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Middle-market M&A relief unlikely soon

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It's been a tough year not only for larger scale mergers and acquisitions, but for the middle market mergers and acquisitions as well.

From all indications, the final quarter of 2009 is unlikely to provide a lot of relief.

As the year began, the primary challenges in that middle-market M&A were the unprecedented turmoil in the senior lending sector and the effect of the recession on middle market businesses. Because most of the recession's effects are largely out of a business owner's control, these times call for an updated—and realistic—analysis of ways to optimize strategic objectives of a business.

Although the federal government moved quickly last fall to avert a seismic financial crisis and to try to thaw the frozen senior credit markets, the senior lending market for M&A transactions at the end of 2008 was basically non-existent. The exceptions, generally, were regional banks and a few national institutions not involved with toxic mortgages, derivative instruments and/or excessive leverage.

Without an efficiently functioning senior credit market, deal activity in the larger market ground to a halt and slowed precipitously in the middle market, which is inconsistently defined but generally involves deals valued in the $15–$500 million range.

Lost in the glare

In the final quarter of 2008, the difficulties of the nation's largest financial players dominated the media—and rightfully so. Lost in that focus on the woes of the financial behemoths, however, was the effect on M&A activity in the middle market, the tier in which the majority of businesses in the Kansas City region traffic.

While middle market M&A activity was materially curtailed on a volume basis from comparable periods before the recession, that segment avoided much of the turbulence affecting M&A transactions in the larger market because more middle market M&A buyers and lenders avoided the excess leverage and other aggressive behavior than their larger counterparts.

With the proliferation of middle market private equity firms over the past decade, the unfathomable amounts of capital in the coffers of such middle market private equity firms and the proliferation of other capital and service providers to support the middle market private equity world, the M&A middle market sector remained fundamentally intact throughout the financial crisis that began last fall.

Certainly, many middle market private equity firms were hurt in the financial tumult, and some are now using available capital not to purchase or invest in companies but to triage issues with overleveraged portfolio companies. A sizeable percentage, though, remain well-positioned to capitalize on buyout and investment opportunities in this recessionary period.

Available data for M&A transactions in the fourth quarter of 2008 would indicate that, in general, the stronger, attractive middle market businesses were being valued at only about a half a multiple of adjusted EBITDA less than the pre-recession environment, while the middle market businesses that were really struggling—and seeking an M&A transaction to "survive more than thrive"—suffered the lower valuations of having little negotiating leverage.

The most material change in both the larger market and middle market M&A has been the changes in the structure of acquisition financing due to the lack of availability of senior priority lien lending.

Because lenders have become much more conservative on how much they will lend on an acquisition target's EBITDA and available collateral, buyers have had to increase the amount of equity they invest in the acquisition's capital structure and/or add mezzanine financing.

To make up the difference in the lower lending levels, recent data indicated that the average equity component of completed deals has escalated to approximately 50–60 percent—up roughly 17–23 percentage points from the pre-recessionary period. In addition to less aggressive lending, buyers are also seeing more stringent loan covenants.

The result? Most buyers are financing acquisitions with the expectation of refinancing the senior debt piece in the near- to mid-term, in order to extract some of the "additional equity" the acquisition required and to obtain more flexible lending covenants.

Looking ahead

From the fourth quarter of last year to the mid-way point of this year, the major factors influencing the volume and dollar amount of middle market M&A activity slowly but steadily improved, including an improving senior credit market.

Such trends are no doubt a natural maturation from the underlying factors driving the lending crisis; however, with the ballooning federal deficit and expectation of higher taxes and greater regulation causing increasing pressure on economic forecasting, it is unlikely those factors will improve materially during the remainder of 2009.