



Middle-Market Insights

Q1 2006

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Spring brings great strides



Merger and acquisition activity started off with a bang in 2006, with first quarter total deal value coming to \$334 billion, the third best ever opening quarter.

The middle-market continued to be active in Q1, though not quite at 2005 levels other than for VC-backed companies, which saw a jump in valuations. Overall, the pace was slightly slower than we saw in 2005, but average valuations crept up a bit from their already lofty levels. There were 767 announced deals under \$500 million in value in Q1, with \$56.7 billion in total deal value, compared to the 2005 quarterly averages of 859 deal announcements and \$55 billion in total deal value.

The value of venture-backed M&A was up significantly – some 47 percent over the last quarter of 2005, and up 10 percent over last year's strong first quarter. The median VC-backed deal size of \$60 million was almost double Q4 05's \$31 million and Q1 05's \$34 million. This quarter has been the most robust since the first quarter of 2001.

In 2005, aggregate US deal volume stood at 10,511 deal announcements, just ahead of 2004's total of 10,456. Aggregate deal value for 2005 reached \$1 trillion versus \$781 billion in 2004. Average deal size grew to \$259 million from \$200 million in 2004.

2005 is a tough act to follow, but 2006 is off to a great start.

The return of optimism

Starting at the top – CEOs in March's Business Roundtable Economic Outlook Survey see continued strength in the economy throughout the next six months. As a result, the CEO Economic Outlook Index has reached 102.2 – the second-highest reading for the index in its 3-1/2 year history. A full 85 percent of CEOs expect their company's sales to increase over the next six months.

"America's CEOs project sustained strong US economic growth over the next six months," said Hank McKinnell, Chairman of Business Roundtable and Chairman and CEO of Pfizer. "The vast majority of CEOs continue to expect strong sales, remain optimistic about capital spending and business investment, and have the strongest employment expectations since we began the CEO survey in 2002."

Next the CFOs, as surveyed by Duke University and CFO Magazine, whose optimism jumped in the first quarter. Forty-two percent of US CFOs are now more optimistic than they were last quarter, while one-fourth are less optimistic.

The top risk factor for corporate America is intense global competition, listed by nearly half of CFOs as one of their top three worries. The second-biggest worry is rising health care costs.

Capital spending is on the rise. Sixty percent of CFOs say they will increase capital spending in the next 12 months, with the average increase 6.5 percent (up from 4.7 percent two quarters ago). Tech spending is expected to rise by 8.4 percent.

CFOs are expecting higher inflation, however they believe that rising prices will not hurt their businesses and that the Federal Reserve should not raise interest rates anytime soon. Companies will continue to accumulate cash during 2006.

The end of interest rate hikes?

In March, the FOMC voted to raise the federal-funds rate for a 15th consecutive quarter-point increase to 4.75 percent. “Most members thought that the end of the tightening process was likely to be near, and some expressed concerns about the dangers of tightening too much, given the lags in the effects of policy,” said the minutes of the meeting.

Futures markets expect the Fed to raise the funds-rate target to 5 percent at its May 10 meeting and put a 54% probability it would raise the rate further, to 5.25 percent, at its June 28-29 meeting. It seems likely that the regime of increasing short-term interest rates will come to an end in 2006.

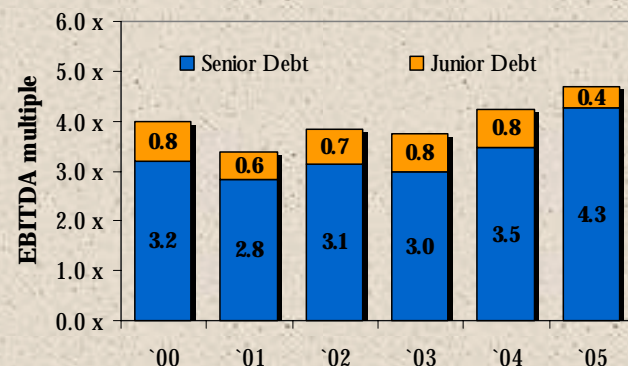
The LBO market remains remarkably active

Buyout finds raised \$31 billion in the first quarter of 2006. Four “mega funds” accounted for almost half of the quarter’s total including Bain Capital IX at \$8 billion. TA Associates raised just over \$4 billion in two funds – TA X, L.P. raised \$3.5 billion while TA Subordinated Debt Fund II raised \$775 million. Other mega funds raised were ArcLight II with \$2.1 billion and GS Mezzanine Partners 2006 with \$1.25 billion. We estimate that there remains a significant “overhang” in private equity commitments looking for a home.

Average EBITDA multiples on LBO deals under \$250 million reached 7.5x in 2005, up from 6.8x in 2004.

Banks are continuing their willingness to lend. Middle-market debt to EBITDA multiples continued to expand. According to Standard & Poor’s, total debt multiples in the last quarter of 2005 reached 5.2x for LBO transactions under \$50 million EBITDA.

Debt multiples remain high
LBO Transactions under \$50 million EBITDA



A convergence of events makes this a great time to be a seller:

- Strategic buyers are holding record levels of cash – many have reduced debt over the past two years to the point they are in a net cash position. A recent ACG/Thomson survey found that “hefty capital reserves of some acquirers” was the most frequent response to the question: “What do you see as the greatest driver of M&A activity in the first half of 2006?”
- CEO and CFO optimism has rebounded to the point that strategic M&A is a logical use of cash and management resources.
- Private equity groups are competing for middle-market deals in auction-style sales once reserved for the billion-dollar plus deals.
- The return of the strategic buyer to the high end of the middle-market in 2005 is expected to carry on to the lower end of the middle-market in 2006.

As with many areas of life, in M&A timing can be everything.

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