


The present economic downturn is headline news day in, day out: the economy shrinking, unemployment rising and companies posting poor results. Furthermore, the malaise is having a significant, perhaps even permanent, effect on mergers, acquisitions and management buyouts.

# How mergers and acquisitions are developing

In every merger and acquisition, the financial structure is an important issue. Take the sale of a certain percentage of stock in a company, for example. After the parties have agreed a price, the next step is to determine how the acquisition amount will be financed. Until the second half of 2008 it was commonplace for banks to finance transactions up to as much as 90%. In such cases this creates high leverage. The other part of the financing consisted of a relatively small proportion of risk-bearing capital, originating from the buyer(s), a private investor or venture capital company.

companies are failing to fulfil their financing covenants (solvency, ICR and DSCR). The upshot is that banks are presently willing to finance only 50-70% of the total acquisition price. What's more, the company must possess a certain, predictable cash flow, pay high interest rate mark-ups, satisfy more covenants and give more collaterals of the company and private commitment of the buyer. All banks are picking the same cherries. The bottom line is that a larger proportion of the acquisition price must be financed using stockholder equity.



The targeted return on contributed stockholder equity differs from company to company and depends on the risk profile. The fee required for risk-bearing capital is significantly higher than the interest rate fee for borrowed capital. So from the company's point of view, borrowed capital is cheaper than stockholder equity. And a higher percentage of borrowed capital increases the return on stockholder equity. That explains why providers of stockholder equity are keen to see most of the acquisition price financed with borrowed capital. To a certain degree an optimum exists for the ratio of borrowed capital to stockholder equity. With higher leverage, the risk attached to stockholder equity is greater and not every provider of such equity is willing to bear the extra risk.

## Developments

The financial system and confidence in the economy have been severely damaged by the unrest within financial institutions. In April 2009 alone, 921 companies went bankrupt in the Netherlands, 55% more than in April 2008. Many more

Venture capital companies currently have their hands full managing their present holdings and executing planned exits from them and are now highly selective when it comes to new investments.

Money has become a scarce commodity, pushing down acquisition prices. Until mid-2008, the usual price paid for an acquisition was 8 to 11 times EBITDA (gross profit minus business expenses), but now it is just 4 to 7 times EBITDA. Our experiences are in line with articles published by Prof. Aswath Damodaran of the Stern School of business, who internationally sees the average market multiple sinking from 8.5 times EBITDA in 2007 to 5.1 times EBITDA in 2008.

Many sellers are still not accustomed to lower prices and expect a far higher price than the market is willing to pay. Due to this apparently unbridgeable difference, the number of merger and acquisition transactions has decreased significantly. The decline is also attributable to the current preference of company directors to strengthen their balance sheet and liquidity positions rather than enter into a merger or acquisition. Research <sup>1</sup> shows that in the Netherlands there were 85 transactions or a 12% increase in the second quarter of 2009 compared with the first quarter. But at 161 transactions the first half of 2009 was barely half the number in the corresponding period of 2008 when there were

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<sup>1</sup> Overfusies.nl

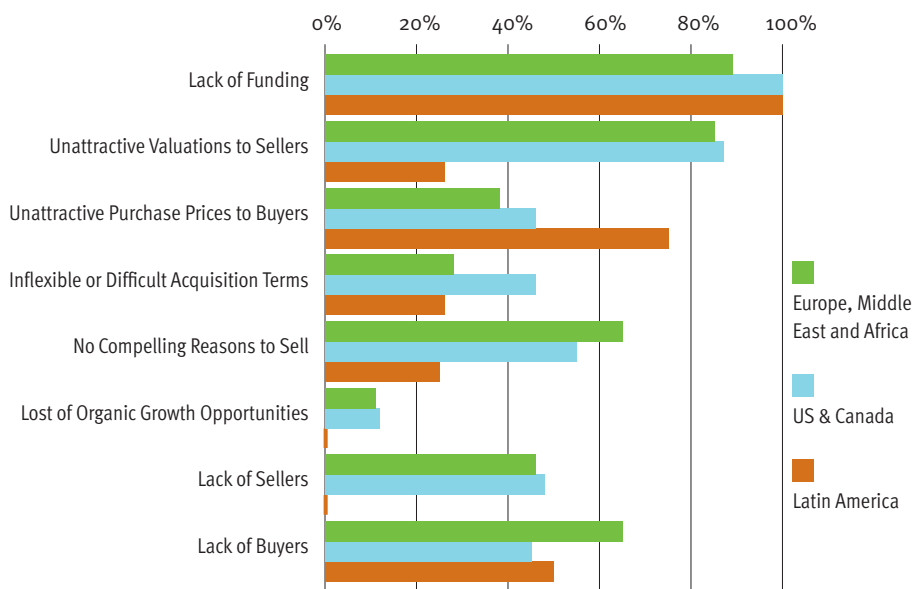


Figure 1: factors that will inhibit the closing of M&A transactions in 2009 Source: IMAP

318. The number of transactions in the full year of 2008 dropped to 465 compared with 781 in 2007.

These conclusions are confirmed by the annual survey of IMAP, an exclusive network of merger and acquisition specialists, which was published in May. The figure below answers the question of which factors will slow down the conclusion of transactions in 2009.

#### Future

Banks are currently cautious when it comes to providing credit, they want to amend the conditions of existing credit agreements and businesses find it very difficult to get a top-up loan to absorb a seasonal dip. To the extent that new credit is being extended, the conditions are formidable. We expect banks to become a little more benevolent in the future. After all, they earn money through commissions that are attractive in the case of acquisition financing and by selling banking products. But the days are gone when a salesperson attended a crash course in reading balance sheets and then set off to sell loans for the bank. In the same time more entrepreneurs will have become accustomed to lower selling prices. These developments will make the number of mergers and acquisitions rise again.

We have also noticed that more and more private investors - 'informal investors' - are showing an interest in acquiring direct

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holdings in companies. Frightened off by grim stories about asset managers, true or otherwise, they now prefer to manage everything themselves. Through various initiatives such as the Zanders Investor Circle, the market for private trading in direct holdings has the potential to grow into a fairly liquid market in which investors can easily find each other. <



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