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MIDDLE MARKET M&A: DATA ROOM USAGE INDICATES UPTICK IN ACTIVITY

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Middle Market M&A: Data Room Usage Indicates Uptick In Activity

BY JOEL LESSEM

The North American M&A market is showing signs of renewed interest from both buyers and sellers. Our analysis shows a surge of pre-deal activity in 2011 that is likely to result in M&A deals later this year. We compiled data room usage from over 200 M&A middle market advisory firms based mainly within North America. The results show a 43 percent growth in activity by M&A advisory firms over the last 24 months, with an average increase in new mandates per firm growing from 0.7 to 1.0 per month, which annualised to an additional four new mandates per year for each firm. Following this steady upward trend of new mandates through 2010, and a brief seasonal lull during the holidays, activity in 2011 is off to a strong start.

Data room mandates provide a leading indicator for future M&A deals, since a typical deal takes five to six months to close. A number of key market forces are driving this activity and shaping expectations for the M&A market over the coming year.

Increasing confidence within the US M&A market

Zane N. Markowitz, senior managing director & partner of The McLean Group's market intelligence and buy-side search division, is not surprised by the increasing number of mandates over the past few months. "Cash is cheap and stock prices are high, which makes acquisitions easier for strategic buyers. The increasing confidence we're seeing in the M&A market today hasn't reached what it was before the 2008 financial crisis, but we're headed in the right direction," he says. "Coming out of past recessions I've noticed that very large firms look for bargain acquisition opportunities, and they are motivated to close deals at the depressed valuations before prices rise. These 'mega' deals then increase overall market confidence and trigger mid-market buyers to follow suit," he adds.

Mr Markowitz is, however, concerned about how the end of quantitative easing and future interest rate hikes will affect the US economy and M&A activity. Many economists remain divided on how the US can exit from its historic quantitative easing programs without sending the markets into a tailspin. Last month, US Federal Reserve Chairman Ben Bernanke held the first-ever Fed press conference which lowered growth forecasts for the US economy from 3.9 percent to 3.3 percent, and shortly after, the US Commerce Department reported that US gross domestic product (GDP) growth slowed in 2011's first quarter to 1.8 percent. The news could impact the levels of investor confidence that is necessary to maintain the momentum for continued growth.

"At the end of the day, psychology plays a big role in the M&A market. We can expect that CEOs in the US will be the driving force behind many deals, and if the CEOs are confident, then deal volumes and valuations will continue to grow."

Consistent volumes and valuations in SaaS technology firms

The number of deals in SaaS technology has been steadily growing, driven by a massive market and the momentum being led by SaaS successes such as Salesforce.com, SuccessFactors Inc, and Taleo Corporation. Technology buyers are shifting from costly capital investments in on-premise technology infrastructure and opting for more cost effective hosted technology which they can rent. "The move to Software-as-a-service (SaaS) or Cloud delivery model is a fundamental shift in the economics of the $1.5 trillion IT industry. SaaS companies have a lower R&D and support cost which makes for better margins and recurring revenue," says Brian Klemenhagen, senior director of financial advisory firm TripleTree.

Quarterly market data compiled by TripleTree on the technology sector reported a 20 percent increase in US-based deal flow, with the number of deals rising from 372 in Q4 2010 to 448 in Q1. This steady growth aligns with SaaS industry sales estimates from Gartner Group, with projected increases to $10.7bn in 2011, up 16.2 percent from 2010, and forecasts that project SaaS applications will represent at least 16 percent of worldwide software sales by 2014.

The tough market conditions in the wake of the financial crisis represented growth opportunities for large technology firms like Google, IBM and Cisco – just a few of a long list of firms that expanded through strategic acquisitions. As a result, the demand for financial advisory services in this space did not see much disruption from the financial crisis. "High margin recurring revenue is extremely attractive to corporate acquirers. Over the last 24 months, valuations have become even more attractive to sellers."

Even brighter days ahead for acquisitions in the US

According to Mike Rosendahl of financial advisory firm PCE Investment Bankers, the difference between 2009 and 2010 was like "night and day". "In general 2009 was characterised by business owners who did not want to sell while business was slow and valuations were depressed. The few businesses that did maintain high growth during that time frame were typically able to complete transactions, but a majority of the deals were distressed sales."

In 2010, many business owners were concerned about the expected expiration of the Bush tax cuts, which would impact the capital gains tax rate and effectively reverse the capital gains tax cut by 5 percent as well as increase ordinary income tax rates for most business owners. "Activity really started to pick up in the middle of 2010 with many transactions initiated by business owners who were motivated to close a deal before the tax rates changed," says Mr Rosendahl.

On 6 December 2010, a compromise tax package proposal had been reached, centered around a temporary, two-year extension of the Bush tax cuts, and this confirmed what many had already expected. "It became clear in November that tax cut would be extended," recalls Mr Rosendahl. This removed the motivating factor for many business owners to rush into a deal, and explains in part the steeper drop in new data room mandates during the 2010 holiday season.

Most buyers and sellers in the US are convinced that economic measures and market forces will keep the US economy growing through 2011. "Overall optimism is building. Companies are doing well and valuations are back, with corporate and financial buyers out looking for good companies."

Foreign investment leading deals across Central Europe

The downturn resulting from the financial crisis was much less pronounced in Central Europe than it was in North America, according to Ondřej Palát, executive director of Patria Corporate Finance in Prague.

"Compared to the US, our local banks and consumers were less leveraged and maintained strong balance sheets," he says. Despite a relatively favourable market position, the market faced several challenges in 2009 and early 2010. "The biggest challenge was multinational buyers who had a tougher time getting approvals on deals from their head office. That changed in the latter half of 2010, and the year ended up being very strong for domestic M&A deals."

Mr Palát admits that many of the deals in 2010 may have been 'deal backlog' from 2009, but just as influential was the growing number of emerging market investors from BRIC nations buying up industrial assets across Central Europe. "Central European exports with western European trading partners rebounded in 2010, and Eastern Europe is still seeing significant deal flow from privatising state industries." He expects that deal flow in 2011 will be comparable to 2010. While this year will not benefit from the deal backlog of last year, the economic fundamentals in the region and worldwide have improved to more than make up for that volume. Also, thanks to overall lower levels of public debt, the Central European countries are not facing budget problems as severe as Greece, Portugal or Ireland. ■

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As Chief Executive Officer, Joel Lessem is responsible for leading Firmex's strategy and growth. Joel has over 18 years' experience in successfully accelerating revenues of growth businesses. Under his leadership, Firmex is rapidly becoming a standard for sharing large volumes of highly confidential and sensitive documents for corporate transactions, litigation and compliance.