Reading the Tea Leaves

Ten trends in mergers and acquisitions in 2011

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Midway through 2011, the factors impacting significant M&A activity are still in play, perhaps even more so. On the sell-side: Private equity funds seek to maximize long-held portfolio investments. Corporations have an unprecedented war chest for strategic and value acquisitions. On the buy side: PE funds have dry powder to put to work, and sellers have adjusted valuation expectations. Banks are out of intensive care --- credit is once again available and on reasonable terms. Below is our take on the 10 significant trends shaping the landscape.

1. The Turning Tide of M&A: Acquisition for Growth vs. Retrenchment

Companies have been hoarding cash for more than two years. Inflation is on the horizon and cash will have less value. A blinding flash of the obvious? Perhaps - but also a harbinger of change. Companies understand that it's time to convert the cash into a higher value asset. With the economy turning around, companies are spending on acquisitions designed to move their businesses forward rather than protecting them against the woes of a bad economy – using acquisitions both for top line growth and to expand into new areas. Well-capitalized corporate buyers continue to seek growth, realization of synergies and diversification through strategic acquisitions that expand their footprint and product capabilities.

2. Social Networks – New Platforms are the X-Factor

A plethora of social networks reports varying degrees of profitability. Some have IPO'ed, like LinkedIn, and others are one step away from extinction. One thing is clear – size really does matter, and those who have it will succeed. With prices that consumers are willing to pay for apps, access and games going down, the number of customers looking at ads and making purchases must go up. The social networks and other on-line behemoths are actively acquiring in this area to expand both the number of customers and the number of devices each customer accesses. Ubiquity across platforms (think seamlessly moving from desktop to smart phone to tablet to automobile) will leave no revenue stone unturned. Look for acquisitions that will assist these networks in making the transition. Driven by multiple trends, including social networking, M&A deals grew not only in number, but in total value, during the first quarter of 2011. Although there were more deals, they were smaller and more strategically focused.

Nanette Heide

3. In Media, Revenue Starts with the User: Making Your Internet Experience New and "Wow". Daily. Hourly. By the Minute, er … Second

In order to keep the user online and in a particular company's universe, offerings and content must continue to wow the user. In this market, setting a trend, or once a trend has been set, competing as quickly as possible, is critical. There is no time to build, and companies will buy both to compete and to stay on top. Given the number of talented developers, acquisition is becoming as important as in-house development. Exclusive access to the hottest trends drives network participation, while continuous feed of new offerings, content and products keeps customers' ever valuable eyeballs glued to a particular network. Media company executives constantly scour the internet universe for new purchases that put their users in front of electronic devices. In fact, many software providers also purchased social networking companies to supplement enterprise applications or advertising/marketing platforms.

Stay tuned for acquisitions that reinvent some of the traditional players as well.

4. Is the PE Roll Up Back? New platforms created by financial buyers

Technology, Energy, Biotech, Healthcare: areas in which we expect to see a significant increase in M&A activity. Back in the game, PE funds will give some strategic buyers a run for their money. The PE-backed, platform building structure enables mega firms to deploy large amounts of cash by transacting multiple deals in the middle market where prices are a better value and business owners are motivated. The PE funds then expect that the new company will be able to achieve operational multiples. Case in point: Mid-Atlantic Convenience Stores (MACS), formed as a retail rollup by Greenwich, Connecticut-based Catterton Partners, which has gone from a 44 store chain to a chain of 300 stores across the mid-Atlantic, overnight.

5. Middle Market? Everyone's Doing It!

Giant deals don't always make money. In fact, some would say that macroeconomic fears and market volatility often outweigh the possible upside to a cross-border mega deal. Combine that with the fact that the operations of a multi-national bureaucratic corporation are costly and complex, and changes fueled by investments do not always drive profits. In contrast, PE involvement with a middle market company can have direct, immediate impact on the company and its operations, increasing strategic value to a corporate buyer and exit multiples to the fund. What's more, with new SBA loan limits increased to $5 million, smaller companies may see more buyers in the market in the second half of 2011.

6. Leveraged Buyouts? Hiding, but not Dead.

Banks have to lend money to make money and financing is once again available for private equity buyers and on favorable terms. PE funds must deploy cash for their LPs to have a return. Reportedly with $400 billion in cash, PE funds must either deploy or give back. It is unlikely that the super mega buyouts and high leverage ratios of 2006 to 2008 will be back anytime soon. However, acquisitions that require big PE backing also require large loans to complete the purchase, a more likely scenario this year. Throw in some mezzanine financing and we're back in 1998 —the comeback of the larger deal.

7. Hey La, Hey La, the Earnout's Back!

Today, where more equity is required, less leverage is available and valuations are increasing, the earnout has made a roaring comeback. Some buyers consider the earnout a good way to ensure the value of their purchase, while some sellers consider it simply a form of seller financing. Whatever your perspective, earnouts are fraught with all kinds of legal and business issues and must be carefully negotiated.

Keli Whitlock

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8. The Role of Real Estate Acquisitions

Real Estate. Really? We think so. The real estate market is not roaring back, but M&A activity will be strong for many reasons. Debt is becoming available, balloons are coming due and valuations are no longer artificially (or otherwise) high. Real estate firms likely will seek to gain market share in existing markets, divest non-core assets, and seek out transformational deals.

9. Why Did the Company Cross the Border?

To get to the markets on the other side. These days, most companies have some international component, whether it's customers, manufacturing, sourcing or sales. Hence, the majority of acquisitions will have cross-border implications. Indeed, at press time, M&A between developed and emerging markets is running at near-record highs. Traditionally, cross-border deals include buyers and sellers in different countries (which still happens with some regularity, typically where a conglomerate is the acquirer). We also expect to see a high percentage of deals focused on regulatory schemes in other countries.

10. Something Normal All Fouled Up: The Effect of Geopolitics

M&A markets love stability, typically without regard to politics -- unless a particular regime causes economic instability for buyer or seller or risk that is too, well, risky. For example, prior to recent political developments, Egypt was the next hot PE market. These days, the rest of Africa is also "hot." While in the long run, most believe that the change is good and the emergence of a greater democracy will cause the global competitiveness of such countries to rise, current political upheaval will likely have a negative effect and result in a slowdown in PE activity in deals involving the Middle East.

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