

## MIDDLE-MARKET M&A

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# LOWER MIDDLE-MARKET TRENDS – US



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## NORTH AMERICA

### Lower middle-market trends – US

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FOR THE LOWER middle-market or transactions with total enterprise value (TEV) of \$10-\$250m, 2010 was a year of recovery that took hold in the second half of the year. Deal flow and EBITDA multiples increased significantly while the improving senior debt market showed signs of strength.

#### Fundamentals behind the recovery

An improved US economy, driven by strong corporate profits and historically low interest rates, were the fundamentals behind the recovery in the lower middle-market. Confidence levels returned to the equity markets – the S&P 500 was up 12.8 percent in 2010 – and both strategic and financial buyers returned to the market.

Strategic buyers have over \$2 trillion of cash on their balance sheets with excess cash reserves targeted for acquisitions. Financial buyers have approximately \$500bn of cash on the sidelines searching for quality deals to build their portfolios and deploy invested funds. Improved economic conditions and an aging portfolio of companies have turned financial buyers into active sellers as they exit and monetise previous investments. The second half of 2010 saw more financial buyer exits than all of 2009. With the reluctance of buyers to make acquisitions in 2008 and 2009 due to uncertain economic conditions, and sellers unwilling to sell at lower valuations, pent up demand was created by both buyers and sellers. As confidence returned and buyer and seller value expectations aligned, the market came back strong in the second half of 2010.

#### 2010 performance

Completed deal volume was approximately double the rate in 2009, for the third quarter in a row, as reported by GF Data Resources. TEV/EBITDA multiples moved to 6.1 times in the fourth quarter of 2010 compared to 5.4 times in 2009 for a 13 percent increase. Purchase price multiples finished at 5.9 times for the year, compared to 5.7 times in 2009 and almost back to the record levels of 6 times in 2007. Companies with above average financial characteristics – TTM EBITDA margins and revenue growth both in excess of 10 percent – carried an 11 percent valuation premium in 2010 and accounted for approximately 54 percent of completed deals, an increase of 45 percent over 2009. A premium for size was evident in 2010, with businesses showing

an adjusted EBITDA of \$6m or greater, trading at an average purchase multiple of 6 times, compared to 5.7 times for businesses with less than \$6m of adjusted EBITDA. Total debt averaged 3.1 times up from 2.7 times in 2009, reflecting a stronger debt market and an interest by banks to invest in the lower middle-market. As credit to qualified buyers has become more available, cash flow lenders are aggressively pursuing transactions.

### **Market drivers**

Based on a slow but improving economic environment, strategic buyers are turning toward acquisitions as a major driver in their growth strategies. Risky larger transformational transactions are being replaced with a more conservative strategy of lower middle-market strategic acquisitions that supplement organic growth. Tuck-in acquisitions of smaller competitors, bolt-on acquisitions of aligned industry players with defensible market positions and companies that can fill gaps in their product lines are all targets as top line growth and market share gains are being pursued. Sellers with strong growth and earnings characteristics will be in high demand and receive premium valuations.

### **A look ahead for 2011**

2011 is shaping up to be a year of continued improvement, backed by positive trends and the recovery that started in the second half of 2010. The same fundamentals are in place; as a result, we expect to see a continued return in confidence and a greater equilibrium between the supply demand imbalances. As higher quality deals come to market, purchase price multipliers are expected to rise. Financial buyers are moving their attention away from larger corporate buyouts and focusing on the lower middle-market, despite higher equity requirements. Sellers are aware that capital gains taxes are scheduled to move to 20 percent in 2013, making 2011 a pivotal year in any exit strategy. While the US accounts for approximately one-third of the global M&A deal volume, the real story in 2010 was the growth in the emerging markets. Cross-border deals will continue to put pressure on the US lower middle-market, as international companies seek a greater US presence in their core businesses. Strong emerging market countries like China, India, Brazil and Mexico will be active acquirers of American based companies in 2011.

The 2011 outlook is somewhat tempered based on the continued expansion and recovery in the US economy and the availability of capital from the credit markets. Both need to happen to ensure a sustained improvement in the lower middle-market. Concerns about the Middle-East and rising oil prices, Europe's sovereign debt crisis, high unemployment rates in the US and the recent earthquake/tsunami disaster in Japan will weigh on continued economic growth. ■

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