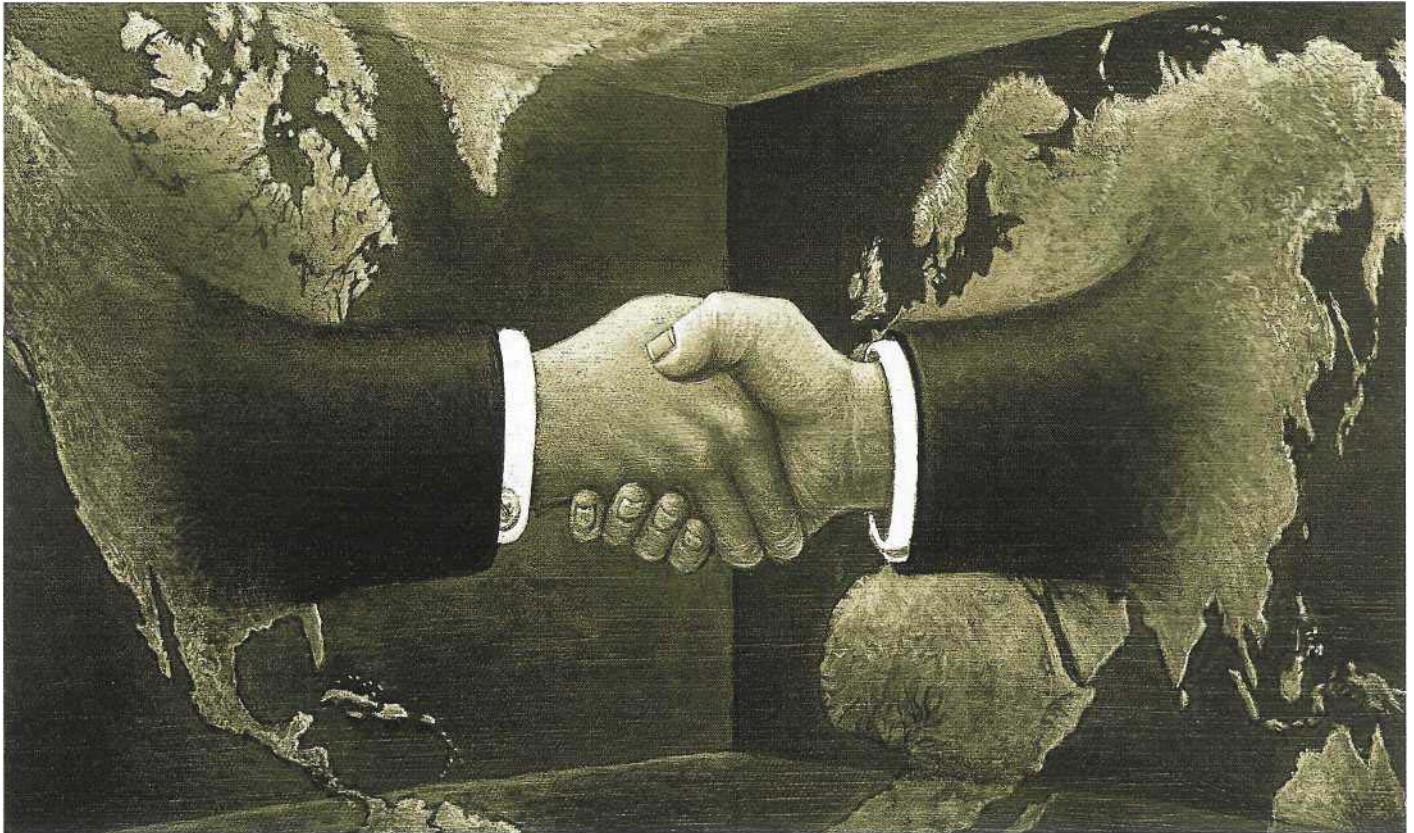


# TRANSATLANTIC MID-MARKET M & A R O U N D T A B L E



## TRANSATLANTIC MID-MARKET M&A

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For the first time in years, corporate profits on both sides of the Atlantic reflect strong performance, leaving many potential acquirers with stable balance sheets and access to significant equity and debt capital. This, combined with the mountain of equity and resources available to the leveraged buyout community, has many market observers anticipating exciting times ahead.

As companies strive for growth, the search for economies of scale, new products, new research and technologies and new geographical markets will continue to drive M&A in 2005. How much of this money will be used to finance transatlantic deals? Will US acquirers continue to dominate the stage in this ever-growing market? Or will Europeans find it difficult to ignore US bargains and the potential for great returns due to a "weak" dollar?



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**What do you see as the principal drivers of transatlantic deal flow?**

**Aust:** The emergence of the euro as globally accepted currency has resulted in European and American companies thinking of Europe as a single economy, and thinking of Europe as one a large, attractive market.

**Blount:** Also, the strong position of the euro against the dollar is making acquisitions in the US financially attractive at the present time.

**Hurley:** Yes, the strength of the euro and the buoyancy of the US deal economy are driving increased two-way activity. US investors see Europe as fertile territory and are shaking up the deal environment there while the relatively weak dollar is making US targets more attractive and less expensive for Europeans. These positive dynamics are set against the background of continuing globalisation in almost every industry.

**Teuten:** Certainly, the weakness of the US dollar will continue to tempt European groups to buy in the US. But the number-one driver

of transatlantic deal flow is the strength of the underlying economies in North America and Europe. The US market is continuing to grow strongly and outpace continental European markets.

**Esbeck:** The desire for companies to expand their product offerings into markets around the world and follow their customers' expansion into international markets is a significant driver. This allows companies to establish distribution in new markets, providing a base to leverage domestic brands and products internationally. The desire to access lower cost manufacturing or to obtain greater distribution scale will drive companies from both continents to look across the pond. Access to reasonably priced capital is helping such deal flow, as is the cooperation and easing of border restrictions in the EU.

**Teuten:** From what we're hearing, companies on both sides of the Atlantic are increasingly optimistic and confident in their business models and their strategies, and are planning to implement those strategies now through acquisitions. On the private equity side, these groups are being very active in provoking and executing deals, creating a heightened level of market competition. Private equity groups are also large-scale sellers of companies and this - ►►

combined with larger corporates' increased focus on core activities, which is leading them to divest non-strategic assets - means there will be a steady stream of companies available for sale. Transatlantic dealflow will continue to be a two-way street between the US and European companies, with increasing volumes and transaction values. Currently, more transactions are taking place in Europe than in the US, but we think that differential will narrow in the coming months.

**How may these factors change the landscape for transatlantic M&A in the coming 12-18 months?**

**Esbeck:** Provided that things remain relatively stable on the terrorist front, there is likely to be an increasing amount of transatlantic activity. In particular, there will be active interest in Eastern Europe from a production perspective and the US with respect to market access. Currency exchange rates may stimulate investment into the US, but strategic fit is most important to European buyers. Likewise, US buyers are not likely to shy away from buying in Europe if the business opportunity is a strategic fit. We have seen a steady increase in middle-market cross-border deal activity during the last two years and I anticipate that it will continue to increase over the next several years.

**Teuten:** There should be strong a growth in North American mid-market activity over the next 18 months. In the first few months of this year, the US M&A market has held up more strongly than the European market. This is particularly so in the private mid-market, where transactions are continuing at an active pace.

**Hurley:** There will be more investment and buyouts in Europe involving US players. That will heat up competition for UK and Continental buyers. As Europe's economy picks up steam as the US economy already has, buyers there will become more confident and set their sights on even more targets here.

**Aust:** There should be no immediate change in activity, simply because our clients do not see currency as a major driver for their M&A thought process. But, significant movement of the dollar relative to the euro could cause some change.

**Blount:** Certainly, if the value of the dollar remains weak, it will encourage more European investment in the US and, conversely, chill US investment in Europe.

**Teuten:** Despite a rising interest rate, the cost of funds is still relatively cheap, particularly in North America, and there are a vast number of sources of funding available, far more so than two or three years ago. Each of these funding groups is actively

promoting transactions.

**Are there any complications or developments that may negatively impact the growth of deals between the US and Europe?**

**Aust:** The US twin deficits - trade and fiscal - may continue to weaken the dollar and discourage European companies from seeking US acquisitions, affecting the deal volume. Also, political tensions between US and Europe have had, and will continue to have, an impact on transatlantic deal volume.

**Blount:** Yes, the political situation between the US government and certain European governments could dampen transactions that depend upon government support.

**Esbeck:** Security risks and terrorist concerns could be the largest negative force in transatlantic deal growth. Protectionist policies within specific countries or the EU have had an adverse impact on deals and could create more complications in the future. And rising interest rates and an increase in credit problems could reduce the funding appetite of banks and other lenders to the M&A market.

**Hurley:** Of course, it would be disappointing if labour unions stall consolidation strategies, accounting differences inhibit compliance with Sarbanes-Oxley requirements, or geopolitical events disturb world order, but the availability of capital and ingenuity of investors in both camps is incredible.

**What effect do you think cultural and historical factors will have on transatlantic strategic decision-making?**

**Aust:** The European Union makes it easier to do business. In the past, Americans looking to buy in Europe had found it hard to navigate complex cultural differences. Unification has helped to eliminate some of these differences. Not only that, but when an American company was looking at target market with perhaps 10 or even 60 million people in a country, cultural factors played an important role in the attractiveness of that country. Fast forward to 2005, and the same corporations are looking at a 300 million-person market; suddenly those cultural differences seem a little less important. It's also worth mentioning that the trend of European labour laws moving closer to the US model makes things easier.

**Blount:** The comfort level of US and West European businessmen in investing and working in each other's geographic areas remains quite high, based on long experience and shared interests. Of course, that comfort level is less certain when East Europe and Russia are included. ▶▶

**Teuten:** Regarding the US, there are some significant "soft" issues affecting transatlantic deal flow, mostly relating to international opinion on US foreign policy and its military actions. In many ways these issues benefit countries like the UK, which are traditional, long-standing allies of the US, and at the same time a potential disadvantage to countries with less sturdy ties. For example, we have found that the US government is much more supportive of aerospace and defense deals involving buyers from the UK than buyers from some other countries.

**Esbeck:** Certainly, all countries will wish to monitor acquisition activities by foreign buyers within their own borders. Many times foreign acquisitions may be viewed as a threat to a country's national security. There will continue to be inherent desires to support industries that have had historical significance to particular countries which can muddle acquisition efforts. However, while these factors may slow down some deal activity, I think the over-riding culture is our mutual commitment to an industrialised way of life, underpinned by a dependence on market-based economies. Capital will not continue to support businesses and industries that do not generate returns on investment. Countries cannot support industries which aren't globally competitive and meet the social requirements of their citizens. For a country to be competitive, the country's businesses must be competitive and that will drive strategic decision-making.

**Brady:** Looking globally, there is a lot of uncertainty in the world, and we continue to see a high volume of capital inflow to the US, as it remains a great place to invest. This will continue to drive off-shore acquisitions of US companies. European markets are well-developed with relatively low risk. India and China have high return potential right now, but the risk and cultural divide today are significant. Investors still feel safer in Europe and the US.

**Deals between trade buyers are likely to be the largest contributors to any rise in activity. Do you expect such deals to increase?**

**Esbeck:** In the US over the last several decades we have seen many consolidation strategies employed to take advantage of administrative efficiencies, provide entry into new markets and gain access to new products. These same opportunities are now more widely available to businesses on both sides of the Atlantic. The ability to communicate and travel easily between the two continents provides additional impetus to trade buyers.

**Aust:** We do see strategic buyers becoming more aggressive. Only 30 percent of European cross-border deals currently involve pri-

vate equity. From late 2001 until 2003, the strategics were on the sidelines due to geo-political concerns, and balance sheet concerns. Now, balance sheets are stronger and we are seeing trade buyers returning to market. They are definitely more bullish.

**Hurley:** There should be fewer of the mega transactions in pharmaceuticals, financial services and utilities that drive the value stats rather than the number of deals and there should be more deals across the board fitting into the basic strategic growth type. If the services directive is adopted, a very large market should open up.

**Teuten:** Corporate acquirers will continue to be significant players in the M&A market, particularly internationally. They are demonstrating increased confidence and optimism in their business and are also aware of the need to grow their businesses aggressively.

**What role are private equity houses playing in this burgeoning market?**

**Blount:** Private equity and venture capital investment are only now recovering from several years of inactivity. One change in that market has been a shift in the exit strategy from looking to a public offering as a way to exit (which was the preferred method in the past) to a sale of the company as the new preferred exit strategy. This could actually put more companies on the market as potential acquisition targets over the next few years.

**Brady:** Most private equity funds' charters dictate that they invest capital in the country where they reside. You don't see the same percentage of private equity dealflow going overseas as you do domestically. However, private equity firms in the US are facing unprecedented competition now. They only make money if they put capital to work. So you may see more flexibility and widening of charters to include off-shore investments. KKR and other large players are already doing this. We are also seeing some middle-market funds opening branches in the UK: Summit is one, Advent is another.

**Do you think the role of private equity in deals will continue over the coming 12 months? Are there enough deals to go around?**

**Teuten:** Generally speaking, equity group interest is good for our clients because it tends to drive multiples higher. But from the perspective of the financial buyers, which have come to dominate the industry via private equity groups, there are never enough good deals to go around. »

**Esbeck:** I think private equity will continue to find attractive deals in which to invest and there will be more entrants into the private equity arena in both the US and Europe. This is due to the fact that there are tens of thousands privately-held middle market businesses in the US and Europe owned by people nearing retirement age. Without private equity there may not be enough buyers to provide price support to their ownership transition. Over the longer term (5 to 10 years) there may be active consolidation within private equity.

**What effect may the anticipated increase in corporate valuations have on transatlantic acquisitions in the coming year?**

**Hurley:** Quite simply, it will squeeze returns for most of the buyers and make it all that much more important for buyers to really know what they are doing. The higher prices entice sellers into the market and force final buy-side auction contestants to hone their strategies.

**Aust:** There will be an increasing pressure to move quickly. An uptick in valuations means buyers won't wait while the price goes even higher. If valuations were moving in the other direction, smart buyers would wait until the price bottoms out.

**Blount:** As valuations rise, there are fewer bargains to be found. This could shift the motivation from a financial play to a strategic move.

**Esbeck:** As interest rates rise it will have an impact on buyer valuation perspective. Seller valuation perspective tends to lag. However, the critical factor for valuations will be the perceived market opportunities associated with the acquisition. I believe the market opportunities will continue to justify high valuations over the coming year.

**Teuten:** Transatlantic deals tend to be driven either by broad macroeconomic factors or strategic imperatives specific to the individual companies involved, rather than more transitory issues. To the extent that corporate valuation or currency values are transitory, they will almost always be trumped by such things as Real Gross Domestic Product in determining the merger environment.

**Do you envisage the middle market, or deals under \$1bn, outperforming other segments of the deal market with respect to deals between the US and Europe?**

**Esbeck:** With respect to the middle market, many times one or both

of the participants are not quoted companies. They may be family-owned. Getting past intergenerational issues and cross-border cultural issues can be a prime factor in getting a deal accomplished. Once this is accomplished, however, the business opportunities can be significant. For larger deals it might be easier to get together on the front end, but more difficult to generate the same percentage rate returns as a well structured middle market transaction.

**Brady:** The more growth-oriented mid-market transactions have been historically the best place to make money, and that should continue to be true. When companies get very large, auctions and financial structures can get overly competitive and valuations may not justify the level of maturity in the business and the level of growth left in the business.

**Teuten:** While I'm cautious about making such predications, historically the mid-market segment has demonstrated greater stability than other segments. For example, it is much less affected by stock prices, which sometimes artificially inflate the announced value of larger deals.

**Hurley:** Middle market deals valued under \$500m will be where the real story will be for 2005.

**With respect to transatlantic deals by volume, do you expect the mid-market to outperform the higher and lower ends of the market?**

**Esbeck:** I do expect the volume of transactions in the mid-market to exceed the high and low end. On the low end, it takes a certain size scale to justify transatlantic investment and this hinders deal activity at this end of the spectrum. On the upper end there will continue to be deals completed, and expanded activity in deals over \$1bn. In the mid-market there is even greater opportunity for deals, due to access to a much broader buyer pool. Both mid-sized and large buyers are candidates for mid-market sellers whereas only large buyers can compete for deals over \$1bn.

**Teuten:** We will see greater stability in mid-market dealflow than at the higher end. Deals in the mid-market, especially those below \$100m, are often unrecorded and are driven by the fundamental need for companies to gain market share, distribution channels, technology, and so on.

**What additional complexities arise in transatlantic dealmaking that do not appear in domestic transactions? »**

**Blount:** The complexities are numerous. They include: different accounting practices; complicated due diligence, particularly when many documents are in a foreign language; antitrust concerns and differing standards between the US HSR process and the European Commissions; and the greater likelihood of governmental involvement, particularly when sensitive or security related products are involved (e.g., compliance with the requirements of Exon-Florio). In addition, since most European companies do not want to subject themselves to SEC regulation, the use of securities as a component of an acquisition in the US by a European company is much less common.

**Aust:** From our point of view, the biggest problems are in dealing with different accounting systems, tax laws, environmental regulations and human resource/pension issues.

**Esbeck:** Anti-trust rules can impact a transaction as well as other regulatory requirements within specific countries. Different tax structures and social obligations add complexities while work rules and property ownership vary from country to country. Basically, what you may take for granted as certain in your own country may be quite different in another. It is an example of why it is important to have the appropriate advisory team helping to bridge such legal and cultural differences.

**Hurley:** Most importantly, US companies don't face the currency issue when buying domestic, and buying abroad still entails financing issues such as collateral liens and the ease of enforcing claims, tax considerations, always the workforce and benefits items, and the communications hurdles.

**Is Central & Eastern Europe attracting the interest of US companies to any significant degree?**

**Aust:** My feeling is that Central and Eastern Europe are more likely to attract the interest of Western Europeans. They are more comfortable with the various language and cultural barriers. On the other hand, US companies looking for low labour costs are more likely to look to China.

**Hurley:** The more integrated Central and Eastern European countries become with the European Union, the better able investors will

be able to see promise. Right now, Germany, France and the Nordic group are of much more interest and of course the UK remains a bright spot.

**Esbeck:** As the governments of Central and Eastern Europe become more predictable and stable, additional capital is likely to be invested by US companies into this region. These countries need capital investment and they offer investors access to lower production costs. Virtually every US manufacturer is seeking to obtain lower input costs, and Central and Eastern Europe may be more attractive than Asia to many US firms, especially those selling significantly into the European market.

**What industry sectors do you feel will play a significant role in the transatlantic M&A landscape?**

**Teuten:** Technology, software and healthcare continue to attract attention. The world still sees America as the home of high technology and wants access to that domain. We also expect to see continued interest in the aerospace and defense fields.

**Blount:** High tech as well as manufacturing will be busy. With a low dollar, there is an incentive for European companies to manufacture in a dollar zone.

**Aust:** It's easier to say which industries will not play a role in transatlantic M&A: basically restaurants, architectural components that are built to country-specific building codes, and those that are focused on things that cannot be transported easily, like cement. Otherwise, we expect growth in food & food ingredients, tech, aerospace, automotive... really any industry.

**Esbeck:** Most industries will see cross-continent activity between Europe and the North America. Companies with global brands will seek to obtain greater market penetration on both continents. Walmart's expansion into Europe pulls vendors along with it. Food and general merchandise producers will seek transatlantic opportunities and logistics should expand. Companies that transport, store and supply products to manufacturers will want to provide such service to their transatlantic clients. The sectors most impacted are likely to be areas where cost reductions and scale economics are needed to remain competitive, such as manufacturing, retail and logistics. ■