How the Financial Crisis Impacts Middle-Market Acquisitions

Its impact may not be as significant as you'd think, so don't cave on your asking price.

By George Spilka

George Spilka is president of George Spilka and Associates, Allison Park, PA, an investment banking firm that specializes in middle-market, closely held corporations. Tel. 412-486-8189; www.georgespilka.com.

The United States is in the midst of its greatest financial crisis since the Great Depression. Congress has passed a bailout package for the financial industry, the most massive governmental intervention in the financial markets in this country's history.

What brought the country to the brink? Very simply, the reckless—verging on idiotic—residential-mortgage lending that began in 2004, combined with the use of modern technology to design exotic financial derivatives with consequences that no one fully understands. The massive use and distribution of these derivative products was almost completely funded by debt.

Why did it happen? The crisis was fostered by a culture of greed that has permeated this country since the dot-com explosion of the 1990s. This culture reached its apex on Wall Street, where the Wall Street wizards felt that no amount of money was enough. It was nurtured and brought to maturity by the easy money policy of the Federal Reserve under former chairman Alan

Greenspan. This resulted in the most excessive and imprudent lending and use of leverage encountered in U.S. history.

The consequences should have been realized by all at least three or four years ago. I assure you that the eventual consequences of their actions were evident to the Wall Street wizards. However, why should they have worried? They already would have made a vast fortune from it. Their personal wealth would be secured before the problem became evident. Others could deal with the carnage. The others turned out to be the United States and the taxpayers.

Impact Limited to the Financial Industry

What hasn't happened in the financial crisis? The impact has been limited to the financial industry, which has been devastated by the losses sustained in the residential-mortgage-lending market and the losses related to credit-default swaps and other derivative products. At the peak of the financial crisis, on Wednesday, September 17, 2008, as financial institutions became concerned about extending credit to anybody, which nearly caused a meltdown of the U.S. financial structure, the Federal Reserve and Department of Treasury stepped in and proposed a bailout package. This brought renewed life to the credit markets. However, while this scenario evolved, U.S. industrial companies (manufacturers and distributors alike) had their strongest balance sheets since the 1970s. America's industrial companies undertook no massive borrowing during this period, nor has there been any meaningful disruption in much of the manufacturing and distribution segments of our economy. The immediate impact has been limited to the financial markets, and this is where the impact will be contained.

As I survey the landscape, although the economic figures indicate that the country is in a recession or an economic downturn (define it as you like), the profits of many U.S. industrial companies remain strong. The results for public companies indicate that although profitability is moderating, it remains at historically high levels. My clients are realizing moderate to strong profit growth this year.

The intermediate and long-term impact of the financial crisis on the economy will be negligible. By the second half of 2009, the country will exit the economic downturn. My major concern regarding future economic performance: the amount of guarantees made by the Federal Reserve and Treasury. These could lead to a significant worsening of the federal deficit. If so, it will exacerbate our dependence on foreign countries and provide further opportunities for foreign sovereign wealth groups. In this scenario, without foreign governments increasing their already large purchases of U.S. debt instruments, we likely will have a significantly increased inflation rate and further weakening of an already weak dollar. Obviously, this foreign ownership of America is not only a political concern, but also has potential long-term business consequences. However, despite the aforementioned concerns, the financial crisis will have limited impact on the intermediate and long-term economy.

Don't Pay Attention to Doomsday Scenarios

My overriding advice: Don't be intimidated by acquirer's "doomsday scenarios." The financial crisis has not changed much of anything in the industrial sector of the U.S. economy. Many companies remain profitable and the intermediate and long-term business outlook remains good. Therefore, make no transaction-price concessions. The necessary patience will provide a bountiful reward.

Owners and executives of middle-market companies, those with a transaction price between $5 and $250 million, will continue receiving calls from brokers, intermediaries and low-grade investment bankers. However, their storyline will now be, either upfront or as a deal progresses, something similar to, "You had better sell at a discount price before the carnage gets worse," or "You should be thankful to receive this price due to current financial conditions." There is no justification for these types of statements.

Most acquirers will tell you that the devastation in the financial markets means that you will have to accept a substantially discounted price. You will be told that pricing will be "dirt cheap" into the foreseeable future and might even deteriorate further. Pay no attention—this is hogwash. Over time, what will be the impact of the financial crisis on the sale of middle-market companies?

• Short-term impact (to one yr.)—Possibly 3-6 months with some turmoil in the acquisition market, and conceivably a degree of transaction pricing weakness through the end of the second quarter of 2009.

• Intermediate-term impact (1-3 yrs.)—No impact on transaction pricing, unless the effect on the federal deficit of the guarantees made by the Federal Reserve and the Treasury have a greater impact than I believe they will. Deal pricing should be similar to that in the first half of 2008, which was reasonably solid.

• Long-term impact (3-plus yrs.)—None. Many things will affect pricing, none of which involving the current financial crisis.

Don’t Change Your Selling Strategy

Based on my economic outlook, I don’t feel the financial crisis should have any significant impact on potential sellers of middle-market companies. Don’t change the overall strategy regarding the sale of your company. If selling satisfies your personal and business objectives, proceed with the process. You might delay contacting potential acquirers until after the first quarter of 2009, but that will not be necessary in most cases.

Furthermore, don’t modify your expected transaction price at this time. I am not reducing the pricing for any current clients.

Owners of companies not yet in the market or those at the very start of the sale process, whose fundamentals and business foundation are somewhat deficient, might want to delay the sale while they strengthen and reposition the company. However, where there is no need to strengthen the company’s fundamentals or foundation, I see no reason why approaching acquirers should be delayed past the start of 2009.

These are times when you truly need a strong-willed, determined, knowledgeable investment banker that understands the causation of the financial crisis and how it is likely to play out. Having one will provide you with the proper guidance in how to proceed in these exciting, but turbulent, times. **MF**