001 to 4.3 X today, a level that hasn't been seen since 1999.

PRIVATE EQUITY

Equity money is now available in greater abundance than ever before. Fifteen years ago, a handful of private-equity firms managed a few billion; today, more than 250 firms control some \$800 billion in capital. Buyouts Magazine, which tracks private-equity deals, estimates that nearly \$175 billion in new money flowed



into US-based private-equity firms last year alone. This equity capital, when leveraged with debt, implies well over \$3 trillion of resources either already invested or looking for a home in the capital structure of private companies.

Hedge funds are also getting into the game. There are now reportedly over 8,000 hedge funds (perhaps better called unregulated investment

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companies) managing over \$1.2 trillion, a portion of which is seeking the higher returns promised by private equity investments.

SELLER'S MARKET

This is a seller's market where owners can often reap the benefit of receiving part of the value buyers expect to create following the acquisition. Among the most telling statistics of the competition for deals is revealed in a recent survey by KPMG's Transaction Services Group, which in the fall of 2005 reported that 43% of the synergies expected to be created in business combinations were included

in the purchase price (i.e., paid to the sellers). While this is not a measure we have seen tracked over time, it is a clear indication that buyers are aggressively pricing acquisitions.

There are no signs on the horizon that this pace is likely to slow. A recent survey of CFOs reported that expectations for merger and acquisition activity are at an all time high. Thirty percent of manufacturing companies surveyed expect to participate in a merger or acquisition in 2006, this up sharply from 23 percent last year. It is the highest percentage in the survey's history.

CONCLUSION

There is no question that, from an economic point of view, the current market represents an exceptionally good time to be a seller and quite a difficult time to be a buyer. Owners of successful companies will find many buyers and high purchase multiples. Purchasers need to show caution about paying too much for the benefits expected to result from a business combination.

Be certain, however, that this is an environment that will not persist forever; it never does. The change, when it occurs, is most often precipitated by lenders faced with borrowers missing financial expectations. History tells us that when that happens, lenders react quickly to tighten credit and the pendulum begins to swing in the opposite direction. ♦

Anatomy of a Management Buyout

When appropriate, managers can become owners through an MBO.

by Michael T. Newsome

An alternative that frequently surfaces in discussions about the sale of a privately held business is a management buyout, or "MBO". Simply put, an MBO is a buyout of a company, subsidiary, division or even a business line that is orchestrated by the management team to gain ownership and reap the rewards of the business' future success. MBO transactions aren't appropriate for every company sale situation and often don't occur even when they are.

MBO DEFINED

When the owners of a business contem-

plate its sale, their rational interest is to obtain its full value. Accordingly, for an MBO to be feasible, there must be a meeting of the minds between management and ownership on the following points:

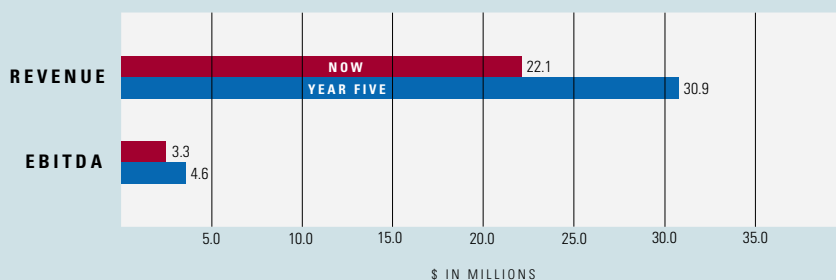
- There is limited potential for a strategic combination with another firm, where costs may be eliminated, revenues enhanced, or assets more efficiently used, because that type of opportunity implies value in excess of the business on a stand-alone basis.
- Management is capable of acting like owners

and is reasonably among the best parties to lead the company into the next phase of its life.

In short, ownership has to want the management to buy the business.

MBO talk often outweighs action for two reasons—complexity and expectations. MBO transactions are difficult with multiple moving and inter-dependent variables. Success requires a reconciliation of value and price and coordination of multiple capital components. For most private company managers, this is unfamiliar ground that must be tread at the same time the day-to-day demands of the

Acme Enterprises' Current and Expected Performance



business are being juggled.

The second stumbling block is expectations, particularly with regard to value. For owners, unrealistic expectations are manifested in a belief that stand-alone value is much higher than what a dispassionate investor might pay. Management might agree to an owner's vision of value, but then be unable to attract the capital to close the deal.

On the flip side, managers often labor under the misimpression that an MBO will put them in control of the business, which is rarely the case, at least initially. An MBO might better be designated an MLBO, as in management-led buyout. Invariably, the total value of the business would, if valued fairly, exceed the amount that can be borrowed from a lender. Unless management has a sizeable amount of capital that can be invested in the buyout, the support of an outside investor is usually required, which almost always implies a controlling interest in the business. What management should expect is an opportunity, in fact a requirement, to make a personally significant investment in the business on the same terms as the financial partners. A mandatory cash investment by management is designed to insure that the economic interests of both investors and managers are aligned. In addition to the cash investment, management can expect to receive an incentive equity position that can be earned if superlative performance is achieved. It is not unusual for 10-20% of equity to be allocated for incentive purposes, which will accrue value once cash investors have recovered their investment.

HOW DOES AN MBO WORK?

As an example of how an MBO might come together, consider Acme Enterprises a hypothetical company having \$22 million of revenue and earning EBITDA of \$3.3 million. A reasonable, perhaps even a bit conservative, enterprise value (outstanding debt + value of equity) would be \$18.2 million, which represents a 5.5X multiple of EBITDA. After accounting for transaction expenses, a total of \$18.9 million would be required to fund the Acme Enterprises buyout.

In today's aggressive credit markets, it should be possible to borrow senior debt equal to 3.0X EBITDA and another 1.5X of mezzanine debt. Equity of \$3.9 million is required to fill out the

capital structure. In this example, the financial investor (private equity firm) kicks in \$3.3 million and management pulls together \$600,000 of equity. These elements fit together in a capital structure along the lines illustrated in the chart below.

In order to fully compensate the mezzanine lender, it would be granted a 16% equity position (typically nominal cost warrants),

Capital Structure

	EBITDA Multiple		Target Return
\$10.0MM	3.0X	SENIOR DEBT	8%
\$5.0MM	1.5X	MEZZANINE DEBT	20%
\$3.9MM	1.2X	EQUITY	30%
\$18.9MM	5.7X		

leaving 84% of the equity value for the owners. Assuming that 10% of the equity is carved out for management as an incentive after the cash investors' capital is returned, the financial investors and management would split the incremental value created on

an 84.6% and 15.4% basis, respectively.

If management's vision of Acme Enterprises' future performance (7% compound annual growth and 15% EBITDA margin) comes to fruition, at the end of five years, Acme would be generating EBITDA of \$4.6 million on revenue of \$30.9 million. Assuming that there is a liquidity event at that point and the business is valued on the same multiple (5.5X) as it was purchased, the company would be worth \$25.5 million. As shown in the table below, total enterprise value grew by \$6.6 million over five years. More importantly, the equity share of the value pie expanded from \$3.6 million to \$17.6 million as the company's cash flow was allocated to paying down the senior debt. Results are pretty attractive—the mezzanine lender earns a 20% return based on the 12% coupon and the implied value of the warrants; the cash investors triple their investment to earn a 29% annual return, and management earns an additional \$1.1 million from the incentive shares for an all-in return of almost 40%. This was a successful deal because the key elements—purchase price, performance expectations, and capital structure—were aligned, all having been considered in the design of the transaction from the outset. Interestingly, this outcome creates an opportunity for managers to now own a controlling interest in the company by rolling their gains and re-leveraging the company to take out the investors.

Apart from basic economic feasibility, there are a number of design complexities associated with structuring an MBO, including the appropriate level of financial leverage relative to ongoing capital investment needs, and/or sustainability and cyclicity of the cash flow. Finally, managers should bear in mind that an MBO entails the formation of a long-term business relationship with a financial partner, where all of the attendant issues of personality and compatibility, control and governance, investment horizon, and exit strategy will come into play. The prospects for a successful buyout are much stronger when there is a good philosophical fit between management and equity investors. ♦

ACME ENTERPRISES MBO	ORIGINAL INVESTMENT			EQUITY RETURNS	
	\$ in Millions	\$	EBITDA Multiple	Fully Diluted Share	5.5 X IRR
Enterprise Value	18.9		5.7		25.5
Senior Debt	(10.0)		3.0		(2.9)
Mezzanine Debt	(5.0)		1.5		(5.0)
Total Equity Value	\$ 3.9		1.2	100.0%	\$ 17.6
Mezzanine Warrants	-			16.0%	2.8
PE Investors	3.3			65.8%	11.6
Management:					
Cash Investment	0.6			12.0%	2.1
Incentive	-			6.2%	1.1
Total Management	\$ 0.6			18.2%	\$ 3.2

The Diverging Roles of the CFO: Broadening Expectations

Growing private companies need more from their CFOs than accounting precision.

by Mark Working

It is getting tougher these days for chief financial officers to meet the expanding performance expectations associated with growing private companies. Owners and executive managers of privately held businesses rely on their CFO for traditional financial leadership, as well as guiding the company's strategic planning efforts and preparing the company for potential public ownership. The expertise required to lead the company in all of these areas has become quite broad, often beyond the capabilities of a single person. This makes for interesting challenges in defining and staffing the financial organization of the future.

CFO TRAINING GROUND

The traditional training ground for CFOs has been public accounting (as high as 90%, according to some sources), where skills related to accounting, systems and compliance are developed and honed. These accounting, as opposed to finance, skills and processes must, to varying degrees, be supplemented by planning expertise necessary for the development of operating and capital budgets that define management objectives and support external capital providers.

CONGRESS PASSES SOX

In the past five years, a rather sweeping transformation has occurred in public accounting, brought about by the deficiencies in financial disclosure that were thought to be at the root of the public company scandals (Enron, Worldcom, Tyco, etc.) that bloomed in the aftermath of the dot-com bubble burst. In a fit of "we're the government and we're here to help you," Congress passed Sarbanes Oxley (SOX) to improve the accuracy of financial reporting and make public company (and private companies aspiring to be public) CFOs, CEOs and Directors personally responsible, under the weight of onerous penalties, for the accuracy of corporate disclosures. The fever for adherence to the requirements of section 404 of SOX has been a boon for accounting firms and they have refocused their businesses on auditing and compliance. These firms have added staff by sopping up all accounting talent out of universities and elsewhere, and have directed these resources towards technical auditing tasks and reporting compliance. Non-compliance oriented services that were in vogue in the late 90's have been scaled back or shed. It remains to be seen whether these changes will ultimately enhance corporate transparency and performance, but it has, however, shifted the skills and expertise of the people that are being trained and developed in public accounting.

It is only a bit of a stretch to say that accountants seem to have gained a more intimate understanding of leaf structure, but have become less able to discern the overall forest. This change has significant implications for the talent pool that private companies draw from for financial staff.

IMPACT OF INSTITUTIONAL INVESTORS

While the energies of accounting firms have been focused on the business of compliance, a countervailing economic force, institutional private equity investors, has been remaking the ownership landscape of

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privately held businesses. Private equity firms now own a significant chunk of middle-market businesses in the U.S. With steadily increasing resources at their disposal, this trend is likely to continue, if not accelerate. While institutional investors have an interest in financial compliance and transparency, their overriding objective is building corporate value. For an investor owned privately held business, the CFO has a central role as the protector of value creation and the guiding force in the allocation of capital resources. In a well functioning executive team, the CFO is expected to provide insight into the value implications of customer relationships, products

and markets, investments in equipment and plant, and acquisitions. As we've written in this publication before, the emphasis on growth and value creation that has become the norm for investor-owned businesses makes a CFO who provides a forward looking economic perspective on the business, is willing to ask the hard questions, and backs conclusions with rigorous analysis, an exceptionally valuable resource.

STRATEGIC ORIENTED CFOs

In today's world, the regulatory environment demands highly specialized accounting technicians who can faithfully apply complex rules with appropriate precision. At the same time, a highly competitive and dynamic business environment places a premium on strategic oriented CFOs that are analysts, planners and leaders who can help drive value creation. This role requires a proficiency in finance and an understanding of business economics that is difficult to acquire in the day-to-day work of public accounting. Rarely does this combination of skills reside in a single individual and the challenge is how to find or develop these people. It is becoming more likely that accounting and finance are separate roles requiring different people with complementary backgrounds. How companies source the financial expertise that they need and organize them within the business is changing. Putting the right people in the proper roles is an important element of a successful strategy. No matter how important the compliance function, our advice is to not sacrifice financial leadership in favor of accounting precision. ♦

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.

Mark Working
206.224.7382
mworking@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Ray D. Rezab
206.224.7386
rezab@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

500 Union Street, Suite 1000
Seattle, Washington 98101



Zachary Scott

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