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Will Manufacturing Businesses Participate in a 2010 M&A Market Recovery?

March 2010 - Since the peak of middle market merger and acquisition (“M&A”) activity in 2007 and early 2008, transaction volume has declined dramatically. Depending on one’s source of statistics, specific timeframe, and business sector, middle market transaction volume is down at least 70%. For firms in the industrial and manufacturing sector, closed transactions were almost non-existent in 2009. Potential sellers – both entrepreneurs seeking a liquidity event and enterprises selling non-core manufacturing businesses – have remained on the sidelines for 18 to 24 months, awaiting a better operating environment and a more receptive and lucrative M&A market. Potential buyers were constrained by the downturn in financial prospects related to the soft economy and were inclined to preserve valuable capital in the face of a general sense of uncertainty.

Fortunately, pent-up supply and demand created by the last eighteen months of inactivity suggests meaningful M&A opportunities will begin to surface in 2010. InterOcean believes that U.S. manufacturing companies will be significant participants in this increase in M&A activity. As we evaluate the supply side of the M&A equation, we note several critical, contributing factors.

Earnings Improvement. Our manufacturing clients are beginning to experience improving order levels and becoming cautiously optimistic about 2010. In fact, many believe that by the end of the second quarter, revenue and margins will have returned to early 2008 levels, suggesting the potential for increasing valuations.

Capital Gains Tax. The prospect of higher long-term capital gains taxes in the future should provide an impetus for private owners to seriously consider sales in 2010 rather than deferring for two or three years.

Carried Interest. Carried interest for private equity (“PE”) firms could be taxed as ordinary income commencing in 2011. Thus, in order to capitalize on today’s relatively low long-term capital gains rate, private equity firms will logically be tempted to give consideration to liquidity strategies, including the possible divestiture of portfolio businesses.

Corporate Divestitures. Improving prospects for manufacturing businesses and the promise of higher valuations will likely stimulate large conglomerates with numerous portfolio investments to pare those businesses that are underperforming or off strategy.

Distressed Companies. The tendency of commercial banks to support distressed debtors will gradually end as prospects improve for recovering a greater share of underwater senior and junior loans from the sale proceeds of debtor companies.

Complementing our projection for a more plentiful universe of acquisition opportunities in 2010, we believe several factors will contribute to greater buyer interest – in turn leading to an important increase in closed transactions.

Private Equity. More and more private equity firms are expressing a willingness to deploy greater equity in transactions, with the prospect of recapitalizing (leveraging) the target business at a future date. By accepting a lower internal rate of return (IRR) on their investments, they may be able to compete effectively with strategic buyers that benefit from readily attainable synergies, lower return thresholds and a long-term ownership horizon. We believe that PE firms are incentivized to deploy significant cash resources at their disposal given the risk that capital must be returned to limited partners if not utilized. We are also beginning to notice greater access to debt financing, particularly for larger transactions.

Credit Availability. Commercial banks appear to be loosening lending restraints, albeit gradually. Simply stated, investing deposits and other short-term liabilities in Fed Funds, commercial paper, Treasuries and other money market instruments offers virtually no yield compared to commercial loans awarding returns of 500 basis points over LIBOR with floors of 3% or 4%. With considerable loan and other earning asset losses recognized in 2009, bank CEOs will begin to focus on

2010 earnings and recognize the interest margin opportunity at hand. We think that the government will assist this transition by softening the intense pressure imposed by regulators on asset quality and begin effectively promoting commercial lending. Manufacturing companies will benefit, because lenders are most comfortable with exposure to asset-rich businesses – especially during periods of financial distress.

Strategic Buyers. Many strategic buyers are in a good position to acquire synergistic businesses at fair values. These companies aggressively reduced costs during the downturn to improve earnings and preserve liquidity. As such, coming out of the current recession, many are well-capitalized – with meaningful cash resources – and are favorably disposed to pursuing attractive acquisitions. However, we anticipate that they will be disciplined and stay focused on opportunities within their core competencies and manufacturing sectors.

Valuation Metrics. Prospective buyers are showing increased flexibility and creativity in valuing prospective acquisitions. Traditionally, acquirers have relied heavily on applying market multiples to trailing twelve-month EBITDA. Using this methodology, manufacturing companies recovering from a severe downturn in operating performance are challenged to attain valuations justifying a sale. We are now seeing receptivity to applying adjustments to EBITDA – essentially leveling the peaks and valleys often associated with cyclical manufacturing companies. At least one PE firm has indicated that – provided operating run rates are at or better than historical levels of performance – it is de-emphasizing the significance of trailing twelve-month EBITDA results in the determination of value. We argue that the current monthly run rate and indications of sustainable operating momentum for a business must be given significant consideration. In addition, greater weight needs to be applied to forward-looking discounted cash flow analysis, which will contribute to more realistic valuations in an improving economic environment. Regardless of the foregoing, those manufacturers that took meaningful action to reduce costs and inventory at the onset of the recession and are witnessing a recovery of order volume will be in a position to expect better valuation outcomes.

It is our view that M&A volumes for middle market manufacturing companies will increase meaningfully in 2010. However, it will require some flexibility on the part of both sellers and buyers. What has been the norm for valuing transactions in the manufacturing sector in the past is not likely to be the case in the near term. Sellers may still be required to adjust value expectations downward from cyclical highs and/or accept structuring features such as earn-outs. Potential acquirers must be realistic in evaluating current operating performance and cannot assume that owners have no recourse. Delaying a sale for another year or two may not be ideal; but if valuations today do not meet realistic expectations, prospects for an improved economic environment may encourage owners to do so.

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About InterOcean: InterOcean Advisors LLC, based in Chicago, Illinois, is a boutique investment bank focused on providing mergers and acquisitions and capital raising advisory services to middle market manufacturing companies, with deep expertise in the metals, automotive, capital equipment, building products, plastics & packaging, medical devices and distribution/business services sectors.

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