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by Edward H. Baker

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Amid the tightest credit conditions in decades, the market for corporate control is favoring low-leverage, growth-oriented transactions.

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Storage systems provider EqualLogic Inc. was all set to go public in November 2007. The traditional road show, during which the company would present itself to the investment banking houses, was scheduled to begin the next day when Dell Inc. swooped in and bought EqualLogic for US$1.4 billion, the largest all-cash purchase ever for a venture-backed company. In keeping with Dell's long-standing strategy of buying businesses that might provide healthier margins than its core line of PCs, EqualLogic offered a fast-growing entry into storage, allowing Dell to compete at the low end of the market with such giants as EMC Corporation.

Strategic M&A transactions such as Dell's, funded with some combination of cash and stock, remain one of the few bright spots in a very depressed M&A market. The data tells the story: Globally, the number of M&A transactions completed by financial sponsors such as private equity firms dropped by 22 percent in the first half of 2008, compared with the same period in 2007, while the dollar value of those deals dropped by a startling 76 percent, from $571 billion to $140 billion, according to researchers Dealogic. For the U.S. alone, the number of deals fell by 31 percent, and total deal value declined by 87 percent, from $338 billion to $45 billion.

In comparison with the weak numbers for buyouts led by private equity firms, strategic M&A is having a relatively strong year. Globally, the number of deals is up 12 percent, though the total value of such deals is down 18 percent, from $2.2 trillion to $1.8 trillion. The U.S. is even stronger, with the number of deals up 9 percent, and total deal value up 3 percent, from $649 billion to $671 billion. The contrast between the poor market for large, highly leveraged buyouts and the continued strength of strategic deals suggests the overall direction the M&A industry is likely to take, not just in the near term but for the foreseeable future. Is this just another one of Wall Street's boom-and-bust cycles, or is the recent shift in power from financial to strategic buying a truly structural change?

The relative strength of the corporate M&A market reflects the strength of corporate balance sheets: Companies still have plenty of cash, despite the sluggish growth in corporate profits overall. Because they typically use mostly cash or stock to make their strategic acquisitions and avoid the use of extreme leverage or the financial engineering schemes of the financial buyers, corporations looking to make deals haven't been significantly affected by the difficulty of getting debt financing. Dell's profits, for instance, have remained strong, and as of May the company had $8.3

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billion in cash on its balance sheet. So although the $1.4 billion in cash it paid for EqualLogic is not exactly a drop in the bucket, Dell could easily afford the acquisition. Moreover, corporate buyers are facing much less competition for the deals they want to do, because private equity buyers are having so much difficulty finding financing.

These dynamics have driven a wide range of large strategic deals this year. In April 2008, for instance, candy maker Mars Inc. bought the William Wrigley Jr. Company for $23 billion; a month later, Hewlett-Packard Company bought out EDS for $13 billion. In June came a far bigger deal, when Belgium's InBev agreed to purchase Anheuser-Busch Companies Inc. for $55 billion. This year's private equity deals pale in comparison: The largest buyout by a financial sponsor thus far was Avista Capital Partners' acquisition of ConvaTec Inc., a maker of wound therapeutics owned by Bristol-Myers Squibb Company, for $4.1 billion.

The upside for strategic buyers is straightforward. Before the summer of 2007, financial buyers were using sky-high leverage ratios to buy everything in sight, driving valuations far past what strategic buyers were willing to pay. But now companies looking to make strategic acquisitions aren't facing that level of competition from financial buyers hungry for deals, and that means lower valuations and more simply structured deals.

How long corporate buyers will continue to hold their advantage depends on the answer to a crucial question facing private equity deal makers: Why are banks so unwilling to lend money to finance highly leveraged private equity buyouts? After all, they too need to keep making money, and until recently, these loans, often made at very high interest rates, were quite lucrative. Jonathan Lynch, a managing director at private equity firm CCMP Capital Advisors LLC, defines the problem succinctly: "The problem is that banks can't risk losing money either. They have to balance their capital reserve requirements against their risky assets, and no one wants to make a mistake right now. As liquidity disappeared, so did the willingness to take risks."

It may take some time for that willingness to return. First, in the near term, market participants need to decide that the chances of another major investment failure have been significantly reduced; at the moment, many believe another one is yet to come. That depends, in turn, on the state of the housing market when all the ill effects of the mortgage crisis become known. Second, the consequences of the loose lending standards of the past few exuberant years in the private equity market need to play out. Will many of the highly leveraged companies in private equity portfolios fail if the economy stays sluggish? Or were the terms of many of these loans — the so-called covenant lite deals — so easy that it's almost impossible to default on them?

Even in the longer term, investors will need to decide just how much risk they're willing to take on. Wall Street is notorious for having a very short memory, and if the past is prologue, it may be all too happy to return to the high-risk times of two years ago, to the tech bubble of the late 1990s, or to the savings and loan crisis of the early 1990s. But if investors have learned one lesson from the current liquidity crisis, it's that they need to understand the nature of the risks they are taking. "Two years ago, people pooh-poohed risk," says Gus Faucher, director of macroeconomics at

Moody's Economy.com. "In retrospect, there was all this risk out there that people didn't recognize. Now they've probably overshot in the other direction. There's an equilibrium out there, but we haven't reached it yet."

Until we do, corporate deal makers can take advantage of the current environment of generally lower valuations and less competition by looking for companies that fit nicely into their businesses. These might simply be so-called bolt-ons, which can augment the purchaser's strength in a particular product area or market. Or they might be more growth-oriented acquisitions that can lead the acquirer into a new product area or market. Either way, it's a good time to make hay while the sun shines. +

Resources

Gerald Adolph, Simon Gillies, and Joerg Krings, "Strategic Due Diligence: A Foundation for M&A Success," *strategy+business enews*, 9/28/2006: Offers a valuable approach to determining the strategic fit of a potential acquisition. www.strategy-business.com/enewsarticle/enews092806

Michael Sisk and Andrew Sambrook, eds., *The Whole Deal: Fulfilling the Promise of Acquisitions and Mergers* (strategy+business Books, 2006): Good advice on the entire scope of M&A transactions, from initial strategic considerations to postmerger integration. www.strategy-business.com/rireader

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