THE TABLE IS SET: Ten Trends for M&A in 2012

Law firm Duane Morris offers annual forecast of what dealmakers should brace for this year

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Private Equity is back! Or is it? The last three years have been uncertain at best. To avoid the volatility of domestic and international markets, the lack of credit, and an increased regulatory environment, many industry players dug holes to hide in, perhaps venturing out to do an "add-on" and then going right back. Based on the convergence of a variety of factors, 2012 is shaping up to potentially return us to active times. Strategics continue to put their cash to work – enabling them to grow by acquisition. Many private equity funds need to deploy their uncalled capital before their investment periods end. Other private equity funds are seeking to exit (finally) long held portfolio companies, so that they can make distributions in advance of fundraising efforts. Thankfully, banks are poised to put their balance sheets to work. So, "the table is set." Below is our annual forecast of the 10 significant trends shaping the landscape in 2012.

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1. Sometimes M&A is like "Predator"; other times, it's more like "The Dating Game." This year, U.S. buyers and sellers seem to have more affinity than aggression for each other regarding valuation; however, the markets are not necessarily cooperating. The fourth quarter of 2011 brought such market volatility that in many cases, the pricing established at the beginning of a deal became very difficult to sustain at the end. On average, deals are taking longer to close, as buyers and sellers work through diligence issues well before closing rather than having to fight about them after. Both sides are more deliberate in their processes. This means that the valuation agreed on at the beginning of a deal is at greater risk. Many factors that contributed to the market extremes in late 2011 are starting to smooth out, but the markets have not yet achieved a sustained improvement. The problems in Europe are not rocketing to the U.S. as previously feared; the residential housing market is working through its inventory and bad debt issues; and companies are beginning to create jobs on a more sustained basis. Volatility should ease somewhat in 2012 as market participants' rational thinking overcomes their fears—and deals are likely to be more stable through the process. The smoother sailing on the horizon did not come in the early part of 2012, and the waters will churn again if conditions in Europe take a turn for the worse and global growth shows significant weakness over the long term.

2. Regulations come and go . . . and come some more. The recent surge in regulation can dampen M&A activity, but can also spur it. This year should mark significant movement driven by regulatory action: Dodd-Frank and the new healthcare laws require that companies have to start planning—and most of them are well into the process as they can neither count on these laws being repealed nor can they wait for the November elections to pass before commencing the sea change that these new regulations will necessitate in their businesses.

Because the new requirements will significantly affect profitability, companies are strategizing now to adjust for that impact. Without time to build, quite a number of buyers in the market are likely. Many effects of the new healthcare laws are not yet visible to consumers, but M&A activity in healthcare IT systems is picking up significantly in an effort to ensure that profitability does not suffer and the industry can continue to grow.

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3. Covenants and ratios and ROI, oh my. It's true that banks are lending and companies are borrowing. The process just is not as carefree as it was in 2006 and 2007. Volume is down and diligence is up. Acquirers and sellers have become accustomed to the idea that banks are no longer giving money away and not carefully monitoring the performance of their portfolios. Therefore, only companies with top line visibility, squared-away balance sheets and solid investors who can provide support in difficult times are going to pass muster with investment committees. This scenario leads to continued downward pressure on valuations and more competition among private equity (PE) firms and strategic acquirers.

4. Global operations are like opinions—everybody's got them. What does that mean for M&A in 2012? It signifies more-specific business and legal due diligence, longer term sheet-to-close times and more complex transactions in almost every instance. From accounting to employment to compliance, global enterprises require effective and efficient management of a greater number of complex operations to maximize value and contain risk. Dealmakers will look in areas with some risk, because that creates value, but cannot abide unpredictable risk, because that eliminates value. Transactions will focus on China, Vietnam, Brazil and India. Deals are unlikely this year in other countries that have promise but that still need to develop some stability and infrastructure. An interesting side-note is China's continuing investment in the infrastructure in Africa. We expect this will continue at a significant pace and may create compelling targets in the future as companies realize they will need to compete in Africa to remain or become globally relevant.

5. It's liquidity, liquidity, liquidity—and growth. It is well-known that PE funds continue to face a competitive market for fundraising. Thus, now more than ever, they must show successful exits in order to raise new funds. A deal backlog exists that is larger than in 2010. M&A transactions will continue to be driven by PE funds seeking to sell their portfolio companies. Some of these sales will be "secondary buyouts," which are likely to remain key in 2012. Portfolio companies in this process are tasked with driving EBITDA, maximizing valuation and acquiring the appropriate leverage.

We expect 2012 to find PE funds' seeking creative ways to help their portfolio companies expand business lines and gain access to new markets—in an effort to generate top-line revenue that translates to value on a sale. Because of the amount of cash on companies' balance sheets and the short time line companies have targeted to achieve significant growth, a "buy-versus-build" mentality can also be expected to continue throughout this year. We anticipate that companies will grow more through acquisitions than internal organic growth. Targets will include new products and product lines, as well as new product features or new distribution channels.

6. Global economic uncertainty: Synchronized swimming. The diversification that used to exist among the global equity markets has essentially vanished. The resulting herd-like behavior among investment professionals, the relative ease of access to exotic markets through globalization, financial innovations and technology advancements lead markets to align themselves, react similarly to the same global stimuli and generally reduce diversification. Global economic upheaval has increased pressure on companies to expand operations, diversify their asset base and distribute costs across larger platforms. This means that global risk management—including currency fluctuations, labor issues and general global economic conditions—has been baked into everyone's blackbird pie.

The implications of the European financial crisis on the U.S. economy and its businesses are unclear – and this generally portends that acquirers will take a hold position. However, the global economic situation coupled with speculation about changes to the U.S. corporate tax rate and the upcoming U.S. presidential election also create urgency—along with general forecasting uncertainty. Stymied somewhat by increasingly aggressive U.S. antitrust enforcement, the acquisition appetite of U.S. businesses and European businesses wishing to enter the U.S. markets is expected to increase in 2012.

7. WWGD? Many companies ask themselves on a daily basis: What would Google do (WWGD)? eBay's answer to this question in 2011 was to create a coherent strategy for its platform, spending $2.9 billion in acquisitions (compared to Google's $14 billion), broadening its e-commerce platform to include both mobile devices and diverse carriers. No longer just an online auction house of second-hand goods, due to acquisitions that include platforms focused on comparison shopping, eBay has expanded its commerce operating system to address the online, mobile, social and local retail markets. We anticipate other online platforms to do the same—increase their presence through myriad technology acquisitions and continue to defy any attempts to pigeonhole them and control their growth.

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8. All we ever talk about anymore is healthcare. Healthcare spending accounts for about 17 percent of the U.S.' gross domestic product (GDP). With that kind of money in any industry, of course it's important—to everyone from PE firms to healthcare businesses to hospital systems to healthcare consumers. The M&A markets will see substantial activity from various companies with great plans for their piece of the healthcare industry. Companies and their financial backers see tremendous opportunities, whether they are trying to improve the accuracy of the billing process; integrate healthcare providers with each other and their equipment; or improve disease management, outcomes and quality of life. Bottom line: The new regulatory environment and advances within the healthcare industry will target efficiency and the related need for greater integration. Meanwhile, the number of companies pouncing on this market will create substantial competition in the industry for acquisitions, which will spur additional innovation and consolidation.

9. Real estate market: Supply, demand and incremental improvement. Inventories are high and values are low, and investors continue to ponder their options. Although foreign investor interest suggests increased opportunities for capital appreciation of commercial real estate, continued uncertainty in the domestic and global economies is likely to continue to negatively affect this market. Global economic growth has softened. Real estate loan delinquencies remain high. Credit markets have turned volatile, and loan underwriting standards continue to tighten. These factors threaten any potential momentum in the real estate industry, so we expect M&A activity in this sector to be as uneven as the recovery.

10. Companies crossing the border to access U.S. private equity $$. The Euro zone debt crisis continues, creating significant opportunities for U.S. PE funds to make investments in financial services assets, particularly banks. This could lead to an increase in M&A activity in 2012 as some European banks prepare for the divestiture of their asset-management divisions in order to bolster their balance sheets and meet new capital requirements. Valuations between buyers and sellers are still diverging, with sellers opting to wait out the low valuations. A robust M&A environment that includes cross-border investing will also depend on the ability of the governments involved to provide a stable environment for investments.

Conclusion:

The digging has stopped, and we are looking to climb out of the hole. Many perils remain along the way, including potential cave-ins related to global economic factors and political decision making that could return us to the bottom of the hole. So, what's the M&A market to do? Do what it does best: buy, build and sell for all the right reasons. Darwinism has made its mark over the past four years. The remaining businesses are strong, and no one is throwing caution to the wind. These favorable signs indicate that the people behind the businesses and the resulting M&A have a good sense of the next steps—building, innovation, expansion and implementation, all at a healthy profit.

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