Valuations Plus

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Altered states: An update on the middle-market mergers and acquisition environment

Mergers & Acquisitions

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The middle-market M&A environment continues to be extremely challenging, although there are some definitive signs of improvement in the late summer of 2009.

Prior to June 2007, the overall M&A market was driven by a massive global liquidity bubble, typified by very lax lending terms, low-risk premiums on all forms of debt and equity, and private equity funds raising billions in cash for deals.

In 2007, the average total debt multiple (total debt/EBITDA) for highly leveraged loans was 4.9x. This was the highest multiple since 1998. Although middle-market transactions garnered only 4.0x total leverage at that point in time, it was still a frothy market.

Specifically, a record $535 billion in new leverage loans were issued in 2007. London InterBank Offered Rate (LIBOR) spreads for these loans remained below 250 basis points until the last quarter of the year. (LIBOR is the interest rate offered for U.S. dollar deposits by a group of large London banks.)

> The foundation of any market is the supply and demand dynamic.

Private equity firms raised a record $288 billion in new money during 2007. Not surprisingly in this environment, M&A deal volume and valuation multiples were at levels not seen since 2000. All of this liquidity chasing deals ensured that most middle-market business owners enjoyed high valuations for their companies and extremely seller-friendly deal terms.

In the second half of 2007 and the first half of 2008, the deal party began to break up. Specifically, the global syndicated debt market started to shut down during the second half of 2007 and was all but closed by mid-2008. Traditional banks, along with hedge funds and nonbank lenders, began to flee the leverage loan market as their liquidity sources started to dry up and they became concerned about the economic outlook and its potential impact on their loan portfolios.

Overall, leverage loan volume plummeted 71 percent from $535 billion in 2007 to $153 billion in 2008. Average total leverage multiples also dropped from 4.9x in 2007 to 3.8x in 2008 as the markets tightened considerably. This contraction was even more acute in the last quarter of 2008.

As the amount of available leverage contracted, the costs of this leverage almost doubled because spreads over LIBOR for leverage loans exceeded 500 basis points in the fourth quarter of 2008. These financing market dynamics led directly to a massive reduction in private equity activity and a virtual disappearance of large leveraged buyouts. It was almost impossible to raise debt financing for large transactions by mid 2008.

One interesting subplot to the deal market during the second half of 2007 into mid-2008 was that middle-market deals (i.e., deals that did not require large bank groups) continued to get consummated at attractive valuations. Despite the implosion in the large syndicated bank market, smaller regional banks continued to lend well into late 2008.

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How to put a price tag on your business

As a savvy entrepreneur, you probably have a "number" in your mind that, if offered, would entice you to sell your business immediately, with no regrets.

But, how would you know whether your number is reasonable? Are you holding out for an unrealistic amount? Or, might you accept a lower number?

This lack of knowledge can cost you more money than any other business decision you make in your lifetime. And, it doesn't matter whether you are passing the business down to a family member or selling to an unrelated investor.

So, how do you know what price tag is right for your business? The answer lies in the part-art, part-science process of a business valuation.

A three-part analysis

Professional business valuation analysts are trained to take a hard look at the characteristics of your company compared with others in your line of business. Here are three important factors they consider:

Your Income Stream. After analyzing your company's financial statements for a period of at least five years, the valuation analyst estimates your expected future earnings. Next, an appropriate capitalization rate is developed. This rate is applied to your estimated earnings to determine a value that one would be willing to pay for your income stream.

See ***Price tag*** *on back*

Altered states *continued from front*

Given this lending dynamic, numerous large private equity funds decided to go "down market" and focused on smaller deals that they could get done without large syndicated loan packages. The increase in private equity money chasing middle-market deals, and the bifurcated lending market, definitely helped hold up valuations for middle-market companies well into 2008. But it became increasingly clear as 2008 unfolded that, while good companies (strong niche, great management teams, strong margins, etc.) were still well-received, a lot of second-tier sellers were not as warmly welcomed.

The second half of 2008, which featured large financial institutions going out of business or sold in arranged marriages, worldwide liquidity crunches, flights to safety, risk premiums climbing to all-time highs, stock markets imploding, volatility indices exploding, and worldwide government intervention into financial markets finally ground the middle-market M&A business to a halt after Labor Day 2008.

> Middle-market valuations are down from their peaks, but they are not that far below the long-term average multiples.

Few deals of any size were completed for the balance of 2008. Middle-market business owners were more interested in surviving than doing deals.

As 2009 commenced, the deal community was essentially in a bunker mentality, and there were very few quality companies in the market. A combination of recession-induced weak earnings for companies, a frozen banking sector, a stock market that tested 10-year lows, and a pervasive feeling among deal participants that making any move was akin to catching a falling knife resulted in a dearth of meaningful transactions.

But as 2009 has progressed, there have been a few positive factors that have begun jump-starting the marketplace for middle-market business owners.

First, the foundation of any market is the supply and demand dynamic. Given the lack of material M&A activity since mid-2008, there is lately a pent-up supply of owners that, for a myriad of valid reasons, want to sell their businesses.

Respective of the deal market, the reasons owners decide to sell have not changed. As good-quality companies come back into the market, they are being well-received, which is providing some stability to valuations. Second, although market valuation multiples are down across the board when viewed against the 2007 and 2008 data, one must bear in mind that these were record years.

To be clear, middle-market valuations are down from their peaks, but they are not that far below the long-term average multiples. Also, the current reported valuations have been skewed lower by the fact that a lot of deals that got done in late 2008 and early 2009 had to get done.

Middle-market deal valuations are also starting to benefit from the improving stock market valuations, which serve as one rough proxy on middle-market valuations. These improving stock market valuations also bring more strategic buyers back into the market as their acquisition currency increases in value.

Another positive impact on the deal marketplace has been the continuing impact of the private equity community, which by some reports still has over $300 billion in dry powder searching for deals. The quality deals in the market right now are receiving very attractive and sustained interest from both financial and strategic buyers.

For the path forward, two main negative dynamics need to be addressed and alleviated.

Operating results at many middle-market businesses were negatively impacted by the recession in late 2008 and 2009, and a lot of potential sellers have poor trailing operating results. It takes time to let these poor results "roll off," and many owners will be wise to wait until their trailing results improve or they have better visibility on their earnings.

The other negative dynamic is the lending market. In 2007 and early 2008, financing sources were willing to lend as much as total leverage of up to 4 times for middle-market acquisitions. Currently, this multiple is about 3 times and at a much higher cost. Despite this contraction in the lending market, it is important to note that the market has improved since early 2009, and leverage spreads have come down appreciably. Furthermore, funds are flowing into the leverage market again, given the attractive spreads that active lenders are receiving.

Good deals are getting done now in the middle market, but the large leverage buyouts will not return until the lending market improves.

Given the overall environment, there is cautious optimism that the deal environment is improving and valuations have started to move back up, particularly for attractive companies. ■

Court cases address active vs. passive participation rules

CASE by CASE

By CPAmerica guest columnist Michael Redemske, CPA

Two recent tax cases may have curious repercussions. They may actually cause ownership interests in some money-losing business ventures to become more valuable.

These cases involve an interpretation of the arcane tax rules surrounding business enterprises in which a business owner does not actively participate in the activities of the business.

An example: A doctor who invested in a vineyard in Northern California cannot take advantage of tax write-offs normally available to farmers. The law says that he can use tax losses from the vineyard to offset his income as a physician only if he actually got his hands dirty in the vineyard.

These "passive activity" rules have been a part of the federal income tax law since 1987. However, two recent cases have given members of a limited liability company (LLC) and partners in a limited liability partnership (LLP) greater ability to avoid the passive activity loss limitations.

> Material participation is generally achieved by meeting one of seven tests.

The passive activity rules generally require business owners to combine their profits and losses from passive activities.

To the extent the result is a net profit, that profit is included in taxable income. To the extent the result is a net loss, the loss is generally not currently deductible. These suspended passive activity losses can be carried forward to offset passive activity income in subsequent years. Suspended losses can also be deducted if the activity that generated the loss is disposed of in a taxable transaction.

Because of the limitations imposed on the deductibility of passive activity losses, an ownership interest in a passive activity that generates losses may be considered less valuable than an ownership interest in a similar non-passive activity.

A passive activity includes any rental activity and any trade or business in which the owner does not materially participate. Material participation is generally achieved by meeting one of seven tests:

1. Participating in the activity for more than 500 hours during the year

2. Participation that constitutes substantially all of the participation in the activity of all individuals, including non-owners

3. Participation in the activity for more than 100 hours during the year, with that participation exceeding any other individual's participation during the year

4. Participation in "significant participation activities" for an aggregate of more than 500 hours during the year

5. Material participation in any five years during the immediately preceding 10 tax years

6. Material participation in any three preceding years, if the activity is a personal service activity

7. Participation on a regular, continuous and substantial basis during the year, taking into account all the relevant facts and circumstances

The tax law presumptively treats losses from certain limited partnership interests as passive but leaves the operating rules to regulations promulgated by the Treasury Department.

Temporary regulations issued in 1988 have never been finalized. The temporary regulations permit a limited partner to establish material participation but restricts the limited partner to the first, fifth and sixth tests.

When Congress enacted the passive activity rules and the Treasury promulgated the temporary regulations, there were no LLPs. The first LLP statute did not come into existence until 1991. Similarly, only one state – Wyoming – had an LLC statute when the passive loss rules came into the tax law. Nonetheless, the IRS has regularly treated members of LLCs and partners in LLPs as limited partners for purposes of applying the passive activity loss rules.

The two recent cases addressing the passive activity rules as they apply to LLCs and LLPs are *Garnett v. Commissioner*, 132 TC __, No. 19, June 30, 2009, and *Thompson v. United States*, US Ct of Fed Claims, 06-211, July 20, 2009.

In *Garnett*, the Tax Court refused to grant summary judgment to the IRS and allowed the case to proceed to trial on whether the owners of LLC and LLP interests materially participated in the activities.

In *Thompson*, the Court of Federal Claims went further and ruled that the IRS and the Treasury had no authority to apply the limited partner provisions of the passive activity rules to members of LLCs and partners in LLPs.

These cases do not open the door for all LLC members and LLP partners to deduct what otherwise would be passive losses. However, they certainly help those who meet one of the four tests that are not available to limited partners.

To the extent an owner of an LLC or LLP interest can benefit immediately from a tax loss, rather than having that loss suspended under the passive activity rules, that owner has a more valuable asset. A tax benefit today is more valuable than a tax benefit some years in the future.

Price tag *continued from inside*

Your Intangible Assets. The most difficult business assets to value are intangibles, such as goodwill, trademarks, patents, location, customer lists, employment contracts, employee levels, covenants not to compete, franchise agreements, industry trends and going-concern value.

Though they define your company's competitive advantage, all too often these critical success factors are unquantified. That's a big mistake that can cost you a significant sum of money. Intangibles are often the reason some companies trade for exceptionally high price tags.

Discounts. After determining the value of your income stream and intangible assets, discounts are usually applied for lack of marketability and minority interest. The value of your business will most likely be discounted for lack of marketability because it is much more difficult, expensive and time consuming to sell an interest in a small business than a publicly traded company. And, if you own a minority interest, defined as less than 50 percent voting control, a further discount is generally taken since that portion of the business is not as valuable, per share, as the controlling interest.

A value you can rely on

Many business owners are told they can rely on rules of thumb for "quick and dirty" approximations of business value. However, professional business analysts usually forgo these instant valuations, recognizing they often fail to account for those things that set your business apart from your competitors. Often, these are the most critical factors to consider to accurately gauge your company's value.

Your best approach to determine an accurate value for your business is to work with a trained valuation expert. Check with our CPA firm first. We have trained staff who are familiar with your business operations and well-qualified to determine the value of your business. The valuation process is complex, requiring proficiency in financial statement analysis, finance, economics, valuation principles and methods, and an overall good business sense.

Isn't it time you discovered the worth of your most valuable asset – and put it to work in building and protecting your wealth? ■

The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation. Please be advised that, based on current IRS rules and standards, the advice contained herein is not intended to be used, nor can it be used, for the avoidance of any tax penalty assessed by the IRS.