

M&A Market Analysis

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2008 Middle-Market M&A Outlook

Middle-Market to Fare Better Than Overall Market: The Economy Holds the Key

The torrid pace of M&A activity in the first half of the year suggested that 2007 totals would easily mark the fifth straight year of increased M&A activity, as well as shatter all previous volume records. Since mid-2003, nearly all of the macro factors that impact M&A activity had been positively aligned to create a near-perfect deal environment, driving increasing levels of activity. These factors included stable economic conditions, increased corporate profits and cash flow, higher stock prices, strong debt and equity financing market conditions, greater corporate/CEO confidence, and substantial amounts of private equity capital available for investment. Flush with cash and extremely liquid debt markets, private equity firms dominated M&A activity in the early part of 2007, announcing larger and larger transactions involving some of the country's largest and well-known companies. In the midst of this frenzy, speculation rose to talk of a \$100 billion take-private in the near future. As is the case, however, things do not always work out as planned. Growing concerns over losses in the sub-prime lending market soon spilled over into the general credit markets, causing buyers to reassess overall risk and curb their appetite for high-yield loans used to fund the large LBO deals. The banks also began to tighten their lending practices, unable to sell many of the loans that they had already agreed to do in their financing packages. These factors dramatically impacted the ability to finance the multi-billion dollar LBOs and caused the termination of several previously announced high profile transactions.

As we analyzed the data, we observed several key trends that helped shape M&A activity during the year. Among these observations, which are discussed in greater detail in this report, are the following:

- The strongest segment of the U.S. M&A market was in the larger transactions, as the billion-dollar-plus transactions rose 21.6% and the \$500 million-\$1 billion deals rose 32.2%.
- The number of announced deals without a disclosed dollar value totaled 7,490, a 6.5% increase over last year and accounted for 62.8% of the total announced deals. We believe that this growing number is masking the true strength of the middle-market, particularly at the lower end of the middle-market.
- Despite the second-half slowdown, 10 of the 12 major industries still managed to post an increase in deal activity compared to last year, with five of the 12 sectors showing double-digit increases. The top industry was real estate, with a 16.7% increase.
- There were a large number of terminated deals with a record aggregate transaction value of more than \$60 billion.
- Divestitures continued to be a major source of deal volume, representing 39.2% of all middle-market transactions and 46.4% of the dollar volume.
- Despite the second-half slowdown, private equity was still a major driver of U.S. M&A activity as the private equity transactions increased 9.9% and the dollar volume rose 10.1%. Private equity transactions accounted for 14.5% of all U.S. M&A transactions and 35.5% of the total dollar volume.
- Total private equity capital raised in 2007 set another record, totaling \$302 billion, a 19% increase over 2006.
- Average debt multiples for middle-market LBOs in 2007 remained at their highest levels in years; 5.6x for deals with less than \$50 million of EBITDA and 6.2x for deals with more than \$50 million. Based on recent anecdotal evidence and discussions with various lenders, we believe that the current pricing on middle-market deals is in the LIBOR +400 basis point range with leverage multiples in the 3.0x-3.5x range for senior and 4.75x-5.5x total.
- The average equity contribution to LBOs, at 30.9%, remained below the 10-year average of 35.6% but is likely to rise significantly throughout 2008.
- Valuation multiples also remained at the upper end of their historical levels, with the median 2007 EBITDA multiple for the middle-market at 11.4x, up from 9.7x in 2006. Reflecting similar market dynamics as in the U.S., valuation multiples in the European middle-market rose substantially in 2007, reaching 11.2x EBITDA compared to 10.5x EBITDA in 2006.

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