Middle-Market Mergers & Acquisitions

Q1 2004

Newbury, Piret & Co., Inc.
One Boston Place
Boston, MA 02108
Tel: 617-367-7300
www.newburypiret.com

Alan V. Fullerton, Jr.
afullerton@newburypiret.com
Boston – (617) 367-7300

Have the Floodgates Opened?

Deal volume doubles in first quarter

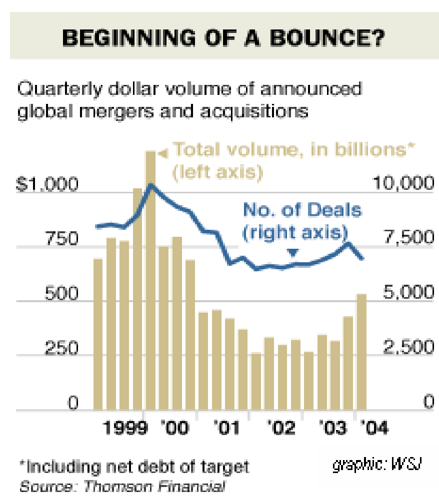
Global merger and acquisition volume jumped more than 90% in the first quarter of 2004 to $515 billion, compared with $265 billion in last year's first quarter, according to research firm Thomson Financial.

A similar survey by Dealogic showed that the volume of billion-dollar deals rose by 139% over the first quarter of 2003. However, the volume of deals worth less than a billion dollars rose by only 12%.

Below the size of the mega-deals, the U.S. middle-market (sub $500 million deals) produced just 634 deals totaling about $38 billion in deal volume in the first quarter of 2004. Last year's fourth quarter results of 726 deals totaling $53 billion encouraged the optimists, while the first quarter of 2004 was the slowest start since 1995.

For the past six months, middle-market investment bankers have been predicting a strong deal market in 2004. Factors such as improved credit availability, stronger corporate earnings, improving macro-economic conditions, and industry-specific surveys such as the continuing strength of the ISM's indices, have been cited as leading indicators of M&A recovery. Venture capitalists and private equity groups remain awash in undeployed capital and venture-backed companies often hold the key to future growth for public acquirers.

Private equity multiples for management-led buyouts and traditional LBO's have increased dramatically. The headline of a recent Daily Deal article simply titled "*Frenzy*" captures the mood.



Why then the slow start to 2004?

First, in some ways, 2003 was 2002 all over again. According to Thomson Financial, M&A activity in the U.S. (including the mega-deals) rose a healthy 20%, to $526 billion, in 2003. However, according to Mergerstat, the lower-end of the U.S. middle-market told a different story. The number of deals with value between $25 million and $250 million totaled 1,080 in 2003, up only 3% from 2002. Volume was up only 5%, to $90 billion. The middle-market in 2003 looked a lot like the previous year.

Second, a weak March stock market erased gains made by many companies over the past six months. March came in like a lion, with the Dow at 10,583, and went out like a lamb, with the Dow dropping to 10,103 on March 15 before rallying to close the month down 200 points at 10,356. Such a market lowers confidence on both sides of the table.

Third, debt availability and leverage multiples, although recovering, remain low relative to where they've been historically. We've seen availability improving the past few months; if this continues, 2004 should be a very strong year.

What's in store for 2004?

In addition to the much-improved economy, the availability of financing will play a decisive role in M&A activity during 2004.

High-yield financing came back strong in 2003 and fueled some of the strength in the mega-deal segment. Junior debt, the middle-market equivalent, is being used to fill the gap left by senior lenders in sub $250 million deals. Junior debt includes tranche B loans and last-out participations as well as classic subordinated (mezzanine) debt. The cost for subordinated debt in a smaller middle-market deal can be 400 basis points higher than for a large middle-market deal.

In 2003, junior debt represented 35-45% of total debt financing in middle-market LBO's. This is all the more surprising when considered along with the fact that the average equity contribution to LBO's has been about 40% for the last 3 years.

Last year, few middle-market deals were done without some tranche of junior debt. As the financing climate improves, lower-cost bank debt is likely to return, lowering the overall cost of capital and resulting in higher value to the sellers in well-managed deals.

Are Business Performance and CEO Confidence the Key Success Factors?

Ask any dealmaker what was the toughest part of getting a deal done last year and you are likely to hear back "performance" – or lack thereof. Nothing this side of Enron stalls a deal faster than missing the numbers. But that's only part of the story. The confidence the buyer has in his or her ability to run the company and achieve the post-deal integration plan can be seriously eroded by poor business performance. Having survived the heady days of the late-90's, investors and acquirers are today in a back-to-basics mode. This means thorough due diligence and high confidence in the target's people and business plan.

The number of prospective deals called off in 2003 is unknowable, but we suspect it was high as buyers and sellers dipped a foot back into the market only to find it not quite to their liking. 2004 looks like a year when the M&A completion rate should be higher. Cyclical industries are recovering. Multiples are up. Business confidence is stronger.

Where are the Multiples?

Multiples in the middle-market vary from industry to industry and are quite deal-dependent. However, a broad transaction sample by Thomson Financial indicates that EBITDA multiples are up between one-half to one turn over 2002. This recent study shows median Enterprise Value to EBITDA multiples of 7.0x in 2002 and 7.9x in 2003. Our recent experience is that financial buyers are competing head-to-head with strategic buyers for high-quality deals and that multiples in excess of 7.0x are currently achievable even at the lower end of the middle-market.

Newbury, Piret is a leading private investment bank to growth companies in business services, manufacturing, healthcare, and technology.