

M&A Market Analysis

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2011 Middle-Market M&A Outlook

By any measure, 2010 was a strong recovery year for the global M&A market following substantial weakness in 2008 and 2009. We entered the year with deal-making and credit market activity beginning to normalize after extremely difficult conditions for much of 2009. Deal activity picked up in Q2 2010, when a building pattern of quarterly corporate profit growth helped broaden access to financing for middle-market M&A transactions. The momentum in the M&A markets accelerated in the second half of 2010, which featured significant growth in announced dollar volume. The entire year was highlighted by stand-out performance in the U.S. middle market, where growth in deal count and dollar volume exceeded 50%. Indeed, the U.S. middle market experienced the highest full-year transaction total since the internet bubble of 2000, as strategic buyers favored bolt-on acquisitions in a low-growth economy while sponsors' sell-side activity surged, driven by robust credit markets and a fear of tax changes in 2011 (which did not materialize). Many key M&A variables remain positive as 2011 begins. If the economy and credit markets cooperate, it will be full steam ahead for a strong year for M&A in 2011.

M&A activity in 2011 should build on last year's recovery due to momentum in deal-making through the end of 2010 as well as the outlook for the primary deal drivers. The neutral-to-positive status of each key variable shown in the chart below underscores a favorable M&A environment. In addition, a recent survey of M&A professionals (detailed on page 5) indicated expectations of moderate growth in M&A activity in 2011. Dollar volumes in 2011 could be consistent with levels achieved in 2005, the second year of the previous M&A recovery, while remaining well below peak historical values. Based on robust trends in the middle market, particularly in the U.S., the 2011 deal count has the opportunity to surpass the record high of 2007. As usual, M&A trends in 2011 will be highly dependent on credit market activity, which could experience periods of disruption (as in 2010), along with economic conditions, with the projected continuation of modest growth representing a satisfactory backdrop.

Primary Drivers of M&A Activity for 2011:

- Strategics Staying Active.** The pieces are in place for a busy 2011 among strategic acquirors. Corporate balance sheets are flush with cash (nearly \$2 trillion for U.S. companies). The economic recovery has restored cautious optimism among executives, bringing M&A to the top of agendas in corporate boardrooms. Due to the high levels of operational leverage in place after massive cost-cutting, corporates view deal-making as the best way to accelerate sales and earnings in a low organic growth environment. The heart of M&A activity is likely to continue to happen squarely in the middle market, with large corporates placing smaller, strategic bets instead of "betting the ranch" with large transactions.
- "Window of Opportunity" for Financial Sponsors.** For financial sponsors, conditions should be near perfect in 2011 for buying and selling assets. After a "lost" year in 2009, sponsors now have healthy businesses that are ripe for harvesting ahead of fundraising that will be taking place in 2011/2012. Against the backdrop of increasing leverage levels and rising valuations, achieving strong realizations as soon as possible is priority one; many sponsors have not forgotten how quickly the markets changed in 2008. As buyers, sponsors are focused on deploying the large amounts of committed capital (estimated at above \$400 billion) and securing new platforms or add-on businesses. Deal flow among sponsors could be dampened somewhat if equity market conditions continue to enable IPOs to represent an appealing alternative to M&A as a liquidity event; but the strong momentum in the M&A markets, particularly the middle market, will continue to make M&A the exit vehicle of choice.
- Modest Economic Growth Projected.** Economic forecasts for developed markets call for 2011 GDP expansion in the lower single digits, which should tilt "buy versus build" decisions toward M&A. With a double-dip recession now seeming unlikely, the confidence of corporate leaders has increased, as evident in gradual payroll additions and improvement in hiring intentions. Challenges to sustaining economic growth include the planned transition from stimulus measures to fiscal tightening in major regions other than the U.S., where recent tax legislation should support near-term growth.
- Credit Markets are the Key Swing Factor.** We expect credit conditions to represent a critical wildcard for M&A in 2011. While private equity shops and corporate acquirors are currently set to take advantage of favorable financing markets in completing transactions, persistent sovereign debt woes and signs of possible overheating in the high yield and leveraged loan markets could represent an impediment for M&A financing activity. Any instability in global credit conditions during 2011, as occurred in 2010 due to government debt obligations in Europe, likely would disrupt capital markets worldwide. In the U.S., fund flows could begin to favor equities over debt due to impressive stock market returns over past two years, thereby limiting access to leverage for M&A. Importantly, the U.S. Federal Reserve is expected to keep benchmark interest rates low throughout 2011, which should ensure that liquidity continues to flow across the credit markets.

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