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The Credit Crunch and its (Negligible) Impact on Mid-Market M&A

Kaulkin's Michael Binko believes that the weakness in the debt markets has affected dealmaking, but not as much as one might assume

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Much is being made by mainstream media of what impact the sub-prime credit crunch is having on broader and seemingly unrelated industry sectors. While these macro discussions make for great evening news fodder, the rubber really hits the road when middle-market business principals ask the question, "Will this crunch impact me and my business and, if so, how?" The uncomfortable, yet realistic, answer is "it depends..."

It depends on many factors, including which industry the inquirer is in; the current size of their organization and its expected growth rate over the next few years; the uniqueness of its market niche; the planned exit scenario; and potential suitors for the company.

For business owners and dealmakers alike, particularly in the middle-market M&A community, it's back to basics.

To clarify the point, let's take a look at one particular sector of middle-market M&A that has been very active in recent years - Accounts Receivable Management (ARM). ARM provides a good example of how the credit crunch is not necessarily wreaking havoc across the board. Instead, the crunch is forcing business principals to take a closer look at strategic growth plans and exit scenarios.

As with the majority of vertical industry sectors, most private businesses involved in the ARM sector (i.e., collection agencies, debt buyers, collection law firms and vendors to those companies) are not of a size that would likely be threatened by a shortage of financing if they were to be involved in a merger or acquisition.

The vast majority of these businesses are well under $50 million in annual fees or revenues. As a result, the buyers of these businesses tend to be larger collection agencies and established businesses from closely related industries.

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These types of buyers are not going to fail to close a transaction because they cannot secure financing in the wake of the eroding subprime housing market. If they are qualified buyers (financially) then they should have pre-existing relationships with cash flow lenders and they are likely able to secure financing based upon the merits of the combined operations.

Any buyer of a business with a price tag under $50 million who uses the excuse that they could not secure funding because of the collapse of the sub-prime market is not well connected to cash flow lenders in the first place and should be avoided as a potential suitor. There is a long list of reasons why a buyer may not close a transaction but this should not be one of them.

For owners of ARM businesses who have built operations with annual revenues in excess of $50 million, the M&A marketplace is considerably different. Most buyers come from outside the industry and can include related industry buyers (i.e. CRM and BPO) as well as private equity firms. Buyers from related industries, for the most part, have financing alternatives already in place including public stock and established lines of credit.

When we take a closer look at the majority of non-public private equity firms we see that they have been successful in accessing value-rich debt to fund deals. For some transactions they have borrowed heavily and financed their deals with junk bonds and, as a result, have leveraged transactions at very high levels.

The changing landscape of the credit market has, indeed, made it more difficult for these highly leveraged multi-hundred-million and billion-dollar buyouts to occur. Buyout firms are being forced to pay higher borrowing rates and put more of their own money into deals because valuations continue to still remain somewhat high.

In fact, while low borrowing rates and numerous sources of debt were available prior to the sub-prime crunch, more and more capital sources are following increasingly risk-averse strategies. To that end, these lenders are tightening the reins on debt capital and the larger deals are being scrutinized more carefully.

This tightening is having an impact on private equity-sourced dealflow at the high end of the market yet not significantly impacting dealflow in the true middle-market.

Indeed, the credit crunch has the potential to impact numerous industries at some level. But if it will result in the doomsday scenario that everyone is talking about, the answer is "not likely." Well-run companies and owners will always be sought after. However, they need to keep their eyes on the ball and put it in-play.

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So what does this mean for the middle-market business owner? The short answer is to continue to focus on core business metrics — measured growth, profitability, increased visibility and operational efficiencies that impact all elements of the business.

When prioritizing these metrics, efforts or investments in areas such as enterprise knowledge management, best-practices, compliance factors and technology consistently offer the most return-on-investment (ROI). These metrics are also the elements of due diligence that have the most visible impact on valuations and multiples in the minds of suitor deal teams.

While some middle-market buyers may be forced to pay higher interest rates than a few months ago, they are still lining up to do deals and financing remains widely available for savvy buyers and experienced deal teams.