

When Should You Be A Seller?

Explaining M&A and the Business Cycle – Why Timing Matters

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Timing the sale of a company can make a difference of millions of dollars. It is one of the most critical decisions an owner or an equity fund can make; however, successful mergers and acquisitions (M&A) can seem so serendipitous. There are plenty of stories of companies having the right product at just the right time - and being swept up by a big buyer for big money. There are just as many stories about companies turning down magnificent offers in hopes of even better ones -- never to see those price levels again. From twenty years of experience, let me suggest that successful M&A and maximizing one's return is not always dependent upon good fortune.

Multiple Expansion

The agent of aggressive M&A valuation is "multiple expansion." Multiples are common yardstick measures of buyer prices as applied to a company's revenues or earnings. The final price paid may result from months of detailed analyses and voluminous spreadsheets, but, in the end, the desire is to simplify and compare a company to other transactions that have occurred in an industry and even to companies that are traded on a public exchange. The most common measures are "multiples of revenues" or "multiples of earnings." In isolation, multiples are not particularly useful in a disciplined corporate finance valuation. But in practice, they can mean everything in an emotionally charged sale of a company.

Multiple expansion becomes the winning lottery ticket for a seller. Imagine that a particular segment of the application software industry has a long-term, demonstrable pricing level where buyers pay 3x revenues to purchase companies. However, for a year or more, this corner of the industry is suddenly booming. Prices spike and buyers are temporarily paying 4x revenues for good companies. In Figure 1, you can see that for a \$20,000,000 revenue company, the absolute purchase price difference today is an additional \$20,000,000 of value at the heady 4x revenue multiple. Beyond the dollars, what does a 1x revenue multiple expansion mean to a seller in terms of blood, sweat and tears? Something very significant. In today's dollars, the owners would need to grind it out for over three more years to achieve the equivalent value in the future for the business. That means:

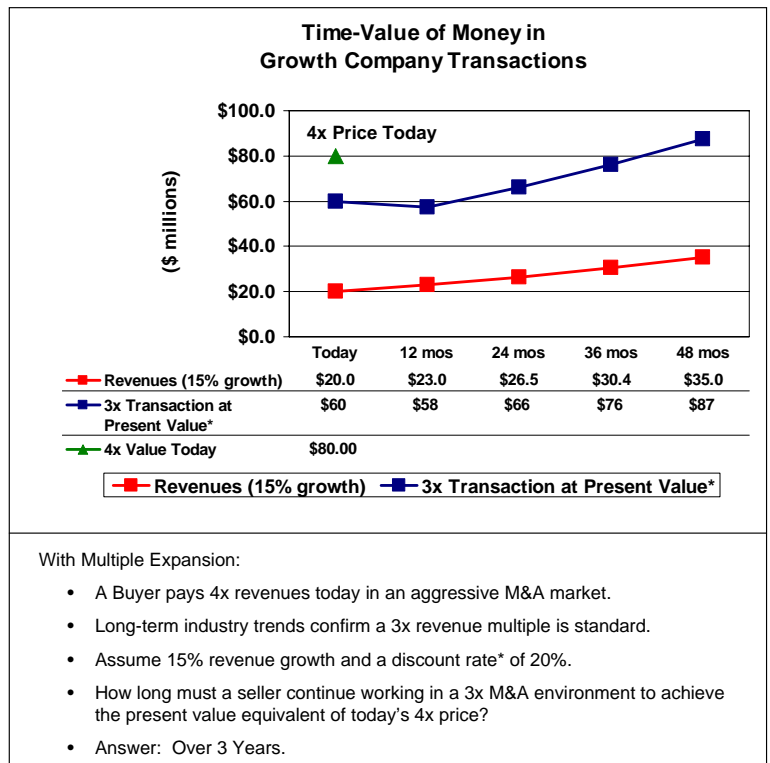


Figure 1 Multiple Expansion for Software Companies

- Three years during which the owners would have to hope that the market does not sour and that no external calamity befalls the company.
- Three years in which they have to maintain industry growth standards and industry margins.
- Three years of risk that can all be paid for in one fortunate M&A event with multiple expansion.

So timing really does matter.

Link to the Business Cycle

Multiple expansion is strongly related to the business cycle, the average duration of which is 5 to 6 years in modern times. In Figure 2, by noting the rise and fall of U.S. M&A volume and number of transactions, you can see the current business cycle and the previous one, with 2002 being the nadir year that divided the two. If you are going to take advantage of timing, then you have to know where your business and your industry are in the business cycle.

To understand how the cycle affects M&A, you only have to imagine how buyers behave at the board and executive levels within the cycle. At the end of the cycle, the economy has slowed to a crawl or even entered a recession. Profits have disappeared. Cash is shrinking on corporate balance sheets. From the board room come directives to the CEO to cut costs, lay off people, focus on sales, preserve cash and *halt all acquisition activity*. Industry purchase price multiples collapse or become irrelevant because no transactions are occurring. These are the dark days of M&A in an industry because there are no buyers with money and no sellers who want to relinquish ownership at these dismal pricing levels.

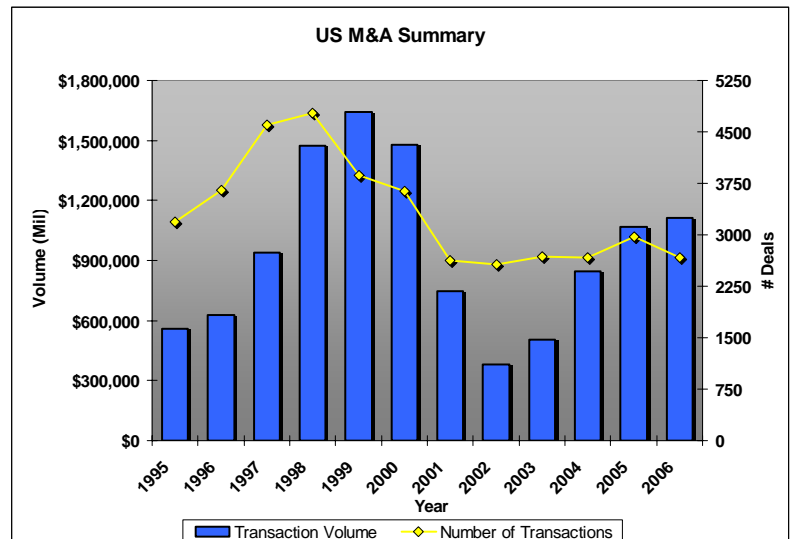


Figure 2 US M&A Market, 1995-2006 through 10 Months

Eventually, the economy makes the necessary adjustments, and economic activity picks up. Within large companies, which are the primary drivers of the M&A cycle, this early period of recovery provides the initial cash flow to fund internal projects and products that have been starved or mothballed during the downturn. Through the corporate budgeting process, managers vie with one another for newly released development funds. As the business cycle heats up, legacy products as well as newly funded projects produce accelerating revenues and profits. Cash accumulates once again on corporate balance sheets. And then, at a point in time that varies from industry to industry, the corporation faces a new dilemma. Internal growth is maximized and projections show a leveling off. Legacy products as well as new products begin to saturate their natural markets. Managers look inward for new R&D and new products, but, in large corporations, there are limitations to innovation, and the pipeline of new ideas is empty. The worm has turned. The overall market is still advancing. Investors are still expecting similar or better returns from the corporation. The same board of directors that only months before was dictating austerity measures is now pounding the table for its executives to deliver acquisitions to fuel growth. This is the high water mark in the M&A cycle where major corporate buyers compete aggressively for new revenues and products -- and multiple expansion occurs.

Timing Subtleties within the M&A Cycle

We are currently well into the expansion stage of the current business cycle, as indicated by a variety of measures such as GDP growth or recent new highs for the stock markets. *In general, this means we are in a robust M&A market, and it is a great time to be a seller.* One look at Figure 2 shows the steady growth of both number and volume of M&A deals since 2002. *In specific, a company still has to time its exit carefully.* Within this general expansion, there are winners and losers, because the business cycle does not treat all industries the same.

Today's winners include industries such as Government IT Services, which is fueled by both war and Homeland Defense spending. That industry's close cousin, the Commercial IT Services industry, has yet to take off, still plagued by lack of demand and the emergence of new offshore IT companies. Today's winners include mobile applications and software; however, the foundation companies of that industry, the telecommunications carriers and service providers, are beset with industry specific issues, such as the overbuilding of network infrastructure and declining prices for core services. Obviously, being in a good M&A period does not solve the problem of when to sell.

It's like the three guys who go out hunting -- an engineer, a mathematician and a statistician. The engineer shoots too high at a deer and then blames his poor shot on his miscalculation of wind speed. The mathematician shoots too low at the same deer and blames his poor shot on a miscalculation of distance and trajectory. The statistician, without firing a shot, leaps up and exclaims, "Eureka, we hit him!"

Here are two tips to timing the sale of a company:

1. **Watch the behavior of the Lead Dogs.** If the big players in your industry are buying companies, then you should be selling and selling soon. The Lead Dogs can drive whole markets, but, as much as you may not want to believe so, these companies will not remain buyers forever. Remember the dynamics that we previously explained. At some point in the upswing of the business cycle, major companies need to make acquisitions to feed the growth machine. Then the inevitable happens. These lead dogs feed too much and get indigestion. When the best properties are gone, they start buying marginal ones. They lose control over the integration process. Management gets distracted from the core business. Profits suffer, and sometimes even the very purpose for the acquisitions -- revenue growth -- suffers. The premium prices and multiples come down, and the M&A window in that industry simply closes. In today's good M&A market, a current example of that behavior is the software segment of the security industry, where consolidation has slowed and the pricing winds are shifting.
2. **Read the trade winds.** Look at your industry's long-term multiples. Look at your profits and growth rates. Are they higher than you have seen in years? Are they above what you used to consider high targets? Is your company really an unstoppable juggernaut, or are you benefiting from a strong economic wind at your back? A wind that you ultimately can not control. If so, then these are what one of our clients calls "the salad days." And it is time to consider realizing a return on your investment.

Seller's Remorse

Many a fortune has been lost by sellers waiting too late to sell. The investor and economist Bernard Baruch understood this dynamic when he declared, "I made my money by selling too soon." Of the several factors that can destroy value in a company, market risk is often the most underestimated. Let me give you an example. In the last months of the great Junk Bond period of the late 1980s, I asked my boss on Wall Street where he invested his personal savings. "I'm a yield guy. Always a yield guy. I have all my money in High Yield Bonds. Even if I lose 20%, I still break even." Not too many months later, when the entire junk bond market collapsed, his net worth had dropped almost overnight by 50% in realized losses.

Near the top of the curve of the business cycle, buyers are looking up toward the sky. They are paying such astronomical prices, because they are deluded that growth in their industry segment will continue *ad infinitum*. They ignore all market risk (at least for another couple of bonus periods or until retirement). The sin is not that buyers will pay so much in heady times, but that sellers so often share in the same hubris and delusions. "I

created this company. My excellent management and stewardship created these fantastic margins. This was a great year, and we are going to grow at this rate for the foreseeable future..." At the peak of a market and at the very moment that buyers are so willing to pay eye-popping multiples, there are always far more sellers who refuse all offers because "the best is yet to come." Obviously, that's what makes a market, and that's why there will always be stories from regretful sellers about "the price that got away."

The Wild Card of Private Equity

The business cycle, the M&A cycle and industry dynamics can explain a great deal about pricing and when to sell; however, in today's M&A market, there is an additional force that is increasingly distorting the normal causal relationships. In any business cycle, as profits and wealth creation accelerate above levels of spending, that excess wealth has to be invested. Much of it seeks the highest returns it can find with a decreasing regard for risk. In the last business cycle, that wealth found its way into the public stock markets, ultimately bidding up stock prices with disastrous consequences for those of us who held stocks when the music stopped. In this business cycle, it appears that significant wealth is flowing freely into hedge funds and private equity funds - particularly into buyout funds whose aim is to own and control businesses.

Supply and demand are getting out of kilter. Too much money from buyout funds is beginning to chase too few deals. The net result is an additional market pressure that inflates purchase price multiples. Increasingly, buyout funds are paying prices loaded with debt that exceeds common conservative coverage ratios. Competition forces funds to put their money to work - to "use it or lose it." We've all seen this movie before, and we know how it ends. In the meantime, if you judge correctly that your industry is in favor and that now is the time to sell, then this added wild card will work for you.

In Summary

U.S. industries are well into the expansion stage of the current business cycle. This creates a generally strong M&A climate as wealth is generated and major corporate buyers exhaust internal growth options. Buyers have money and they often need acquisitions to fuel growth. The current M&A cycle finds additional support from the oversupply of capital into equity funds, particularly buyout funds. The actual peak period of acquisition activity within the business cycle varies from industry to industry, depending on when in the cycle an industry hits its stride. Timing the sale of a company can mean a significant difference in actual value received and return on investment. To take advantage of timing, a seller needs to be brutally realistic in looking at its industry and its current and projected performance.

About Douglas M. Schmidt

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CEO and Managing Director

Mr. Schmidt has been an active member of the Mid-Atlantic financial community for over 15 years and is one of the most experienced middle market professionals in the region. As an investment banker with Ferris, Baker Watts and Legg Mason Wood Walker and as an investor with Grotech Capital Group, Mr. Schmidt has participated in the past decade's exceptional growth of technology companies in the region. He has helped to finance technology companies such as BTG, Nichols Research Corp., Advanced Communications Systems, Complete Business Solutions, MAXIMUS, PEC Solutions, and Cysive. Mr. Schmidt began his investment banking career in the 1980s with First Chicago and then Drexel Burnham Lambert in New York, where he was a merger and acquisition specialist. In two decades, he has led dozens of private and public market merger and acquisition transactions, including sales of IRRC, Cordant, Questech, Business Impact Systems, and SHERIKON. As an investment banker for mid-market technology companies, Mr. Schmidt has executed close to \$3 billion in M&A, private placement, and IPO transactions.

Mr. Schmidt is a longstanding member and former director of the Mid-Atlantic Venture Association (MAVA), past chairman of the Greater Baltimore Technology Council, and an active member of the Northern Virginia Technology Council's Capital Formation Committee. He is active as a speaker in the region on a variety of topics including



financing, entrepreneurship, and M&A. Mr. Schmidt holds an AB from Harvard College and an MPPM from the Yale School of Management.

About Chessiecap

Chessiecap, Inc. is a team of transaction professionals that leverages exceptional investment banking expertise to drive premium value transactions. Our **Prepare, Deliver, & Transact** methodology strengthens growth and middle market companies and accelerates their access to capital markets. For more information, visit www.chessiecap.com.

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