# RECOVERY IS IN THE AIR

TIMES MAY BE TOUGH BUT IT'S NOT ALL BAD NEWS FOR MERGERS AND ACQUISITIONS IN THE UK MID-CAP MARKET, SAYS **FENTON BURGIN** OF CLOSE BROTHERS.

The end of 2001 left most market commentators speculating whether the bottom of the cycle had been hit. The UK corporate environment was in a period of some considerable uncertainty as it tried to assess the long term effects of recession in the world's three largest economies, the events of 11 September and the continuing strength of sterling against the euro.

The second quarter of 2002 has seen the beginnings of a recovery, albeit a fragile one. Global M&A deal volume fell by 50% to £183bn in the first quarter, compared with just under £350bn in the first quarter of 2001, according to Dealogic, with M&A activity involving UK companies in the first two months of the year totalling just £9.3bn. However, while the global investment banks have been hit by a noticeable shortage of big ticket £3.5bn-plus transactions, the signs are that conditions may now be in place for a limited recovery in the UK mid-market.

Gresham Trust, the UK private equity house, recently interviewed directors from 100 middle market companies, balanced between service and manufacturing sectors. It found that more than a quarter anticipated buying another company in 2002.

**UNDER PRESSURE.** Early stage deal activity has increased due to price expectations having come down to more realistic levels, continued low interest rates and greater confidence about the UK economy. At the end of last year, investors battened down the hatches faced with a depressed equity market and concerns over valuations.

Many sellers experienced prices that had fallen by double-digit percentages. Now the gulf in expectations has narrowed but the majority of mid-market companies continue to focus on 'bolt-on' acquisitions rather than large-scale transactions. Moreover, while valuations may be more realistic, most banks report that its taking a lot longer to close transactions.

Does this renewed optimism ignore more fundamental market developments whose effects have been accelerated by the events of last September? Many UK mid-market companies now face a reduced access to equity. "Irrespective of specific sector or credit issues, the minimum investment range is £30-£50m and the company must have deliverable future earnings growth potential" is an increasingly common response from the leading players in the investment management community.

A number of mid-market companies unwilling to sell equity at current levels continue to underestimate the scale of the shift that has taken place. For those companies contemplating coming to the market in 2002, the picture is not straightforward. The UK initial public offering (IPO) market ended 2001 with the lowest level of activity in a quarter for more than a decade, according to KPMG Corporate Finance.

Yet the pressure on institutional investors to invest their substantial cash piles is mounting. Recovery in the UK IPO market is likely to focus on established companies with strong track records, revenues and profits and will in part be driven by private equity houses looking to exit. Given the time taken to come to market, any upturn in activity is likely to be weighted towards the third quarter of 2002 or the first half of 2003.

At the end of the first quarter, Kappa, the Dutch packaging group, and HMV Media, both appointed banks to lead their IPOs. Recent market commentary has also focused on Coral Eurobet, Focus Group, Gala Group, Heath Lambert, Punch Pub Company, Rank Hovis McDougall and United Biscuits, Yell – all possible floats this year.

**GAINING EXPOSURE TO THE RIGHT SECTORS.** We see the leisure, retail, utilities and support services sectors as being the most active in the rest of 2002. Low market valuations across technology, media and telecoms stocks continue to hold back activity, with few investors brave enough for opportunistic buying or able to secure the necessary support from the debt markets. In telecoms in particular, the price paid for third generation phone licences and resulting high debt levels across the sector mean many companies are finding banks and institutional investors are unwilling to take on further sector exposure, irrespective of the particular transaction under consideration. Activity is likely to be driven by venture capitalists and financial sponsors which perceive that value and prices are now realistic.

UK manufacturing continues to suffer under sterling's strength and increased competition from those areas of the world with lower labour costs. Margins continue to be pressured, with many companies weighed down with relatively high levels of gearing. The situation is unlikely to improve in the short term. Those companies that have sensible capital structures and tangible technological advantages will benefit at the expense of a number of high-profile UK manufacturing companies that used high levels of debt to expand rapidly through acquisitions in the late 1990s.

Retail remains remarkably buoyant, helped by high consumer spending and lower interest rates. However, the continued recovery of the UK economy is highly dependent on British consumers continuing to spend. While the Office for National Statistics showed retail sales volumes rising 1.5% in February and the year-on-year rate moving to just below 6%, it remains to be seen the extent to which the potential for higher short-term UK interest rates may dampen the present retail optimism.

In the utilities and support services sector, we see continued activity, with a number of companies that have stable and predictable future earnings, following Anglian Water Services' £3.4bn securitisation model.

Asset finance is also being increasingly used as an alternative financing technique. The recent £165m MBO of Palmer & Harvey McLane was supported by £160m, five-year asset finance – one of the largest ever deals of its kind. In the UK mid-market, companies that face a reduced access to equity capital are increasingly running with higher levels of debt and are needing to use more innovative financing structures to meet their objectives.

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**THE UK BANK DEBT MARKETS.** In the US, reduced levels of big ticket merger and acquisition activity and reduced average deal sizes have led to some of the bulge bracket investment banks targeting the mid-market. In the UK, the signs are that this may also be the case. In February, Goldman Sachs failed to complete a challenging deal to sell pharmaceuticals company Bioglan for £10m – the remarkable point was not the outcome but the fact Goldman Sachs was involved in a deal of this size. Many of the traditional mid-market specialists report increased competition from the larger investment banks.

The number of recent high-profile restructurings has heightened banks' focus on credit and cashflow quality, leverage levels and management.

It is now not uncommon to see corporate deals with senior debt to Ebitda ratios in excess of three times being declined by credit committees in favour of transactions with more modest leverage, even if opportunities for ancillary business exist. However, for transactions that meet these criteria, there is undoubtedly strong demand and pricing both in terms of up-front fees and margins has stabilised.

In the post-Enron and Marconi environment, effective adverse change language and flexible underwriting terms, where the bank retains the right to change the pricing and other terms and conditions of the facility in syndication, are now market standard for almost all corporate bank transactions. The moves towards free transferability may lead in the short term to the development of an unrated collateralised loan obligation (CLO) market. Moody's Investor's Service Jeremy Gluck was recently reported as saying that the "big area of potential growth is banks securitising their own middle market loans."

For the mid-sized UK company, in the medium-term, we see a further erosion of relationship banking and the need for the UK finance director and treasurer to become increasingly sophisticated in the way they view the banking market as a source of capital.

**LANDMARK DEALS SEND OUT POSITIVE SIGNALS.** RWE's £3.1bn takeover of Innogy, the £3.5bn takeover of Reemtsma by Imperial Tobacco, Cinven and Enterprise Inns' acquisition of Nomura's Unique and Voyager pubs business and the latter's acquisition of Laurel Pub Co's leased pubs, Johnston Press' £560m takeover of Regional Independent Media, and Taylor & Francis' acquisition of Blackwells all indicate the London market's ability and demand for well structured transactions.

However, the relative lack of large scale £3bn-plus financings has resulted in some UK mid-market companies securing extremely competitive terms and conditions, such as Smith & Nephew, which achieved a sub-50bp per year margin over Libor for its five-year Oratec acquisition facilities and an oversubscribed facility. This trend is likely to continue for those companies that can demonstrate stable cashflows and relatively conservative credit structures.

Separately, many UK companies and private equity owners are waiting to assess the impact of potential tax changes, where firms selling a stake in a subsidiary that is in excess of 20% no longer have to pay tax on the gains made from the disposal. In addition, plans that goodwill amortisation will be deductible form taxable earnings is good news for acqusitive companies.

Both of these developments may lead to increased activity, with companies keener to spin off non-core businesses and encourage acquisitions.

**A LOT TO LEARN FROM HIGH-PROFILE RESTRUCTURINGS.** Borrowers are experiencing banks' greater focus on portfolio management and more stringent application of sector and credit rating caps. The demise of Marconi – which successfully raised €3bn in May 2001 from the bank markets – Enron, Railtrack and others, has led many institutions to reassess their credit procedures and the degree to which they are prepared to give credit for unquantified acquisition synergies and cost savings. Merrill Lynch is reported to be incorporating a wide range of performance measures into its research and developing a standardised methodology to evaluate the companies and sectors.

Market standard key tests include cashflow relative to net income, return on invested capital, return on asset measures and receivables and inventory turn. It is all too easy to blame analysts and banks for their willingness to accept pro forma accounting and other methodologies used to hype the positive news on acquisitions, but many UK firms could also usefully assess the extent to which they have used sale and leasebacks and other forms of off balance sheet structures. Post-Enron, we anticipate greater market focus on the number of UK firms that have audit committees which include independent non-executive directors who are former employees of the auditor.

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