Stockpiled Cash, Buyer Interest Bode Well for Distressed M&A

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Over the past few years, the U.S. emerged from the worst financial crisis since the Great Depression. Nearly every corner of the capital markets and the wider economy were affected. Highly sensitive to the state of the markets, economic conditions, and the psychology of chief executives, the M&A landscape was not immune.

At its peak, the credit crisis radically altered deal dynamics, rendering previously dominant players impotent while empowering others. Fighting for their survival, banks elected to preserve as much capital as possible, dramatically reducing loan origination and, consequently, slowing down deal making. Strategic buyers, concerned about an uncertain economy, decided to put their M&A plans on hold. The unavailability of cheap debt financing to fund transactions brought private-equity-backed deal making to a virtual halt.

Given its countercyclical nature, distressed M&A deal volume was robust during the recession. Private-equity firms experienced in buying companies out of bankruptcy acquired troubled companies at a rapid clip, especially through 363 asset sales and Article 9 foreclosure sales. Post-crisis, after banks and other lending institutions resolved their balance sheet issues via the Troubled Assets Relief Program (TARP), public stock offerings, and a return to profitability, they have resumed lending.

Given the anemic economic recovery and the still low probability of meaningful organic growth, strategic buyers are poised to become active M&A players. Likewise, record fundraising and the availability of debt financing has primed private-equity firms to re-enter deal making. The renewed appetite of strategic buyers for acquisitions and the desire of private-equity buyers to use their significant capital base bodes well for distressed M&A activity for the near future.

Height of the Crisis

Senior lenders' pullback from lending and the resulting impact on the economy and deal financing had a seismic effect on the willingness and ability of strategic and private-equity buyers to engage in M&A activity. As securitization came to a halt, banks were forced to carry large portfolios of mortgages and leveraged loans on their balance sheets that they could no longer sell to outside investors and, as a result, they had to build big reserves (**Figure 1**).

Facing sizable write-downs on these loan portfolios and precipitous drops in their stock prices, banks scaled back their lending efforts to help build up their cash reserves. Banks' unwillingness to lend during the credit crisis was one of the primary factors that slowed growth and sparked the recession.

Furthermore, banks tightened their lending standards, making it much more difficult to obtain deal financing. Concerned about potential leveraged buyout (LBO) targets' ability to service debt in a recessionary environment, banks stopped offering loose financing terms, such as PIK toggles and covenant-lite loans. Similarly, banks discontinued the practice of providing staple financing to potential acquirers in M&A transactions. Combined, these factors contributed to a dramatic slowdown in deal making.

At the height of the credit crisis, strategic buyers in both "healthy" and distressed M&A transactions were relatively inactive due to the uncertainty in the economy. The effects of the collapse of the mortgage market rippled through financial markets and eventually sparked a global recession. The U.S gross domestic product (GDP) was negative for four consecutive quarters (**Figure 2**). As the economy deteriorated, customers pulled back on spending, causing corporate revenues to decline.

Feeling pressure from their shareholders to improve profitability, companies across the U.S.

Figure 1

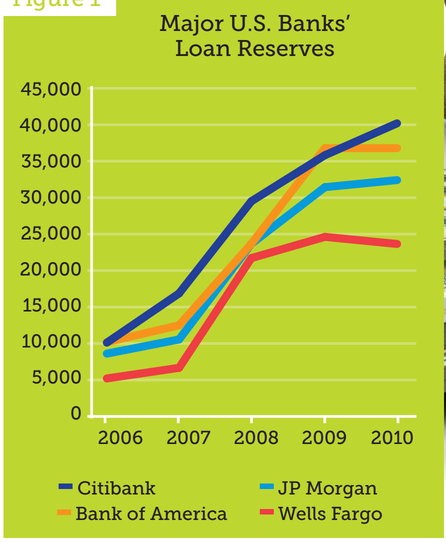
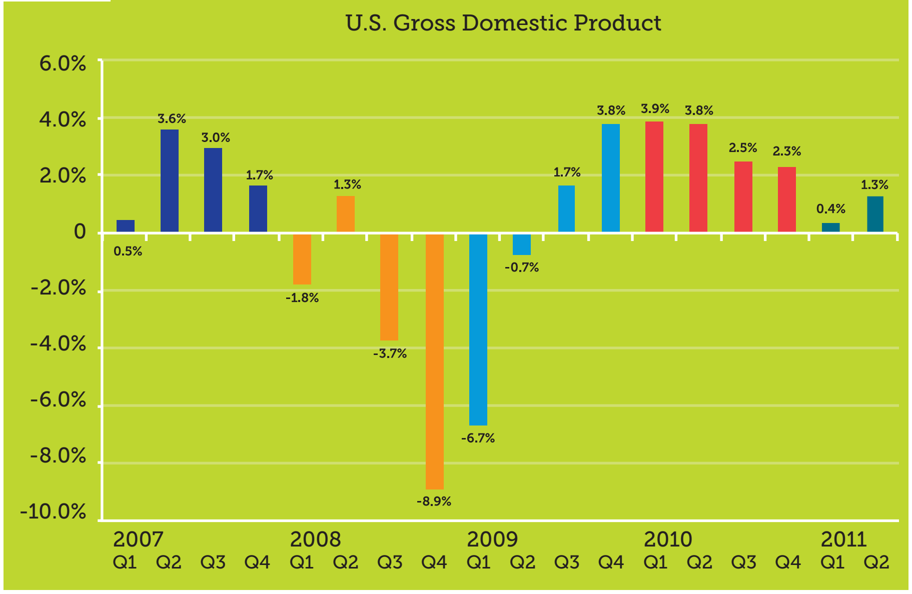


Figure 2



implemented cost cutting measures, such as headcount reductions, and improved their operational efficiencies. However, in a business environment characterized by little or no growth, there was a limit to how much companies could boost net income solely through cost reductions.

As organic growth seemed unlikely, the most viable option for growing revenue and increasing profitability was acquiring other companies. Instead, worried that the economy might get worse, companies held on to their cash reserves rather than use that capital to engage in M&A activity and buy struggling competitors at attractive valuations. As a result, during the credit crisis, companies in the U.S. had high amounts of cash on their balance sheets.

Similarly, private-equity firms that focus on healthy targets were generally absent from deal making during the credit crisis. Prior to 2008, private-equity firms drove the M&A boom by taking some of the largest public companies private through LBOs. The availability of cheap financing enabled private-equity firms to compete effectively with strategic buyers by bidding up valuations to record highs while still meeting their internal rate of return (IRR) hurdles.

During the credit crisis, private-equity firms were sidelined because of their inability to obtain financing at attractive terms. To close deals, they would have had to contribute significantly more equity compared to pre-crisis transactions, which would have impacted their IRRs adversely. As a result, the number of LBO transactions declined steeply during this period (**Figure 3**). Facing pressure from their limited partners (LPs) to deploy capital, private-equity firms acquired minority stakes, mostly in financial services companies. Within the course of a year, they lost their clout as the dominant force in deal making in the U.S.

Challenging economic conditions and the lack of cost-effective financing caused a surge in distressed M&A transactions during the recession. Before the credit crisis, companies took on high levels of debt due to the availability of cheap financing. Private-equity firms closed an unprecedented number of LBO transactions during the mid-2000s by levering up the balance sheets of target companies. In addition, companies borrowed heavily to fund their growth plans.

At the height of the credit crisis, large amounts of debt came to maturity. Moreover, the recession made it increasingly difficult for companies to service their debt. Banks' conservative stance on lending meant that the likelihood of successfully refinancing debt was low.

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Figure 3

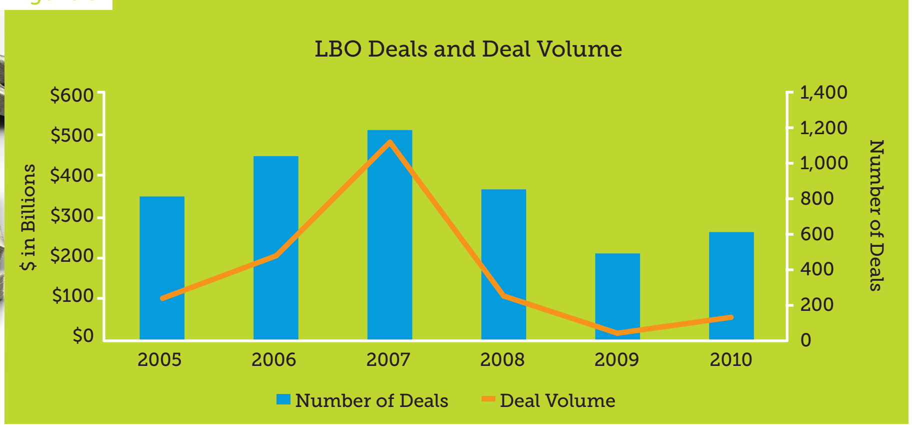
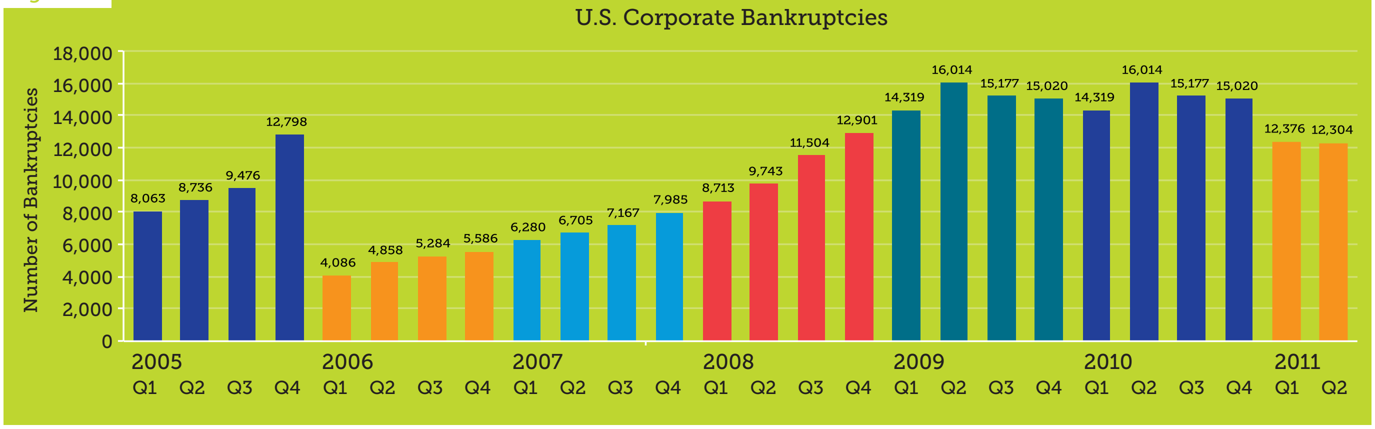


Figure 4



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Activity Resumes

Consequently, the number of corporate bankruptcies in the U.S. was historically high during this period (**Figure 4**), leading to an increase in distressed M&A activity. Strategic buyers were not acquisitive because they were not comfortable with taking acquisition-related risks in an uncertain economic climate. Private-equity firms that traditionally focused on healthy businesses lacked the expertise and/or stomach to buy troubled companies. In contrast, private-equity firms with track records of buying financially distressed targets had the requisite deal experience to actively acquire bankrupt companies through 363 asset sales and other workout sales structures.

To be able to create the renewed loan environment, banks went through a cleansing process, although much of that was done with a helping hand by the U.S. government. TARP, instituted by President Bush and continued by President Obama, allowed banks to repair broken balance sheets devastated by major increases in loan write-offs. The Fed's injection of capital provided liquidity and helped restore confidence in the marketplace to stave off bank runs and calm the panicked public.

Now, three years into TARP, the program has been labeled a success by the U.S. Treasury, with more than $10 billion in profit recovered by the government and more than $20 billion in total expected to be returned to taxpayers. The Fed's continued promise to keep the fed funds rate low has kept banks' cost of funds low, which should encourage increased lending, boost profits, and allow banks to build up their balance sheets.

As economic recovery slowly takes hold, strategic acquirers have emerged from the depths of the abyss to make key acquisitions for myriad reasons, including expanding product offerings (Johnson & Johnson acquiring Synthes), bolstering existing intellectual property (Google acquiring Motorola Mobility), and growing customer bases (AT&T acquiring T-Mobile). Healthy balance sheets coupled with a brightened economic outlook have provided strategic acquirers with an appetite to enhance organic growth through acquisitions.

Furthermore, companies in the S&P 500 index have been sitting on escalating cash balances. With the threat of inflation looming, as well as a low current yield, it is becoming more attractive for corporations to convert cash into acquisitions that help to positively change their businesses. Additionally, much of the fatty cost structure that corporations once carried has been pared back to improve profitability and create lean, mean acquiring machines.

Public equity markets have rebounded, with the S&P 500 Index showing gains of nearly 15 percent from July 31, 2010, to July 31, 2011, and of more than 30 percent from July 31, 2009, to July 31, 2011. The equity markets' return to health provides fresh acquisition ammunition in the form of stock, while the Fed's promise of low interest rates into 2013 creates a spirited lending environment that companies are using to add to a growing acquisition arsenal. With an ability to squeeze synergistic costs out of acquired businesses, corporate acquirers can typically justify higher prices for targets' stakeholders and are using that muscle to increase acquisition activity.

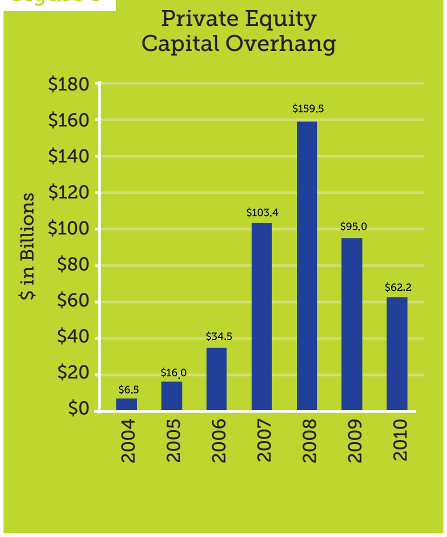
Low interest rates are also benefiting the private-equity world. Previously, private-equity firms were required to put in greater percentages of equity into each new deal. But the lending spigot has been reopened, which has increased leverage back into acquisitions, albeit at reduced levels from the feast of the mid-2000s.

Fundraising has remained strong, with experts projecting about $300 billion in global funds raised for 2011. Combined with the record amounts raised from 2006 through 2010 (**Figure 5**), funds have ample dry powder to make new acquisitions. This dry powder burns a hole in the funds' pockets, as they face pressure from LPs to put capital to work for appropriate returns. Additionally, LBOs are back, having recovered from historic lows. With the improved leveraged loan environment and the significant fundraising done by mezzanine funds, the likelihood of private-equity acquisitions has been increased.

No More 'Kicking the Can'

The increased appetite of strategic and financial acquirers, bolstered by the return to health of the banking system, bodes well for increases in acquisitions of distressed businesses. The threat of a falling knife has lessened significantly as the economy has bottomed out, and banks are better capitalized, more

Figure 5



fully reserved, and more willing to take write-offs, all of which drive increased distressed M&A opportunity. Asset-based lending and other creative financing structures have returned to the market to allow for improved financing dynamics.

With the ability to find cost savings inherent in a distressed business and therefore ignore the profitability or lack thereof, strategic acquirers remain interested in tough deals as a way to expand while finding attractive valuations not seen in healthier deals. Distress-focused private-equity firms have followed the herd of their healthy ilk and have raised significant funds in the past few years. With a willingness to roll up their sleeves, these funds continue to seek new investments in tough deals. Due to the significant amount of fundraising completed over the past few years, even funds that typically require certain levels of profitability and general corporate health are starting to look at deals with hair, especially in industries in which the funds have specific knowledge.

Although banks will be required to maintain higher cash reserves in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act and Basel III bank regulations, the Fed's assurance that it will keep interest rates low through 2013 should encourage banks to continue lending. In the absence of significant organic growth due to the weak economic recovery, strategic buyers are expected to increasingly use M&A as a growth strategy. Record fundraising by private-equity firms in the near term and their access to cheap financing sets the stage for the return of the LBO, albeit not at the record levels seen in the mid-2000s. Distressed M&A activity is also projected to be robust in the near future.

During the height of the credit crisis, banks were not willing to sell portfolio companies at fire sale prices and take steep write-offs, so they often opted to "kick the can down the road." Because banks have been able to repair their balance sheets and financing is no longer restricted, banks are more willing to exit their positions in troubled companies through M&A transactions without facing significant haircuts. J

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