

Doing deals during a recession



The general consensus among solicitors, bankers and accountants in London (at least those whose views that I have canvassed) is that closing deals is going to prove tougher than it has been for a long time in 2009.

There are several reasons for this negativity.

Let us take, for example, the "credit crunch." In the context of corporate mergers and acquisitions this essentially means the inability to finance a deal through debt. Unfortunately, all of the signs for 2009 are that credit markets will remain tight and I have seen some deals dashed on the rocks of lender reticence in the latter part of 2008. Commentators in the US are pencilling in 2010 as the year that relatively easy credit becomes available once more and, despite the Government's platitudes, in the UK we tend to lag behind the US.

So if one is unable to finance deals through debt where else to look? Cash reserves would be the obvious place to start – two deals that I am working on at the moment are for acquiring companies which have been very prudent over the past 5 years, which have built up decent cash reserves and have spotted distressed opportunities in their market sectors (industrial electrical testing equipment and recruitment consultancy respectively).

Other sources of finance may include mezzanine debt (which may still be available – at a price!), equity finance and even the existing shareholder base which could be tapped for cash via a rights issue. Each of these does not come without its problems – it is very much a deal facilitators market and so any company or person who is willing to put their hands in their pockets and pull out a rabbit will expect their pound of flesh.

Even if a high street bank *can* be convinced to loosen its purse strings, this does not mean that we are immediately able to ignore the "credit crunch" and plough on:

- Margins and arrangement fees are high and getting higher. As lenders perceive their risks to be increasing so they are increasing their rewards.
- The length of time taken to obtain credit committee approval is increasing, even when a lender indicates it is, in principle, willing to fund a deal. Where time is of the essence for a transaction, one needs to be mindful of this. Recently, an unexpected delay cost my client several thousand pounds in increased fees (and in fact nearly torpedoed the deal) because a set of interim financial statements had to be updated when a deadline was missed as a result of bank inaction.
- The due diligence procedure can be more invasive leading to an increased administrative burden on sellers, and in particular on finance directors who tend to coordinate this activity.

Even once a deal has completed problems may arise. I know of at least one major bank that has openly (foolishly?) admitted to its customers that it has conducted a review of all facility documentation in order to see if it was able to increase the interest payable. In cases where it was able to, it has written to those customers unilaterally altering the margin payable under the relevant facility letter and explaining why the margin has increased. I guess banks no longer consider customer retention something to be encouraged.

Let us also not forget the recession – well, are we in a recession? At the time of writing it is not yet possible to say whether the UK economy is in economic recession (although it is strongly suspected...) as the figures for the 4th quarter of 2008 have not yet been published but we should not get so hung up on the economic definition. If we take the

dictionary definition – "a period of reduced economic activity" – then I think we can all agree now that we are in a recession and have been for some time.

If there is less economic activity then there is likely to be less corporate activity and less deals closing, at least by value and no doubt in absolute terms. A recession is partly psychological and unfortunately self-perpetuating and is exacerbated by external factors such as the "credit crunch". I fully expect typical characteristics of a recession such as declining demand for output, rising unemployment and falling turnovers and profits to feature heavily in the business headlines of 2009. This loss of confidence across the board threatens to paralyse consumers and businesses.

In some cases, this loss of confidence is well-founded. Witness a recent example of the "domino effect" which can lead to businesses failing through no fault of their own (and the fear of which engenders a reticence to even engage in corporate activity): Zavvi. A little more than 12 months after the management team at Zavvi, the music and DVD retailer, bought out the business then known as Virgin Megastores from the Branson empire they were forced to call in the administrators. The chief reason, we are told, was the demise of Woolworths and its distribution arm, Entertainment UK (on which Zavvi relied for CD and DVD distribution). In other words, Zavvi's failure was directly brought about as a result of the failure of another company over which it had no influence.

Personally I think the demise of Zavvi may owe just a little to the "recession" as well; or at least changing consumer behaviour. After all, only eight weeks prior to its management buy-out in 2007, Fopp – then the UK's largest independent music retailer – was forced to call in the administrators leading to the closure of its 81 stores.

If the bleak picture I have painted above is worthy of a postcard of Cumbria in January then I apologize to some extent; it would be false to give the impression that 2009 will be a period of total business inactivity – deals are done in times of a recession.

In fact, I recently attended a seminar conducted by a well known business coaching organization and the message was a positive one; the economic downturn is a time to strip out inefficiencies, refocus and grow (they said). In others words, it is a good time – and not a bad time – to be in business.

So how does this positive message translate in real terms?

I am starting to pick up instructions, both on the buy and the sell side and with two distinct themes emerging.

On the one hand, trade buyers and owners of "buy and build" strategy businesses are also using the credit squeeze as an opportunity to apply downward pressure on prices to secure what they perceive to be a good deal.

On the other hand, there are management teams who find themselves at the helm of a business division no longer seen as core by their employer and who are being encouraged to buy into a business they know to be fundamentally solid at a depressed – or should one say "realistic" – price. Often, this means not only a depressed price to manage future revenue expectations but also to reflect the fact that lower multiples are being sought by sellers (and indeed offered by buyers).

In relation to management buy-outs, high street banks are still relatively willing to lend. This is logical, really, because in a downturn, there is a flight to safety – banks are always likely to be keen to lend (funds permitting) to long-term, successful, incumbent management of a fundamentally sound business who are going to continue in situ.

In the case of some "buy and build" businesses, the above still applies but many of those businesses are in fact in an even stronger position; there are still numerous companies that listed on London markets as "cash shells" and which still have cash resources to spare. Although these "cash shells" still like to leverage any acquisition, loan to value ratios

are typically far lower than on traditional lends and as such are favoured by increasingly more risk averse lenders.

Using the AIM market and PLUS as arbitrary economic bellwethers, 19 mergers and acquisitions were completed during December 2008, which does not compare favourably with the 29 deals completed in December 2007 but does at least far exceed the number of deals completed in the December following the tragedy in the US on 11th September 2001. November 2008 even saw the completion of a mega-deal (by AIM standards) when Eni S.p.A. acquired First Calgary Petroleums for circa £488million. If there is a trend emerging though it is that there were very few new issues and fundraisings in December 2008 as compared to either December 2007 or December 2001; this trend very much supports the theory that 2009 will be a year of rationalization – of M&A – and not one of easy credit and open cheque books.

With challenges, though, come opportunities. One of my clients has asked me to watch out for acquisition opportunities across all market sectors. They have cash reserves and consider that now is a good time to acquire at historically low valuations. The only criteria being that any business is very profitable, has a long trading history, has strong management, opportunities to rationalize and cost-save and good prospects even in an economic downturn. If only all clients were so undemanding.

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