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December 2002

Mergers and Acquisitions: The Current Climate

Historical View

As with many industries and sectors of the economy, activity in the mergers and acquisitions (M&A) market has declined over the past two years. According to Mergerstat, a firm that tracks U.S. and U.S. cross-border M&A activity, transactions peaked in 2000, reaching 11,123 deals valued at an estimated \$1,269 billion. Since 2002, both the number of deals and the average deal value have declined. In 2001, Mergerstat reported 8,545 deals valued at \$683 billion, and through November 24, 2002, a total of 6,555 deals valued at \$408 billion have been reported. The larger relative decline in value is attributed to fewer “mega” deals, such as AOL-Time Warner, and the end of the tech boom.

Current Climate

While 2002 is projected to be another down year with approximately 7,250 deals, it remains significantly higher than any year in history prior to 1997. The impact of the recession and September 11th lingers, but is felt much less now than early this year. In fact, we believe M&A activity has been in an upswing since this summer, and expect this increase to continue next year. The primary reasons for the improvement include the decision by many owners who have been sitting on the sidelines to move forward with plans to sell, acceptance that valuations have stabilized, and pent-up demand from buyers.

A large number of high quality, well-funded buyers exist in today’s market. Buyer interest remains strong for “old economy” businesses, with more predictable revenue and profits. However, due to the volatility and problems seen with some large public companies, buyers are more cautious when evaluating acquisition candidates, resulting in deals taking a longer time to close.

The availability of senior debt remains tight, and cash flow loans without collateral are difficult to obtain. As a result, buyers must bring a larger amount of equity as a percentage of the total purchase price. This has had some effect in causing valuations to decline slightly, although good businesses are still selling for attractive prices.

Given the uncertainty of today’s economic climate and the performance challenges it creates for many companies, buyers have been reluctant to pay high prices without some assurance of the acquisition’s future performance. Sellers, in turn, may wish to participate in the future earnings as a way to make the deal more attractive to them. To help meet the needs of both buyers and sellers, and bridge the valuation gap, both parties are increasingly turning to earnouts. An earnout is a method for triggering changes in the purchase price based on future financial performance of the target company.

Preparing for Sale

For business owners considering selling their business in the current climate there are a number of steps that they should take today to make sure the sale process is successful and ultimately maximize the sale price.

- **Prepare audited financials, if possible.** A buyer is most concerned with the financial performance of the selling company. Audited financials give the buyer comfort that the financial picture presented by management is accurate. The greater the buyer's comfort, the lower the perceived risk, the more likely the buyer will pay a higher price.
- **Show real earnings, minimize adjustments to cash flow.** Buyers do not get excited about companies operating on a break-even basis with a list of add-backs. \$1 million in earnings is more desirable than \$500,000 of earnings and \$500,000 of adjustments.
- **Clean up the balance sheet.** If there is a write-down required on assets, such as obsolete inventory or uncollectible accounts receivable, handle these items beforehand.
- **Build a management team.** The existence of a solid management team reduces the buyer's reliance on any given member of the team. As a result, the buyer is more comfortable that the future success is not dependent on the current owner.
- **Allow sufficient time following a material change in the business to prove results.** To receive full credit for any positive changes in the business, the selling company needs to provide quantitative proof of the change's impact on the financial performance of the company.

Once a business owner makes the decision to sell, it is important to show a good story through superior documentation. M&A advisors use the Confidential Offering Memorandum as a key selling tool when packaging the company for sale. The memorandum should promote the company's organization, including management and employees, the products and services provided, the facilities, customers, competitors, and other key topics. The company's strengths and competitive advantages should be emphasized. Most importantly, a section for the growth strategies of the company should provide potential buyers with a credible road-map for the future.

Finally, leave sufficient time, both for the planning stages, as well as the actual selling process. Once the decision to sell is made, and the process is initiated, expect that it will take between six and twelve months to close the deal. A well-prepared company will sell more quickly and for a higher price.

Selling a company is something most people do only once. For many owners, it is one of the most important decisions of their lives. Enlist the help of professionals, including your CPA, attorney, and an M&A advisory firm.

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