M&A temp check

H&W sits down with the experts and looks for answers in an uncertain market

As we reach the home stretch of 2012, the market for private equity and investment banking remains in a cloud of uncertainty. With the volume of M&A activity and private equity placements continuing at modest levels, many experts believe 2013 may usher in a significant increase in transactions. Conversely, some fear the flagging global economy and rising tax rates will continue to hamper growth. Meanwhile, as a rising number of baby boomers are preparing to exit their businesses, many have had their exit strategy delayed by the unstable economy.

To help sort through all the uncertainty, we sat down with some of southern California's leading private equity and investment banking firms and asked them a series of questions about the market.

Here's what they told us.

Let's begin with a global look at M&A activity. What sectors are receiving the most attention?

Josh Harmsen and Dan Lubeck, Solis Capital Partners: Given the risk environment, we expect investors to focus more attention on industries that exhibit the following characteristics: highly scalable business models with limited capital expenditures, variable cost structure, limited exposure to non hedgeable inputs or technological obsolescence, value-added services and products with a clear competitive advantage, limited customer concentration and a history of profitability and organic growth.

What specific industries meet these criteria?

David Iannini, William and Henry Associates: The market is focusing on the healthiest sectors of the economy: medical, health care, high technology for M&A and green-tech for capital raising. Most other sectors will receive little or no interest.

Harmsen and Lubeck: Industries we see as attractive include application and infrastructure software, business and outsourced services, health care services and niche manufacturing.

David Bonrouhi, Calabasas Capital: Health care is very strong. Consumer products and restaurants have also rebounded nicely.

And areas to avoid?

Bonrouhi: We're staying away from financials.

Iannini: There is virtually no market for pre-revenue companies.

How are you evaluating basic needs sectors vs. luxury items going forward?

Fred Jager, Hunter Wise Financial Group: As the population gets older worldwide, there is a greater need for medical and dental. People will still eat, and more people seemingly eat more. We all need clothes, but we all do not need expensive clothes. Ditto on cars, homes and scores of other basics. In-ground resources, i.e. oil, gas and coal, as well as quality water, are all going to be essentials for years to come. So the basic needs industries will continue to be active, but the luxury items will have questionable, if any, growth. Manufacturing will continue to slowly return to parts of the United States, and, as a result, more suppliers will begin to do better.

Bonrouhi: The great thing about food and restaurants, two areas where our firm really has deep domain expertise, is that people have to eat. That doesn't mean they have to eat everything, but branded healthy food companies and multi-unit restaurant chains, particularly value segments such as quick service and fast casual, have a big advantage. There have recently been a number of growth equity investments and buyouts completed by private equity firms in the food and restaurants sectors at eye-popping valuations.

What factors are affecting the number of private equity opportunities and closings?

Harmsen and Lubeck: There are many factors affecting the number of deals closing. The aging population of business owners are implementing transition plans and seeking liquidity and diversification, particularly in the western United States. The uncertain tax environment and the slowly improving business conditions in the United States are slowing down decision making, which affects the number of transactions. On the positive side, the lending conditions have improved, and a significant amount of private equity capital needs to be invested.

Iannini: Continued uncertainties such as a weak U.S. economy, European crises and a slowing Chinese economy will continue to dampen the enthusiasm of both buyer/investors and sellers/issuers. The weak balance sheets and profits of most companies, as well as lending by banks in the lower middle market, particularly for cash flow-based loans, will also play a role.

Bonrouhi: There is a limited supply of high-quality companies coming to the market.

Are there any year-end opportunities for equity investment?

Bruce Lipian and Drew Adams, StoneCreek Capital: For the remainder of 2012, we expect a flurry of private equity investment activity for several reasons. First, there is a strong likelihood that the capital gains tax rate will go up in 2013, making it economically advantageous for owners who are thinking about selling in 2012. Second, the investor commitment period for many private equity funds that haven't invested their capital as quickly

as they had hoped is going to expire in the next 12 to 24 months, motivating the general partners of those funds to intensify their efforts to invest their remaining capital. Third, access to debt capital, both senior and mezzanine, is readily available on reasonable terms for good deals. As a result, purchase price multiples for high-quality companies are likely to remain on the high side, for larger transactions where there is a good company, good industry and growth story, seven to 10 times but for most companies still in the four to six times range."

So what is your forecast for 2013?

Jager: It will be another transition year, to some substantial degree variable upon the world and U.S. economy.

Iannini: I expect the slow pace of M&A and private placements to continue, particularly because any tax benefits of doing a transaction in 2012 will have gone away.

Bonrouhi: Not as high as 2010 but better than 2012. Once the election is settled and fiscal issues are resolved, M&A activity should pick up.

Harmsen and Lubeck: We expect a meaningful uptick in M&A and PE placements in 2013 and the few years following.

Let's end with the baby boomers. There has been much discussion about the impending flurry of baby boomers exiting their businesses, but are they making a proper exit strategy?

Lipian and Adams: Far too few owners take adequate steps to enhance the exit value of their equity by thoughtfully grooming and positioning their company for sale. As a result, the economic consequence to the owner is often a discounted purchase price multiple of EBITDA (typically one to two times lower).

Harmsen and Lubeck: We generally don't see baby boomers making adequate preparations for sale events.

Iannini: Many businesses are discussing and preparing for exits, either through a full or partial sale. But, they are generally unwilling to move forward until some of the uncertainties above are resolved, their financial performance improves and market conditions improve.

Bonrouhi: Most business owners are only thinking about an exit when their business is down, which means it's not the opportune time to consider a sale. Planning needs to begin years in advance so when the business is at a multi-year peak, the owner is ready to pull the trigger.

So what's holding them back?

Lipian and Adams: Three primary reasons owners don't take the steps to prepare their business for sale are uneasiness dealing with the prospect of selling, lack of awareness of what buyers focus on and care about and not wanting to hurt the company's profitability by incurring incremental costs (getting audited financial statements, hiring a financial consultant to advise on value-enhancement strategies, conducting a legal review, etc.).

Harmsen and Lubeck: The lack of preparation is generally caused by the following:

- Lack of clear goals and objectives regarding what they want to accomplish and when
- Lack of understanding of all the potential sale and liquidity options available to them (sell, partnership, recap, ESOP, etc.)
- Lack of understanding regarding the sale process and the significant time and resource commitments required
- They don't know where to start (hire an investment banker, personally seek out a buyer, hire a lawyer, etc.)
- Lack of trust in an unknown process and fear of being taken advantage of

Bonrouhi: Many are holding back because they believe they can outgrow any increase in tax rates.

This sounds like a risky move. What are the potential consequences of not forming an exit strategy?

Lipian: and Adams: Regrettably, failure to incur the time, effort and expense related to positioning a company for sale is far more costly than the cost of positioning the company for sale. For example, a business generating $3 million in EBITDA with a 10- to 15-percent EBITDA margin should sell for four to five times EBITDA. However, that business is likely to sell at or above the high end of the range if the owner has prepared the business for sale versus selling at or below the low end of the range if the owner hasn't prepared the business for sale. As a result, the cost to the owner of not positioning the company for sale in this example is a minimum of $3 million in proceeds at exit.

How should a business owner approach an exit strategy to avoid these catastrophic outcomes?

Jager: Every business owner should logically think about getting out of the company even before getting into the company. With that in mind, the systems and procedures will all be in place to exit if and when the time comes to sell or merge. However, if the business has not considered that approach, and, truthfully, most don't, then the managers need to employ a team of professionals (accountants, attorneys, wealth managers, investment bankers, etc.) to get the business in the best possible position prior to a sale or merger. It is very much like working on the curb appeal of your house and cleaning up and painting the inside prior to putting your home on the market. **LE**