

# Deals & Dealmakers

Part six: mid-cap M&A

## Nuts and bolts

Why medium-sized mergers and acquisitions are on the rise

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• Interactive: a timeline of key events in global M&A activity in the past year  
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## Deal volumes on the rise in the mid-market

Significant recent mergers and acquisitions activity is supported

**A**S THE GLOBAL ECONOMY traces a delicate trajectory back on to a path to growth, dealmakers are reporting a surge in interest in mergers and acquisitions. The mid-market is typically a fertile source of deals, and the beginning of this M&A cycle is no different, with a resurgence in acquisitions already apparent.

In the UK last year, eight FTSE 250 stocks fell to buyers, a volume typical of the early stages of an M&A cycle. On average, about 17 UK mid-cap stocks are taken over in the middle to late stages of an M&A cycle, according to analysts at Citi, the financial services group, suggesting more activity to come.

According to Dealogic, the data provider, mid-market M&A as a percentage of total global activity has reached 24 per cent, a level not seen since 2004.

"We are seeing significant M&A activity in the mid-market area. It is a fertile ground for deals," says Cyrus Kapadia, deputy head of UK investment banking at Lazard. "Many corporates have been through a period of difficult cost-cutting and have been careful about their use of cash, but are now in a better position from an M&A financing perspective."

Global mid-market M&A, for deals of \$100m-\$1bn, reached \$675bn in 2010, a level of dealmaking not surpassed since 2007 and up from \$489bn in 2009, according to Dealogic. Nearly half of that total has been reached already this year, with \$310.6bn of mid-market deals completed by May 31. For deals of between \$250m and \$5bn, global volumes reached \$789bn last year, according to Mergermarket, the news and data company.

"Chief executives are increasingly looking at what their competitors are doing and whether to be proactive on a particular situation," adds Mr Kapadia. "They want to make sure that any deal will be perceived as a success. A transaction in the mid-market area may well be more appealing than a multibillion-dollar transformational deal that would naturally be higher risk in the current environment."

A strong recovery in capital markets has supported the revival in dealmaking. As investors search for yield in an environment of low interest rates, bond markets have boomed and opened to a greater range of riskier, smaller borrowers.

"Both debt and equity are available for deals in the mid-market, although access to capital for smaller companies is generally more volatile," says Tom Willett, chairman of corporate finance for Europe, the Middle East and Africa at Royal Bank of Scotland. He adds that macroeconomic uncertainty continues to complicate dealmaking even in the mid-market.

The oil and gas, property and healthcare sectors have been the busiest for mid-market M&A so far this year, with an 89 per cent increase in activity in healthcare on the same period last year, according to Dealogic. The US has seen the most activity, followed by China and the UK.

However, shareholders are not always supportive of M&A, and some bankers highlight the uncertainty some boards have about getting the necessary support for dealmaking.

"While the mid-market is generally in reasonable financial health, shareholders in the UK tend to look to companies to manage efficient balance sheets and return any excess cash to shareholders," says Mr Willett. "US investors seem to be better disposed towards M&A as an acceptable use of surplus cash."

The depth of demand for high-yield bonds has helped finance a resurgence in leveraged buy-outs by companies backed by private equity, which has boosted M&A volumes. In the first quarter of 2011, junk bond issuance has continued apace, with



global issuance up 28 per cent at \$103bn, a record start to the year.

**B**ANKERS AND INVESTORS SAY A large source of deal activity has been companies backed by private equity. In the first quarter of 2011, private equity buy-outs were up 71 per cent from the same period last year, accounting for a higher proportion of M&A activity, reports Mergermarket.

"We have done £170m [\$278m] in the year to date in six new deals, which is in line with our strategy of investing through the cycle, and what we would do in an average year," says Darryl Eales, chief executive of LDC, the UK mid-market private equity house that is part of Lloyds Banking Group. "Our plan is to do £300m-£350m in 2011. I'm confident we will do that because the pipeline is strong. In a typical year, we would do £250m- to £300m-worth of deals."

But competition for assets is intensifying. "We have been trying to originate more deals ourselves as a way of dealing with this more competitive environment, and our regional network is a great strength here," adds Mr Eales. "Trade

## rise in the mid-market

by a recovery in capital markets, writes *Anousha Sakoui*



## 'Many corporates have been through a period of cost-cutting but are now in a better position'

buyers are back in the market very aggressively."

However, lending has not returned to pre-crisis levels, and dealmakers say activity has been limited by restrictions on the provision of finance for M&A with smaller companies.

"For businesses with an ebitda [earnings before interest, tax, depreciation and amortisation] of £25m [\$36m] or more, you can attract a more international group of lenders, but if earnings are below that, then companies are restricted to a narrower set of local lenders. That can make deals more difficult to finance on attractive terms," says Neil MacDougall, managing partner at Silverfleet Capital, the private equity company.

Not all shareholders are keen to sell out of their companies yet, presenting opportunities for new investors to provide capital.

"We have recently seen opportunities to invest alongside existing owners who don't want to sell their companies but want capital to invest," says Stephen Welton, chief executive of the Business Growth Fund, which has £2.5bn to invest in UK companies. The fund was launched by banks last month in response to government pressure to lend more to small and medium-sized enterprises.

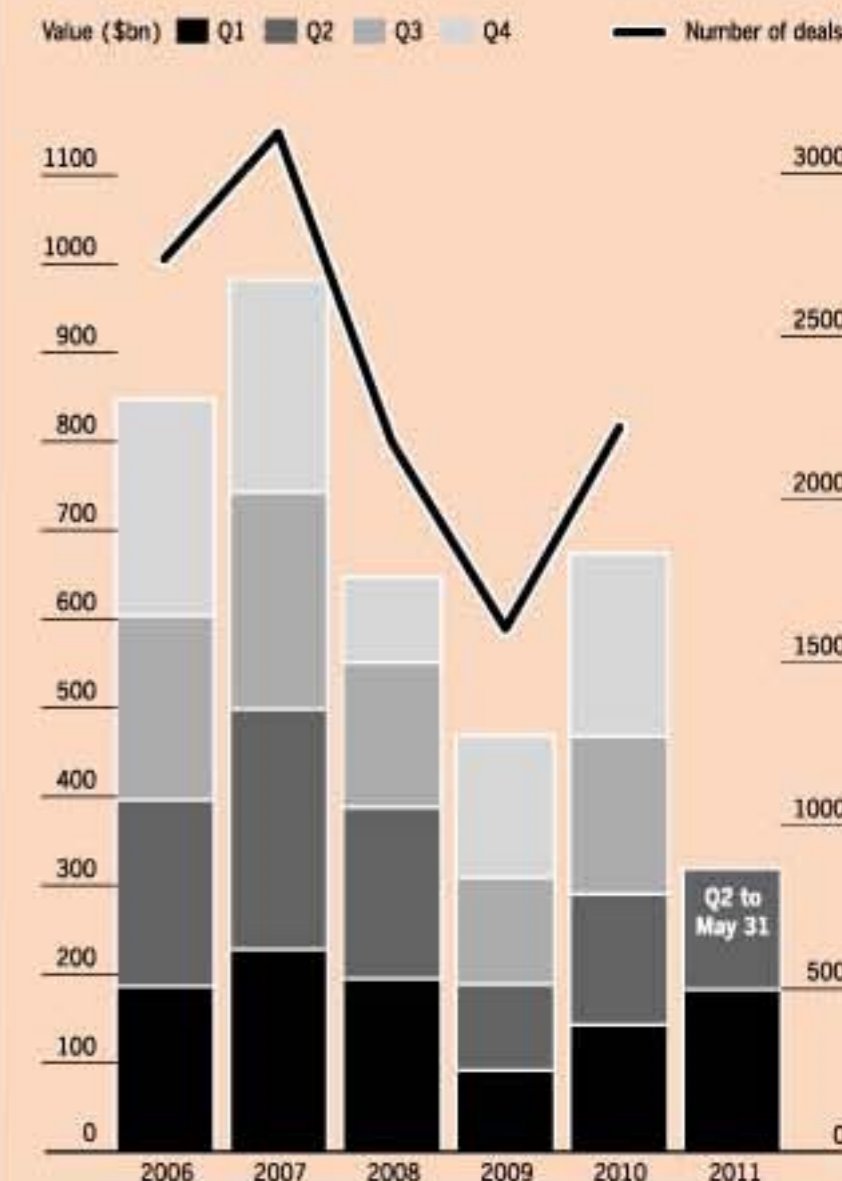
Mr MacDougall says Silverfleet is the busiest it has been for several years. "France and the UK continue to be active for us, and Germany has picked up again in the past few months," he says.

Opportunities could be more attractive in continental Europe. "There is on average a definite gap between the growth prospects of deals in the UK and, say, Germany," says Mr MacDougall. "Would you find it easier to believe the same forecasts from a UK company or a similar German company given the difference in the strength of their domestic economies? You have to take into account the impact of reductions in government expenditure and the levels of personal spending, which in Germany are much less of an issue."

The rise in dealmaking is expected to continue through 2011. KPMG, the professional services

## Global mid-market M&amp;A

Deals from \$100m to \$1bn in value



Source: Dealogic

firm, predicts UK companies will have comparatively larger war chests this year, but bankers note nervousness about the economic outlook as a barrier to deals. Earlier this year, KPMG noted a fall in forward price/earnings ratios, which some see as an indicator of confidence to do deals.

As the recovery in capital markets strengthens and confidence about the economic recovery improves among corporate leaders, the shift could be towards bigger deals.

In April, the global M&A deal count was 3.8 per cent below the same period last year, but announced dollar volume grew 21.4 per cent, driven by an increase of more than 40 per cent for the number of deals valued above \$500m, according to RW Baird, the mid-market investment bank.

In the global middle market, the first four months of the year saw a 7.2 per cent decrease in the deal total and 24.1 per cent growth in dollar volume. In April, the monthly total of transactions dropped 22.6 per cent to 2,096, the lowest since August 2008. However, reported dollar volume increased 38.5 per cent to \$195.8bn. In the mid-market, the transaction total was down 21.5 per cent, whereas dollar value climbed 21.6 per cent.

# Mid-caps hold value for advisers

Competition for mandates leads to increased pressure on fees, writes *Anousha Sakoui*

**C**ATERING FOR MID-MARKET companies is an attractive source of business for advisers. While the peak of the mergers and acquisitions cycle may eventually bring the highly desired mega-cap transactions, in the meantime advisers' bread-and-butter business remains in the mid-market.

While the definition of "mid-market" varies among market participants – from companies of £50m (\$82m) to more than £1bn – it is getting attention for the fees these businesses could generate as they grow.

"[The] preference for most advisers is to get to know companies earlier in their life cycles rather than simply jumping on the bandwagon as momentum builds," says Matthew Judge, director of technology corporate finance at Evolution Securities, the investment bank.

Jon Hughes, who leads the transaction business of Ernst & Young, the professional services group, in the UK, says in order to win mandates in the mid-market it is becoming increasingly important to demonstrate deep sector expertise.

"Cost remains important to clients when seeking advisers, and there are advisers out there that have had to buy work to keep their people busy," says Mr Hughes. "But most buyers realise that 'cheap and cheerful' isn't the way to go, and are instead looking for an adviser to add value."

Some bankers believe advising mid-caps versus large caps differs because in a smaller company the shareholder base is more concentrated and management itself is often a material shareholder. Advisers point to the recent battle for Mouchel, the business services group, as an illustration of the importance that a small number of shareholders can have for the outcome of a deal.

Unlike larger companies that often have in-house M&A specialists, advisers say many mid-cap companies lack the necessary expertise to deal with the demands of being a public company. "Non-executive directors strengthen the team considerably, but advisers bring real current knowledge of the rules and regulations, which can be invaluable – they are perhaps much more integral to the process," says Mr Judge.

The landscape, advisers say, is very competitive. But the crisis has helped reduce the field. "There seem to be fewer players – most advisory firms have slimmed down," says Howard Leigh, senior partner at Cavendish Corporate Finance.

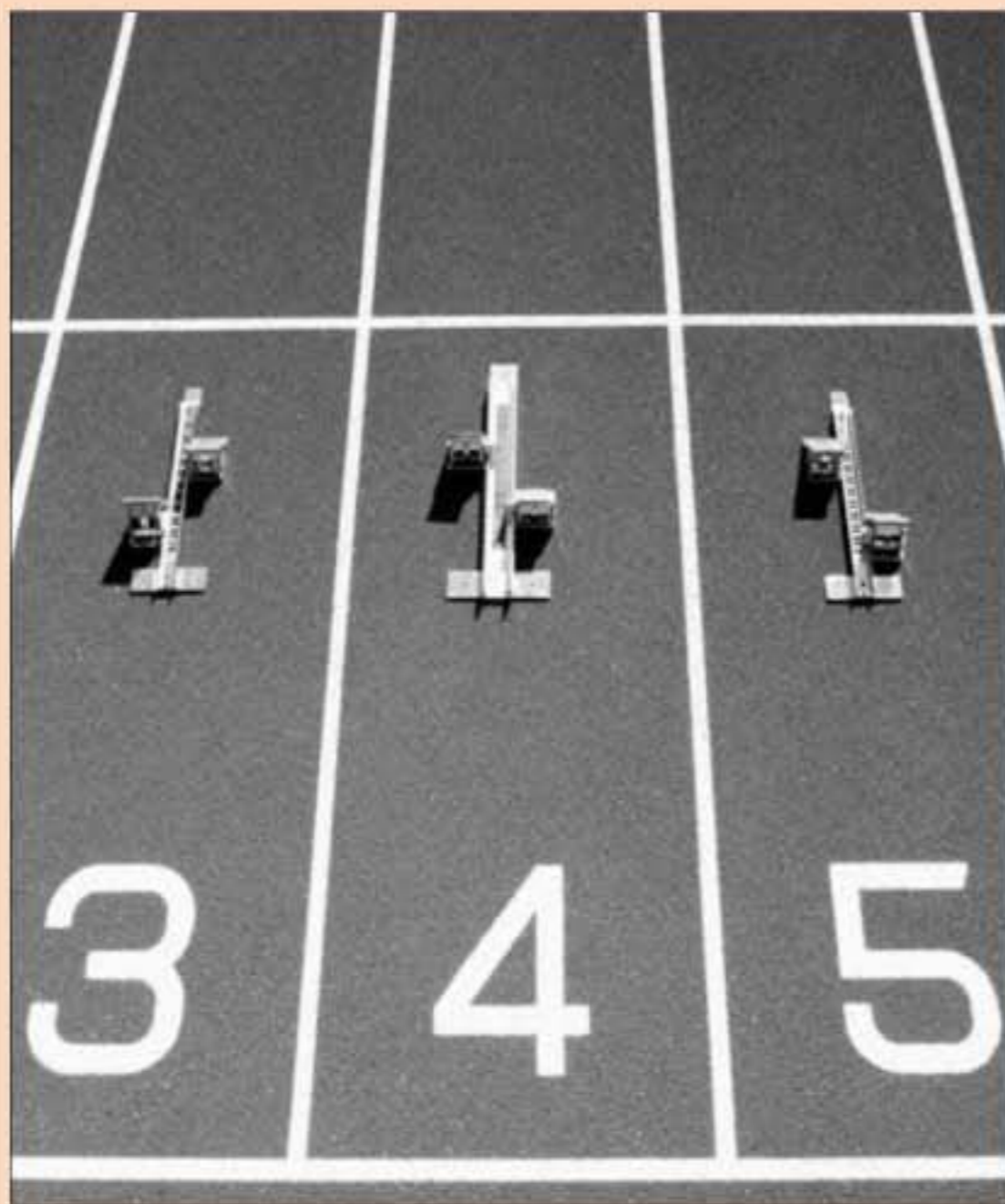
Darryl Eales, chief executive of LDC, the private equity fund that is part of Lloyds Banking Group, believes the dominance of the big four accountancy firms has been reduced.

"There is a greater number of independent boutiques, which have become more proactive," says Mr Eales, who adds that they are more focused on delivery of value from advisers. "In a typical transaction, we give advisers a base-level fee of 1 per cent of the deal value but then give them an aggressive mechanism, which allows them to earn a higher fee if they help us exit above an agreed level. This gives advisers a strong incentive to deliver above the price we are expecting."

However, M&A volumes remain low and bankers say competition has been increasing from the larger investment banks for business with smaller companies. "When markets and M&A are down, two new entrants come into the middle-market advisory community: the investment banks lower their bar in order to grab revenue, and a new wave of boutiques [often set up by bankers seeking new challenges in the downturn] also joins the fray," says David McCorquodale, corporate finance partner at KPMG, the professional services group.

He adds: "As markets pick up, the investment banks chase the larger fish and only the very best boutiques survive. Clients usually demand long-term relationships and want to know that

The race is on: medium-sized companies could generate substantial fees as they grow



their advisers will be there with them through thick and thin."

Some of the new boutiques recently set up include Smith Square Partners and Qatalyst.

**T**HE RESULT, SAY ADVISERS, IS increased pressure on fees. "Corporate clients' readiness to pay fees will depend on the quality of advice and service they receive," says Etienne Bottari, head of corporate finance at Numis, the UK broker. "Corporates are giving greater credence to trusted relationships; they are selective about the deals they wish to pursue and want high-quality advice to ensure shareholder support. This requires an adviser with a strong knowledge and understanding of the company and its strategy, as well as of the mid-market institutional investor base."

But there are still good reasons for advisers to want to assist mid-cap companies, despite

falling fees. "Mid-cap companies are more likely to be doing deals of relatively significant scale [relative to their market capitalisation] and thus require external debt or equity funding – where the ability to earn fees grows," says David Currie, head of investment banking at Investec.

"There is some pressure on fees, but the segment has other rewards from an adviser's point of view – the nature of the relationship with top management, and the greater traction of the advice itself," says David Clasen, executive director at Clasen+Co, the boutique advisory firm. "The mid-market is more ready to accept advisers without a balance sheet. This makes for a stronger relationship with the client, based on quality of ideas and advice rather than as an add-on to skinny loan margins from a reluctant credit committee."

Advisers say the relationships between mid-cap companies and their advisers tend to be closer.

"Clients in the mid-market tend to look for a relationship-based approach with their corporate finance and broker advisers, and will turn to those trusted relationships in an M&A transaction in view of their strong knowledge of the company and the shareholder base," says Mr Bottari of Numis. "In large-cap transactions, M&A advisers can often be brought in on a transaction basis only."

**'Advisers bring real knowledge of the rules and regulations, which can be invaluable'**

PHOTO: GETTY

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# Opening up the mid-market

A rising number of investors are keen to buy into medium-sized companies. By *Daniel Schäfer*

**E**QUITTY CAPITAL FOR SMALL and medium-sized enterprises has long stood in the shadow of the flashy leveraged buy-out world, where investors scrambled in the run-up to the financial crisis to get access to the largest private equity funds.

But those days are over. Investors have turned the spotlight on SMEs and started to pour money into this segment of the equity investment world.

In a recent global private equity survey by Bain & Co, the consultancy, the number of pension funds, endowments, funds of funds and other institutional investors that said they would want to invest in small and mid-market buy-out groups more than doubled from 32 per cent to 65 per cent between mid-2009 and mid-2010. "[Investors] have shied away from the large and mega-buy-out funds and are concentrating instead on middle-market funds," wrote the report's authors.

This was a logical consequence of the financial crisis, which all but shut off the possibility of large buy-out funds pursuing the multibillion-dollar deals they had done in the past, and turned some of the biggest takeovers in the industry sour.

With large buy-out funds no longer dominating the headlines, smaller dealmakers entered the fray. For example, Germany's largest private equity takeover in 2009 was that of Külle, a sausage-skin manufacturer, by Silverfleet, the mid-market specialist from the UK. Only half the €212.5m (\$306.8m) deal was financed through bank debt.

But in spite of recent investor hype around SME investments, growth capital investors say their industry has always had a steady and unspectacular flow of deals. "There is, and always has been, a rich vein of opportunities for people like us who want to invest in growth companies," says Robert Easton, managing director and co-head of Carlyle Europe Technology Partners.

Carlyle's second Europe Technology Partners fund, raised in 2006 with €530m, invests between €20m and €60m in small and mid-cap buy-outs and expansion capital. The fund invests €100m-€150m each year in a handful of takeovers or minority stakes. This year, it has already invested €100m in three companies, and Mr Easton says he would be delighted if he could do one or two more deals.

Private equity managers such as Mr Easton maintain it is a myth that companies with sound business models are struggling to find equity.

"Twelve to 18 months ago, companies were not able to find debt but they were always able to attract equity. So the credit crisis has not affected

## 'I do not have any evidence that established companies have difficulties in finding capital'

what we do as much," he says. "There are companies that do not get funded as they are simply not attractive, but that has always been the case."

Bill Crossan, managing partner at Growth Capital Partners, a UK fund that invests in small companies worth between £5m (\$8m) and £50m, says: "Start-ups might sometimes struggle to find capital, but I do not have any evidence that established companies have such difficulties."

In the UK, their arguments go somewhat against a government-triggered review that in 2009 identified a "market failure" in the provision of growth capital to SMEs. The Rowlands report - which was led by Chris Rowlands, former chairman of 3i, the private equity group, in Asia - identified an equity gap for growing UK companies with a yearly turnover of £10m-£100m and for equity cheques of £2m-£10m. It estimated there were 25,000-32,000 growing or



Middle of the market: private equity managers say medium-sized companies with sound business plans should not struggle to find equity

## 'The Business Growth Fund is a political accident of the financial crisis'

► restructuring UK businesses that might need an injection of growth capital.

These findings led to the creation by five banks of the £2.5bn Business Growth Fund, which aims to take stakes of the size identified as a market gap in the report. However, private equity managers say it will lead to further competition in a sector that is already fiercely competitive.

"The fund is a political accident of the financial crisis. It is essentially headline and vote grabbing," says one private equity executive. "My fear is that in reality their cheques will be bigger and they will end up in the private equity segment with deals between £10m and £30m."

Some industry insiders say the fund comes at a time when already fierce competition for deals risks triggering an overheating of prices. Several funds that were raised in 2005 and 2006 are coming to the end of their investment period but have only deployed 50-60 per cent of their capital.

## Due diligence leads to a heavenly match in the search for investment

**W**HEN ROBIN SHENFIELD, CHIEF executive and founder of The Mill, decided he needed outside capital to fund a further geographic and product expansion of the London-based visual-effects company he founded 21 years ago, he left nothing to chance.

The entrepreneur spent days on the phone to check out the track record of Carlyle Group, the US private equity company he eventually brought in as a growth capital investor.

"I made about a dozen reference calls to chief executives and finance directors of the companies they [Carlyle] invested in to understand how they worked and what their differentiation factor was," Mr Shenfield recalls.

He also wanted to make sure the group would stand by its commitment even if something went wrong. "It would feel rather odd to face a lot of questions in the due-diligence process from an investor and not repay the compliment," he says.

His thorough approach seems to have paid off. Carlyle struck the deal to take over The Mill in February 2007. Since then, it has almost doubled revenues to £74m (\$121m), increased the number of staff from 230 to 625, and managed to keep up its profit margin of more than 20 per cent throughout the recession.

It did so through a combination of rapid expansion in the US, broadening its product portfolio by going into digital advertising and video games, and cost and job cuts when the crisis hit in 2008.

"We managed to keep our feet on the floor during the crisis, building up competence in digital advertising and expanding our footprint in the US," says Mr Shenfield.

He says Carlyle was a good sparring partner from the outset. "They have understood our enthusiasm about the US. Some managers are quite wary about whether UK businesses can succeed in the US, but Carlyle believed in it."

Carlyle also pushed management to do things differently. "When they came in, they asked us very challenging questions, such as: 'Are we moving into digital advertising fast enough?' In 2007, we were not doing any of that, and now it is quite a lot," says Mr Shenfield.

But can a returns-driven financial investor and a creative visual-effects company that produces

"There are plenty of people around with exactly the same problem," says one industry executive.

"In a number of auctions there might be an irrational player - one who will overpay for exactly the wrong reason, which is the need to deploy capital."

But overall, the mid-market for deals is seen to be healthy, not least because the easy days of obtaining debt have not yet come back in this segment of the market.

"In the mid-market deals we have seen, while it is true that leverage multiples have been creeping up and debt is easier to come by, the process is still expensive and, critically, time-consuming," says Nick Hazell, a partner in the private equity team at Taylor Wessing, the law firm.

He adds that with good deals being fiercely fought over, private equity investors are often tempted to fund the entire value of a takeover with equity, at least initially, to be sure of success.

According to Mr Easton, what the credit crunch has changed is that private equity investors can rely neither on simply selling their investments at higher prices nor on the leverage effect. "There is definitely more sector focus and an even larger focus on adding value to the company. Having a concise plan for the company at the outset, and then executing that plan, has become much more important," he says.



Creative business: The Mill did post-production work on this year's Axe/Lynx 'Angels Will Fall' advertising campaign

advertising content for consumer brands be a good match culturally?

The entrepreneur, who still owns a stake in the group, is adamant that in spite of some cultural differences, the chemistry has been right, and there is a common goal: success.

"The key is to not let financial and operational discipline distract you from your core product development," he says.

The Mill used Carlyle's global network to expand rapidly through new offices in Los Angeles and Singapore, and broadened strategic partnerships with advertising agencies and brand owners, which included some of the private equity group's other portfolio companies.

This worked so well that when Carlyle prepared for a sale, Mr Shenfield was happy to accept another private equity owner. In April this year, Barclays Private Equity, the UK buy-out group, bought The Mill for £119m.

*Daniel Schäfer*

# Turning on the taps

There is an abundance of funding available for mid-caps, writes *Robin Wigglesworth*

**B**ANKERS AND INVESTORS may be eyeing indebted western governments with newfound trepidation, but despite the uncertain global economic backdrop, businesses around the world are basking in cheap and abundant funding – not least mid-cap companies.

Subdued central bank interest rates and quantitative easing in the US and Europe have created a worldwide “need for yield” as pension funds, insurers and other bond investors seek higher – or safer – returns than are available from government bonds in these countries.

Along with emerging markets, mid-sized companies have been the significant beneficiaries as investors move down the credit curve and lend to smaller and riskier, but better-paying, businesses – many of which are tapping the public debt markets for the first time.

“Debt capital markets are booming,” says Vis Raghavan, head of international capital markets at JPMorgan, the investment bank. “We haven’t seen liquidity like this for a long time, and it’s across the spectrum. The driver is a quest for yield.”

Bond markets have often been the preserve of larger corporate names, while smaller companies, particularly in Europe, have traditionally relied on local banks for the bulk of their external financing. However, the wounds inflicted on many lenders by the financial crisis – coupled with ongoing uncertainty over regulatory changes – have made bank borrowing more

difficult, spurring many small and medium-sized enterprises to the bond market.

For example, Iliad, a French telecommunications company, in May tapped the bond markets for the first time, selling a five-year €500m (\$729m) bond that carried a modest 4.875 per cent coupon despite the lack of a credit rating.

“It’s part of a secular trend in Europe, which is becoming more like the US, where bonds play a bigger role in company funding,” says Jean-Marc

**‘There’s just so much liquidity, you wouldn’t believe there are still lingering economic concerns’**

Mercier, global head of debt syndicate at HSBC, the banking group.

Investors have also become more amenable to smaller bond sales. Bankers now frequently see deals of £100m (\$164m) from new issuers, according to Mr Raghavan.

“The quest for yield means that most deals can be done – at the right price. There’s just so much liquidity, you wouldn’t believe there are still lingering economic concerns,” he says.

While smaller companies are often considered riskier, investors have been heartened by a drop in the overall global corporate default rate. So far, only 15 companies have defaulted this year, down from a total of 82 last year and a record high of 265 in 2009, according to Standard & Poor’s, the credit rating agency.

**A**S A RESULT, COMPANIES IN THE US and Canada have sold more than \$114bn of non-investment grade (also called high-yield or junk) bonds so far this year. This is a 44 per cent increase over the same period in 2010, according to Dealogic, the data provider. European companies have sold more than \$55bn of high-yield bonds this year, almost a doubling of the volume from the same period last year.

Non-investment-grade companies across the world, many of which are SMEs, have sold more than \$214bn of bonds this year, according to Dealogic. Despite some recent jitters, the market looks set to beat last year’s record of \$369.8bn.

Still, although the volume of high-yield issuance has increased, bankers say what was widely touted as a potential seismic shift of smaller, private companies eschewing banks for bonds has disappointed somewhat.

“The bank-to-bond revolution hasn’t materialised to the extent that some people envisaged,” says Jonathan Brown, head of bond syndicate Europe at Barclays Capital, the investment bank. “We’ve seen more new companies come to the market but it’s hardly been a revolution, and European banks seem now to have a renewed appetite to lend again.”

**I**NDEED, WHILE LENDERS IN SOME countries have continued to remain cautious – most notably in the UK, where net lending to companies has dipped, according to Capital Economics, the consultancy – there are signs that banks are becoming more active.

In Europe, private sector lending growth inched up to 2.6 per cent in April, and syndicated loans are up – at \$345bn so far this year – by 11 per cent compared with the same period in 2010, according to Dealogic. In the US, the volume of syndicated loans has almost doubled, to \$642bn, compared with the same period last year.

While syndicated loans are usually the preserve of large companies, the increase is an indication of improving liquidity in banks.

“After a move towards bonds in the midst of the financial crisis, the bank market is becoming more active again for many of these companies,” says Tomas Lundquist, head of European corporate debt capital markets for Citigroup, the US bank.

Many companies are also turning to the private placement market, a discrete halfway house between banks and bond markets where investors – often pension funds and insurers – channel funds directly into unlisted and unrated companies through bespoke lending agreements.

**Mid-sized companies are now tapping public debt markets for the first time**



The private placement market is opaque, as its name indicates, but Barclays Capital estimates that almost \$41bn of deals were struck between investors and companies last year, almost double 2009’s total and the highest since 2003. The sizes of deals range from \$50m to \$1bn, but typical facilities are about \$200m.

“It’s now one of the most buoyant times for privates we’ve seen for a while,” says Angus Wheelchel, director in the private capital markets team at Barclays Capital.

US companies have been the dominant borrowers and lenders on the private placement market, but some European insurers are becoming more active. European companies made up much of the \$18bn of non-US borrowings last year.

Mr Wheelchel says many of these European companies have been taking advantage of the “very aggressive” pricing in the private placement market, which is denominated in US dollars, by swapping the proceeds into sterling and euros.

The *Schuldscheindarlehen* market, a German version of the US private placement market, dropped sharply last year as many German and Austrian mid-sized companies turned to the bond market, but HSBC expects the market to stabilise at about €5bn this year.

Yet for all the debt market’s current vim, bankers and economists say mid-sized companies remain reluctant borrowers, given the halting global recovery. While financing may be readily and cheaply available, many companies still have the financial crisis fresh in mind, and prefer to rely on internally generated funds for expansion.

**Companies are turning to the private placement market – between banks and bond markets**

## It is a turbulent time to go public

Price disagreements and volatility are to blame. By *Robin Wigglesworth*

**T**HE VIBRANT INTERNATIONAL corporate bond markets stand in sharp contrast to the turbulent equity markets. It has made for a mixed year for initial public offerings.

On the one hand, global IPO activity has remained relatively steady overall, with more than 500 companies raising in excess of \$93bn by the end of May, a gain of 9 per cent compared with the same period last year, according to Dealogic, the data provider. US exchanges have benefited from a rash of listings by private equity-owned companies, while Asia has continued to churn out well-received IPOs.

However, bankers have been left a bit frustrated. Hopes of an increasingly sharp IPO resurgence – fuelled by a strong end to the year in 2010, when a total of \$281bn was raised, the most since 2007 – have been dashed.

“At the start of the year there were high expectations all round, but it hasn’t really turned out the way we hoped,” says Adam Welham, head of European equities syndicate at Barclays Capital, the investment bank.

There have been several IPOs of large or well-known companies this year, such as the \$11bn London listing of Glencore, the commodities trader, and LinkedIn, the business

networking website, which soared when it first started trading. However, mid-sized and more obscure companies have had a harder time.

“IPOs by small and mid-sized companies have on the whole been pretty challenging,” says another senior banker. “Deals are getting done, but not as many as we’d hoped.”

Bankers attribute the disappointing IPO market to a combination of stock market volatility and the unrealistic pricing of many companies.

The Vix index, which measures the implied volatility in the S&P 500 and is often known as Wall Street’s “fear gauge”, currently hovers near pre-financial-crisis levels. However, investors have still been perturbed by unexpected events such as the earthquake in Japan, the wave of unrest in the Middle East and Europe’s sovereign debt crisis.

The senior banker argues: “You can do IPOs when markets are rising, you can do IPOs when markets are falling, but they become very hard when markets are as volatile as they are now.”

Investor uncertainty has been compounded by disagreements on pricing. Small and mid-sized enterprises are often owned by entrepreneurs, families or other investors unwilling to accept any price, while investors have proved loath to risk even a short-term decline in their investments – leading to a stand-off. Russian Helicopters had to postpone its \$500m joint London and Moscow listing after investors did not accept the touted price.

Mr Welham says: “Investors are still happy to look at anything as long as they understand the story and like the valuation. But that’s the rub – there have been quite a few companies that, in hindsight, may have chosen to do things slightly differently.”

# The cloud has a silver lining

Remote access computing has helped boost the recovery in tech-sector mergers and acquisitions. By *Paul Taylor*

**T**HE US TECHNOLOGY mergers and acquisitions market has shown a remarkable rebound since the beginning of the year. With strong demand for technology initial public offerings, some commentators are already talking of a bubble.

During the first five months of the year, dealmakers announced 851 transactions with US technology companies as the target, together valued at \$54.7bn, according to Dealogic, the data provider. Another 108 deals targeting US-based telecoms companies totalled \$80bn.

M&A spending in the US technology sector is running at its fastest pace for four years. In the same period last year, deals targeting technology companies in the country came to \$32.6bn, with telecoms companies adding \$27.9bn.

In part, the figures reflect the return of the "big deal". For example, Microsoft committed to pay \$8.5bn last month for Skype, the internet telephone company. In the US telecoms sector, AT&T's proposed \$39bn bid for Deutsche Telekom's T-Mobile USA unit – the biggest telecoms deal since 2006 – was announced in March and is now subject to scrutiny by regulators. There have also been 21 other deals in the telecoms and technology sectors valued at more than \$1bn so far this year.

However, as the number of deals of less than \$1bn tracked by Dealogic in the first five months of this year indicates, the rebound in M&A activity is broad-based and includes a growing number of mid-market participants. There were 548 transactions of less than \$1bn involving a technology company as the target, acquirer or divestor (a technology company was the target in 462), according to Dealogic. Among the more interesting deals, SuccessFactors, the human resources software group, agreed to pay \$290m for privately owned Plateau Systems, a provider of web-based software tools for business.

The technology practice of Ernst & Young, the professional services group, attributes the upturn to the increasing interest in cloud computing (the use of technology to access remote computing power and data over the internet), software as a service (SaaS), social networking, mobile communications and information security.

E&Y's quarterly global technology M&A update for the first quarter of 2011 noted that these factors encouraged companies to conduct "a larger number of smaller, strategically focused deals in the first quarter, continuing a trend that began last year".

"These trends speak to the rapid pace of change driven by the cloud, social networking and smart mobility, and the ways in which technology is becoming an increasing part of everyday life – not just something we do while at work," says Joe Steger, global technology transaction advisory services leader at E&Y.

"On the business side, the trends reflect that information is becoming a larger component of the value of all products and services," he adds. Indeed, E&Y estimates that non-technology companies accounted for 15 per cent of the quarter's total value in disclosed-value deals, demonstrating that information technology is blurring into other industries more and more.

In the US, as elsewhere, companies continued to make multiple small acquisitions and weave them together to address strategic business initiatives.

"This was evident, for example, among internet companies, which acquired multiple social-networking companies, and among established software and SaaS companies, which bought multiple SaaS companies," says Mr Steger.

Further examples of this pattern were software and SaaS providers purchasing social networking companies to add social functions to enterprise

applications or advertising/marketing platforms. Salesforce.com, the web-based customer management software provider and a SaaS pioneer, announced in March that it would pay \$326m for Radian6, a Canadian social media monitoring company, having recently completed its \$31m purchase of Dimdim, a web-conferencing start-up.

"Overall, this pattern enables buyers to maintain their competitiveness or extend their strategies in the face of rapid technology innovation, while ... capitalising on current and evolving trends," says Mr Steger. "However, given the rapid pace and competitive nature of these deals, it still demands rigorous deal valuation, structuring, due diligence and integration."

Cloud computing was the driver behind dozens of deals, including several of the largest. Telephone and cable network operators acquired services companies with large data centres to build up their ability to provide these services. Among the most significant, Verizon Communications paid \$1.4bn for Terremark Worldwide and Time Warner Cable paid \$230m for NavSite.

In addition, two deals involving acquisitions of storage systems suitable for use in cloud-computing data centres made the list of the quarter's top 10 deals by dollar value. Many smaller cloud deals involved adding cloud-based functions to existing applications or services.

**A**MONG TECHNOLOGY COMPANIES targeting the expanding market for "big data" analytics, Hewlett Packard agreed to pay about \$275m for Vertica Systems in February and Teradata acquired Aster Data Systems for \$295m in March. Those deals came nine months after EMC, the storage market leader, paid an estimated \$400m for Greenplum. EMC has also boosted its security management capabilities by buying NetWitness in a deal believed to be worth up to \$500m.

The top 10 deals also included three semiconductor deals that brought together makers of chips for mobile phone technologies and chip makers that produce devices for WiFi, WiMax, Bluetooth, GPS and other wireless communications technologies. The largest was Qualcomm's \$3.2bn purchase of Atheros Communications, but there were half a dozen smaller transactions.

Among a string of e-discovery (the recovery of electronic data, often for legal purposes) deals, Autonomy completed the \$390m acquisition of Iron Mountain's digital assets earlier this month, while Symantec, the security software and services market leader, acquired Clearwell Systems.

The use of internet and mobile video began to soar in 2010 for entertainment, business conferencing and personal use, and technology companies are responding by acquiring strategic video technologies. Cisco acquired Inlet Technologies, a video-encoding provider, for \$85m. In fact, video deals were apparent in every sector during the first quarter. Deals involving chips for video image processing were done in the semiconductor sector, for video transmission optimisation technologies in the communications equipment sector, and for video-on-demand services in the internet sector.

E&Y argues that the momentum behind global technology M&A growth suggests a strong 2011. It also notes that technology companies have the fuel they need to increase spending in this area. On aggregate, the cash and investments held by the sector's top 25 companies grew to \$544bn by the end of the first quarter.

**'Information is becoming a larger component of the value of all products and services'**

**Blue skies in sight: mergers and acquisitions spending in the US technology sector is running at its fastest pace for four years**

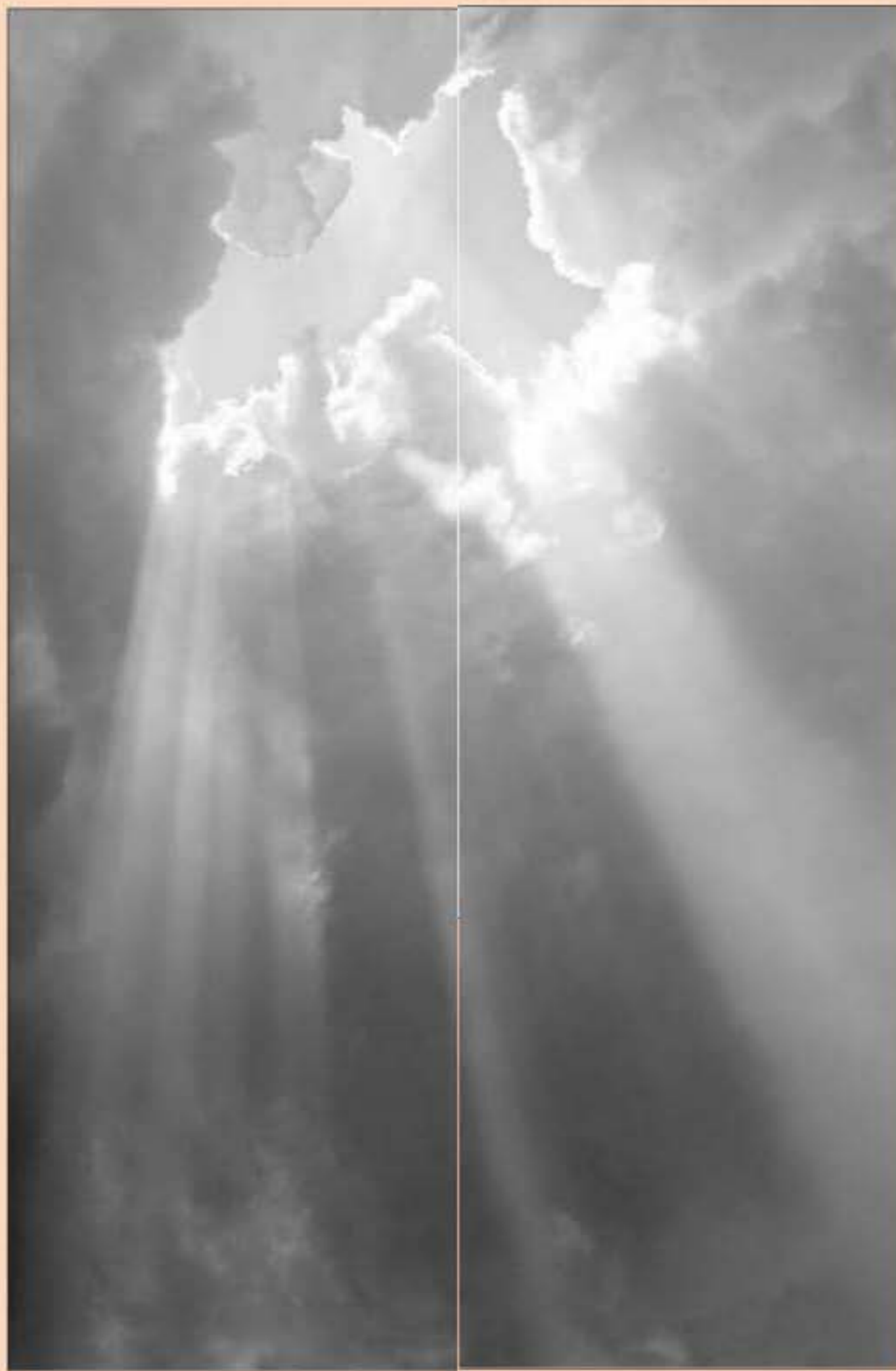


PHOTO: GETTY

**Paul Watters** Europe's favourable default environment is unlikely to last



**J**UDGING BY THE IMPRESSIVE rebound in earnings and cash flow of larger corporations in Europe, it is tempting to assume credit quality is only going one way. Yet beneath the surface, the leveraged-finance market remains burdened by legacy issues in the form of significant refinancing risk. This is the result of the relaxation of credit standards from 2005 to 2008, as lenders' focus shifted from the ability to repay debt from cash flow to the interest-only model. This was based on the false premise that lenders would always be willing and able to roll existing debt over.

Last year, most larger European companies, streamlined after tough cost savings, saw a sharp increase in earnings and free cash flow despite often-modest sales growth. Measures including record low interest rates and quantitative easing stabilised most European economies. Demand from newly industrialised countries and emerging markets also boosted exports.

In 2010, Standard & Poor's saw only 28 European speculative-grade companies (those with public long-term ratings or private credit estimates of "BB+" and below) default on €18.1bn (\$26.1bn) of debt. This was a sharp fall from 103 companies that defaulted on €62.4bn of debt in 2009. As a result, the default rate for such companies, having peaked at 14.7 per cent in the third quarter of 2009, ended 2010 at 3.8 per cent, back below its long-term average of 4 per cent.

That means that in the 2006-10 period (which includes the recession), 22.6 per cent of the roughly 750 sub-investment grade, mostly private, companies that S&P tracks experienced a default. However, several cyclical sectors, such as high technology, vehicles, property, building materials and retail saw cumulative defaults pass 30 per cent.

Can today's low level of defaults persist? In the absence of default triggers and while the ability to service interest continues, it is likely to stay

## The willingness of banks to retain exposure to leveraged corporates will remain constrained

relatively low in the short term. But the level may not fall as far as some people expect, as some companies may seek to restructure sooner rather than later.

However, given S&P's estimate that about €415bn of debt needs to be refinanced between 2011 and 2017, with about €100bn due in both 2014 and 2015, it is doubtful that the default outlook will be as benign in 2012.

First, a number of sub-investment-grade companies could struggle to refinance maturing debt. There are limited options for injecting additional equity and concern over the willingness of banks, or the ability of institutional investors, to refinance highly leveraged companies.

From a debt perspective, the willingness of European banks to retain balance-sheet exposure to large and mid-sized leveraged corporates will remain constrained in the longer term, due to rising capital charges, high wholesale funding costs and scarcity of capital. In February, the European Central Bank's survey of small and medium-sized enterprises' access to finance in

## Can today's low level of defaults persist? It is doubtful

the euro area showed banks were generally unwilling to provide loans. Terms and conditions also worsened slightly.

The need to refinance bank loans has driven the resurgence of the European high-yield market. So far this year, 45 issuers have tapped the high-yield bond market for refinancing, of which at least 21 have refinanced bank debt amounting to €8.3bn, recent data show.

In the absence of rehabilitation in the collateralised loan obligation market, structured credit investors are not expected to have much ability to support refinancing.

**T**HE SECOND REASON WHY THE default outlook is unlikely to remain favourable, is that many companies show weak credit characteristics. Of 750 companies that S&P monitors in the European leveraged-finance market, roughly 270 – mostly privately loan financed – were viewed as having very weak corporate credit profiles (B- or lower) at the end of 2010. Many of these companies, particularly smaller ones, are unlikely to find a financing solution. They will be subject to a more critical credit-appraisal process when a trigger event arises.

There are three potential triggers for an early start to restructuring (even without a missed payment or bankruptcy filing): a breach as financial covenants tighten; a request for additional debt financing to support working capital, inventories or capital investment; and going-concern issues arising a year or so ahead of debt maturing.

Raising additional equity to repay debt would, in most cases, be the ideal solution. The initial public offering market has been unresponsive to aggressively financed, low-growth companies, but trade sales, such as that of Cognis, the German chemicals manufacturer, to BASF, the world's largest chemicals group, and secondary buy-outs, such as the sale of Mivisa Envases, the Spanish can manufacturer, to Blackstone, the private equity firm, remain potential solutions.

Existing shareholders investing additional equity is more problematic, as it is often difficult to justify doing so to redeem debt at par.

The upshot is that although the near-term default outlook is expected to remain good in 2011, there is likely to be a pick-up in balance-sheet restructurings next year as highly leveraged, vulnerable companies find senior lenders unwilling to carry legacy loan exposures for much longer without a viable plan to stabilise the capital structure. The default rate could return to the 5.5-7.5 per cent range in 2012 and remain there in 2013.

While the hangover from the 2006-08 leveraged-finance boom looks set to continue, lenders might consider the shift towards interest-only debt servicing and its implications for leverage over the course of the economic cycle.

*The writer is senior director and head of corporate research at Standard & Poor's, the credit rating agency*

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