Bright Spots Still Exist Amid Merger Gloom

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NEW YORK (Dow Jones) -- The merger and acquisition market may be in a slump along with the rest of the economy, but smaller deals are continuing to be done, especially in sectors such as information technology, health care and outsourcing.

While the credit markets remain largely locked for leveraged buyouts, hampering overall deal activity, quality companies are still being sold, said market participants. Demand is coming primarily from large corporations looking to expand their product offerings, and private equity firms seeking add-on deals for their platform companies. Owners of small businesses who know how to navigate the market are still able to cash out in the current environment.

To be sure, the deal market is far from buoyant. Overall M&A volume was down about 40% to $112.9 billion for completed transactions in the U.S.
this year as of March 11 compared with the same 2008 period, while the number of deals was down about 38% to 1,253, according to data provider Dealogic. Deals for small companies weren't immune to the downturn, with transactions valued at $100 million or less declining 48% to $7.8 billion year-over-year. The number of such deals was down 24% to 421, according to Dealogic.

Meanwhile, according to David Mead, head of Mead Consulting Group, the supply of small businesses on the auction block will continue to increase. Mead estimates the number of companies with up to $75 million in revenue that will be up for sale could increase to as many as 800,000 in 2009 from 300,000 in 2005. This means if the deal market doesn't improve, valuation of companies will continue to decrease - a scenario sellers aren't ready to accept just yet.

"Valuation expectations haven't completely re-calibrated to the current environment," said Bryan Davis, a partner with law firm Jones Day.

Businesses With Cash Flow Still Selling

Nonetheless, businesses with strong cash flow and good growth prospects are still finding new homes, market participants said. Indeed, according to Mead, such companies were able to fetch nearly the same multiples of cash flow as those for similar businesses a year ago - before the credit crunch worsened.

And sectors that are resistant to recession saw more deal-making than others. One of those is technology, the sector that has seen the largest deal volume this year - almost $300 million compared with No. 2, telecommunications, with $127 million, according to Dealogic. The demand is driven by customers' need to cut costs - by buying software that manages case load for courts, for instance - and larger technology companies' desire to expand their product portfolios.

SunGard Data Systems Inc., a software provider acquired by a private equity consortium in 2005 in the largest technology buyout at that time, has been very acquisitive since then. It made its latest addition in March, purchasing Performance Pathways Inc., a vendor of software to K-12 schools, for an undisclosed amount. The deal helped to expand SunGard's offerings for the education sector as its education software previously was used primarily by colleges and universities.

The second active sector is health care. Favorable demographic trends such as aging baby-boomers have led to increased demand for medical devices and health-care services. And the Obama administration's plans for sweeping health-care reform are expected to spur demand for technology that helps to automate processing of medical records.

Vesta Inc., a provider of tubes used in medical devices, acquired competitor ExtruMed LLC in March for an undisclosed sum. The combined company, with between $50 million and $100 million in revenue, produces tubes that have such wide applications as dialysis and vascular access. The sellers, private equity firms Inverness Graham Investments and Wedbush Capital Partners, reported a 3.5 times cash-on-cash return in as many years.

The third sector that has seen active deal making is outsourcing, which processes such functions as billing and payments for clients, "One of the things that happens in a downturn is that companies return to core operations and look to outsource functions that are not efficiently done internally," said Mead.

That trend has driven TriNet Group Inc., a privately owned outsourcer of human resources services, to go on a buying spree, acquiring seven companies over the last four years. The largest purchase to date was a $98 million pending deal for publicly traded Gevity HR Inc., which is much larger than TriNet in terms of revenue. TriNet said it will continue to pursue add-on deals thanks for strong demand for such functions as processing employee benefits.

Partial Sale Is Option For Owners

For business owners looking to sell in the next year or so, there are ways to maximize pricing, said market participants. One is to sell a minority interest instead of the entire company, such as through a partial recapitalization with an outside equity infusion. This allows the owners to take some chips off the table, while retaining the ability to sell the remaining stakes several years down the road when the deal market improves. There is plenty of demand for such transactions, said Stephen McGee, executive director of Grant

Thornton Corporate Finance LLC. "We've got a lot of inquiries from private equity firms to do minority deals."

Another way to maximize value is to offer seller's notes, said Thomas Bonney, head of consulting firm CMF Associates. This is how it works: Suppose a company is worth six times cash flow, but the buyer is willing or able to pay only five times. Instead of receiving all six times in cash, the seller elects to receive five times in cash and make the remaining one turn in seller's notes that will be repaid in a few years with the company's future cash flow. The method is a way to bridge the gap in valuation between the buyer and the seller and help close the deal, Bonney said.

For owners that don't plan to sell their businesses in the near future but may do so down the road, time is probably on their side. But still, "there are ways to put the best face on companies," said Mead. Efforts such as cutting operating costs, reducing redundant functions, hiring professional managers, and continuing paying down debt will help prepare a company for sale.

"When market and financial windows are open, they are prepared to jump through," said Bonney.

And some expect the deal market to improve later in the year. "There is a guarded optimism that the second half of this year will be better than the first half," according to Jones Day's Davis. "And if history is any guide, once things turn, there tends to be an explosion of deal activity."

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