# M&A Market Analysis

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## 2010 Middle-Market M&A Outlook

We started 2009 against the backdrop of frozen capital markets and M&A activity hitting record levels of month-over-month declines. In short, nothing seemed to be working in Q1 except select deals in the pharma and tech sectors, which were the only sectors with stable balance sheets and earnings. After we trudged through the frozen tundra of Q1, a suddenly red-hot high yield market started to thaw the overall credit markets in Q2. By the second half of 2009, financing for large M&A deals reemerged, and the green shoots of a broad-based M&A recovery seemed in place; it was like springtime in M&A-land as household names such as Dell, Xerox, Disney, and Kraft announced game-changing deals weekly. Although M&A activity in 2009 declined substantially for the second consecutive year, this momentum in the second half of 2009 appears to be carrying into 2010, as M&A discussions are at the top of the agendas in most boardrooms. We are hopeful that this activity translates into a 2010 that feels like a blazing hot summer full of deals, but the economy and the credit markets will be the key factors in sustaining an M&A rebound.

After two years of significant declines, M&A activity by the numbers appears poised to grow moderately in 2010 based on improved trends in late 2009 and the outlook for various drivers. In 2010, metrics matching the Q4 run rate would translate to a 7% increase in deal count and 36% growth in dollar volume. A recent survey of M&A professionals (detailed on page 5) revealed optimism regarding upcoming deal activity, supporting the notion that an M&A rebound in 2010 may be larger than the numbers would suggest. Although 2010 activity will still be far below peak levels, the chart below shows several key variables that seem to have shifted to a clear positive status. These factors, particularly the rapidly improving credit markets and an increase in CEO confidence, could be the catalysts needed for a robust M&A environment that could resemble 2004 – the last time we came out of a recession. However, the M&A market in 2010 will go the way the economy goes: any hint of a double-dip recession could roil the credit markets, and M&A activity would in turn dry up as fast it sprouted up.

**Key Drivers of M&A Activity for 2010 Include:**

- **Strategics Stepping Up.** Backed by large cash hoards and access to capital, strategic acquirors should be increasingly active on the M&A front in 2010. Due to limited capacity to lift earnings through cost cutting and with organic sales growth likely remaining anemic, the operational leverage achievable through acquisition synergies should be appealing to corporate boards contemplating "build vs. buy" decisions. The liquidity readily available to finance the large, strategic transactions in the second half of 2009 should trickle down to a broader group of corporate buyers in 2010, underpinning growth for deals in the $100 million to $1 billion range. In addition, the recent uptick in valuations could drive divestiture activity, as corporates may view the healthier environment as an attractive opportunity to unload non-core assets.
- **Private Equity Activity Reemerging.** Following a couple of very slow years, private equity firms should contribute more to deal flow in 2010, both as sellers looking to exit long-term holdings and as buyers seeking to deploy large amounts of committed capital (estimated to exceed $500 billion). In addition, the increase in credit liquidity should begin pushing LBO total debt levels higher. However, deal-making among financial sponsors could remain restricted by ongoing focus on struggling portfolio companies, reduced fund-raising capacity, and higher equity requirements to get LBOs completed despite increasing debt levels. In addition, although decreasing, the gap between public and private market valuations could push sponsors to view an IPO as the preferred liquidity event over M&A, which could dampen M&A activity from sponsors.
- **Credit Market Markets Will Lead the Way.** While banks continue to be selective in lending for M&A purposes, the renewed appetite for large leveraged loans in late 2009 demonstrated that liquidity is increasingly finding its way to high quality opportunities, including in the middle market. However, since lending conditions have not normalized for smaller companies, a decline in delinquency levels (as is projected in 2010) appears necessary for access to debt capital to broaden.
- **The Economy is the Wildcard.** Despite the return of GDP growth in the second half of 2009, concerns persist about the sustainability of better economic conditions. Corporate boardrooms may become risk averse again if they feel a W-shaped recovery is becoming likely amid high unemployment, household deleveraging, and continued dependence on transitory stimulus measures. Trends for M&A in the Industrial space should be a meaningful litmus test for the recovery; if the economic recovery has in fact taken hold, executives in this sector should have the confidence to pursue M&A strategies that would enable them to capitalize on the substantial consolidation opportunities available in most Industrial sub-sectors.

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