"Tough" is the New "Growth" for Middle-Market M&A Deals

The five years leading into 2008 were great for sellers of middle market companies. A strong economy, high public company valuations, and huge new pools of private equity capital drove both strategic and financial buyers on a buyout binge. Deals made in those days were driven by the growth mantra. Strategic acquirers did deals to continue to fuel their own company's reported growth. Financial buyers bought into the growth vision not once, but sequentially. They often bought a strong platform company, then fed their own growth scenario by making multiple add-on acquisitions in the belief that growth for its own sake would eventually drive up their aggregate valuations.

The bad news for owners who didn't sell their companies before now is that all the growth assumptions are gone from the buyers' minds. The good news for those who want to sell their companies now is that "toughness" in a difficult economy is the new "growth" for buyers.

In the past, growth covered a lot of shortcomings for both buyers and sellers. Growing revenues kept the focus on sales but not always on profits. It was easier for sellers to paint a positive picture of the company's historical growth and extrapolate that into continued success. Buyers who bought into the growth vision had an easy time overlooking shortcomings in the company's products, markets, channels, and infrastructure. The standard discounted cash flow valuation analysis derives the majority of its present value from the assumed exit value. Growth assumptions that underpinned those exit values made it easy for buyers to internally justify higher current valuations. Buyers have learned hard lessons from these old attitudes toward acquisition.

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Perspectives have been permanently changed by this economic slowdown. Those companies who have weathered the storms of the last year and are holding their own now look pretty good to all kinds of buyers. Strategic buyers, who are afraid of buying someone else's problems, look favorably on acquisitions of companies that have touched the bottom and are now flat to up in sales and earnings. Financial buyers who have been burned by over-leveraged deals will now pay a premium for a company with stable and predictable cash flow.

Today, buyers are looking for companies that have demonstrated their ability to make money during hard times. Companies with management that has responded effectively to today's challenges are attractive to buyers. The ability to downsize, shift markets, and redirect resources adds value in the minds of today's buyers. Companies that can demonstrate increased market share or reduced costs deliver the promise of strong profitability when the economy begins to recover.

Yes, this is still a sellers' market, just a different kind of sellers' market. The Alliance of M&A Advisors just reported that the total amount of uninvested buyout money hit a record of $400 billion (yes, billion) in April 2009. This means that financial buyers are under pressure from
their investors to put money to work. Likewise, in this economy, public companies that have cash are still hungry for deals that will pump up their revenues and earnings.

Our advice to owners is this: if you can demonstrate that your company has turned the corner, if your backlog is growing, if your first half of 2009 is better than the last half of 2008, you will get a good response from both strategic and financial buyers in today's market. Your company does not need to be setting a record year; you just need to be running at a better rate than you were a few months ago. If you can demonstrate that your company is tough enough to weather today's economy, we can introduce you to buyers who will want to hear your story.