The Deal

Middle market remains strong

by Vyvyan Tenorio 4, Jan 2008

While the flow of large leveraged buyouts came to an abrupt halt last summer amid the credit markets' turmoil, M&A activity has remained surprisingly robust in the middle and small-cap markets by both strategic and financial buyers, making some dealmakers optimistic about 2008.

Many investment bankers who focus on transactions under $500 million say that the performance of smaller companies has remained strong and that mergers are going forward, with financing only rarely being a deal breaker. On the other hand, some financial sponsors suspect that if tight financing conditions prevail amid a weakening economy, the steep valuations of recent years will likely moderate, and deal activity will slacken.

Overall, the middle market is proving less sensitive to the credit woes to which larger deals have succumbed, although any optimistic predictions are tempered by concerns over the economy.

"I've said in July that I expect a recession in 2008," said Kevin Landry, chairman of Boston private equity firm TA Associates Inc. "Even though the economy has been pretty good, I just think the subprime issues will continue to drag things down. With the current liquidity crisis, assets will deteriorate, and most people are predicting default rates will start rising."

The good news first: Last year's numbers didn't look too bad for strategic M&A in the U.S. despite the credit crunch. The year closed with about $10 billion worth of deals in December for transactions $100 million to $500 million in size, compared with $10.9 billion in November and $9.9 billion in January 2007, according to research firm Dealogic.

In the same deal value range, financial sponsors also closed in December with a slight increase in value, at $1.96 billion, versus $1.9 billion in November. But there were only seven buyouts in that range announced in December, and nine in November, compared with 16 in January. And the dollar amounts for both strategic and sponsor-led deals are well below comparable months in 2006, based on Dealogic surveys.

For now at least, M&A advisers in this segment are sounding upbeat when asked about market expectations.

Last year was another record year for boutique advisory firm Harris Williams & Co., the midmarket specialist firm of PNC Financial Services Group Inc., said managing partner Christopher Williams. "The second half was even stronger for the firm," he said, and its backlog of signed engagements is up perhaps 10% to 20% over the same period last year.

Williams reported that strategic buyers were dominant last month, with five of six completed deals going to strategic buyers. Strategics accounted for about 55% to 60% of Harris Williams' total tab last year; this year may be slightly more skewed toward strategics, with about 65% to 75%, said Williams. "We expect them to be pretty aggressive in '08," he added.

Financing hasn't been an issue so far, said John Pollock, a partner at Charlotte, N.C.-based Edgeview Partners. The firm, a unit of CIT Group Inc., focused on transactions between $50 million to $500 million in enterprise value, hasn't had a single deal fail to close, he said.

Pollock is one of those who believes the middle market will be more resilient over the long term. As a barometer of how the economy is doing, said Pollock, corporate clients "are showing very good underlying growth year over year," with the exception of consumer-oriented deals.

Pollock noted that two of Edgeview's assignments last year involved Compass Diversified Trust, a publicly traded entity akin to a business development company, or BDC. Last September, the trust, managed by Westport, Conn.'s Compass Group International LLC, acquired American Furniture Manufacturing Inc., an Ecru, Miss.-based maker of upholstered furniture, for about $93 million. And in March, it bought Aeroglide Corp., a Cary, N.C., maker of industrial drying and cooling equipment, for about $57 million.

"American Furniture was doing very well even in a tough economy," said Pollock, but it helped "to be dealing with a buyer who could take down the whole capital structure."

With access to capital markets, BDCs are expected to gain higher visibility in tight credit markets, sources said.

David Vorhoff, a managing director at McColl Partners LLC of Charlotte, N.C., said his firm observed that companies under $100 million in enterprise value, which are typically sold at a discount, showed narrower spreads last year with bigger companies. This was partly attributed to the preponderance of new midmarket buyout funds that have emerged in recent years, as well as a migration to smaller-sized deals where buyers see more operational upside and organic growth opportunities.

To be sure, the midmarket isn't immune. Debt is clearly more expensive, and leverage ratios have come down, industry executives agreed. Lenders who rely primarily on cash flow deals are harder to find than asset-based lenders, Vorhoff added.

Still, Vorhoff said that while the last five months have been slow for the firm, the first quarter of 2008 promised to be its largest ever, if all deals in the pipeline are completed.

Meanwhile, activity in the growth equity niche, where there is little or no leverage, remains healthy, though some firms such as TA Associates, which specializes in growth equity, may expect a slowing trend.

Looking at the past five years, said Landry, "we've gone from 30% to 40% of deals with leverage to 80%. In terms of ownership, we went from having an average ownership of 35% in the vast majority of our deals to owning 65% in '07. I suspect both those numbers will go down, by how much, that isn't clear." Landry added, however, that his firm will be equally happy going back to being a minority investor.

Many midmarket sponsors believe that the dislocations in the market will yield new opportunities, though with some risks, as Robin Marshall, a partner at 3i Group plc's U.S. growth capital operations, points out. "This is a year to be careful," he said. "Life will go on, but as investors we have to be careful not to be too aggressive."