Cameron Partners Insight Series

Recent Developments in Mergers & Acquisitions and the Credit Crunch

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Introduction

Our September 2007 Insight Series paper reviewed and analysed global and New Zealand M&A trends. Our paper highlighted:

- The acceleration of global M&A activity between the calendar years 2002 and 2006.
- The similar acceleration of M&A activity in New Zealand over the same period.
- The strong forces driving these trends (globalisation of trade, liberalisation of formerly closed economies, the progressive integration of world capital markets, the ICT revolution and the rise of private equity).
- The impact of these forces at the regional level which is leading to a much closer integration of the Australian and New Zealand economies and is driving much of New Zealand's M&A activity.

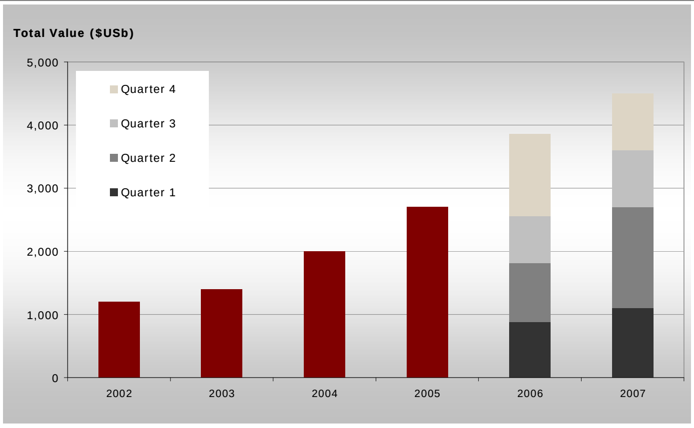
It also noted that an additional boost to New Zealand's M&A activity has been provided by 'baby boomer' owners in the mid-market addressing succession challenges or crystallising their wealth through selling their businesses. The paper also analysed the type of M&A transactions and the industries in which such activity had been concentrated and noted the increasing role of private equity. We concluded that these trends would continue.

Since we released our previous Insight Series paper, Western economies have experienced a severe financial crisis and a 'credit crunch' which is significantly affecting the business environment and economic activity. This Insight Series article examines how these recent developments have been affecting global and New Zealand M&A activity and considers the outlook.

Global M&A Activity

Global M&A activity continued to rise through 2007, hitting US$4.5 trillion for the calendar year compared with US$3.8 trillion for 2006. However, as *Figure 1* below shows, M&A activity slowed markedly in the 4th quarter of 2007 and at US$0.9 trillion was considerably less than that of the 4th quarter in 2006 (US$1.3 trillion).

Figure 1: Global M&A Activity (By Value)



Source: Thomson Financial

The slowdown was concentrated in private equity M&A activity. An article in the latest McKinsey Quarterly[1] presented data showing that, in the 11 months of 2007:

- The volume of private equity M&A deals fell by 51% in the second half of the year.
- The volume of corporate M&A in same period, on the other hand, rose by 4% compared to 2006.

In the same article the authors noted that:

- Cross border M&A now represents 40% of global M&A activity, compared to 20% in 2002.
- M&A activity among companies in emerging markets such as India, China, and the Middle East has increased significantly. These companies are increasingly establishing themselves as both buyers and sellers and overall represent around 15% of global M&A activity.
- 'Mega deals' (those with a value greater than US$10 billion) contributed 30% of the volume of the deals (above the 10 year average of 20%).
- Hostile takeovers contributed to 12% of total deal volumes compared to the 10 year average of 3%.

This data highlights that:

- M&A activity continues at high levels, albeit at a more subdued rate of growth.
- This activity is being driven by the powerful structural forces identified in our previous Insight Series paper. The high proportion of cross border deals is evidence of these forces – particularly the integration of world capital markets and the impact of the ICT revolution on regional and global scale economies.

[1] "Deal making in 2007: Is the M&A boom over?" (2008 Number 1, The McKinsey Quarterly) by Antonio Capaldo, Richard Dobbs and Hannu Suonio.

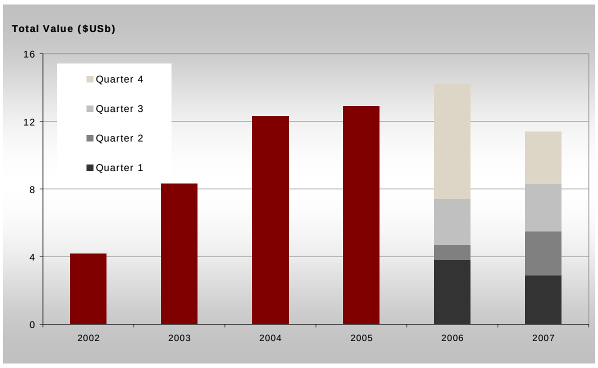
- These same forces are leading to an increasing participation in global M&A activity by companies from emerging economies.
- Private equity M&A activity dropped in the second half of 2007 as the impact of the credit crunch on the cost and availability of debt funding took effect.

New Zealand M&A Activity

M&A activity in New Zealand continued to rise through until the 3rd quarter of 2007. The volume of transactions rose through the year with the total volume of transactions in 2007 considerably exceeding (48% higher) the number of transactions in 2006.

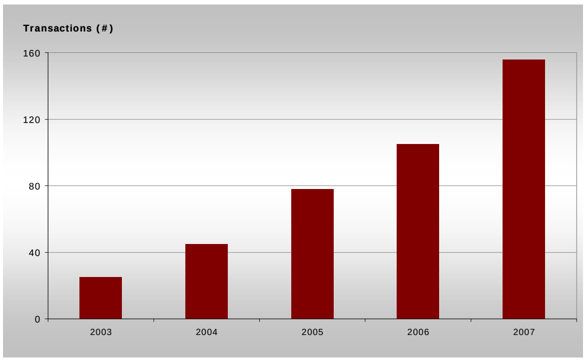
However, the value of M&A activity declined sharply in the last quarter of 2007 as transaction funding tightened. *Figure 2 and 3* below suggest that tightened funding had a greater impact on larger transactions but smaller mid-market transactions continued to flourish. This is consistent with our own direct experience in the New Zealand M&A landscape.

Figure 2: NZ M&A Activity (By Value)



Source: *Thomson Financial*

Figure 3: NZ M&A Activity (By Volume)



Source: *Cameron Partners M&A Database*

In our previous Insight Series paper we highlighted that, in 2006, the majority of transactions (around 67%) were the result of industry consolidation. To an even greater extent this has also been the case in 2007. Industry consolidations represented around 85% of transactions in 2007.

Once again, nearly all industry groups experienced consolidation M&A activity to a greater or lesser extent. We note that the Financial & Professional Services sector experienced a significant increase in activity in 2007. The volume of transactions in this sector more than tripled between 2006 and 2007, accounting for close to a quarter of all transactions in 2007.

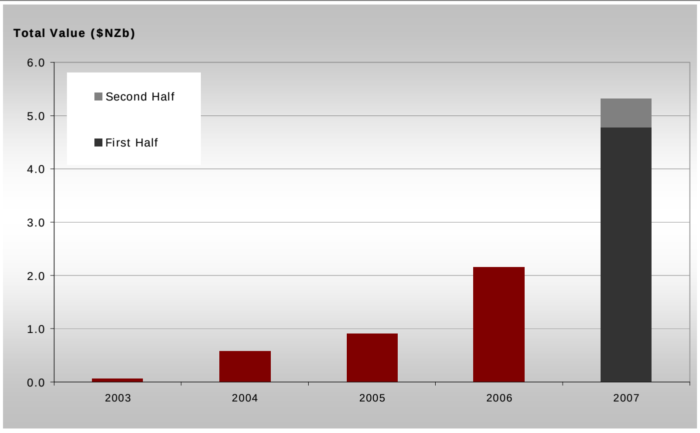
As predicted in our previous Insight Series paper, private equity has increasingly participated in consolidation transactions, often acquiring ‘bolt-ons’ to attach to previous platform acquisitions. For example, three recent bolt-on acquisitions include:

- Next Capital's acquisition of Nutra Life.
- Crescent Capital Partners' acquisition of Brandlines.
- Pacific Equity Partners' pending acquisition of Brinks Chicken.

Private equity transactions by value increased dramatically between 2006 and 2007. However, we note that the majority of the transactions (by value) occurred in the first half of 2007, for the most part a result of the Yellow Pages and Independent Liquor transactions (over $2 billion and $1 billion in value respectively).

Figure 4 below illustrates the dramatic decrease in the value of private equity transactions in the second half of 2007, a result of the heightened cost of, and reduced availability of, debt funding. When combined with the observation that $3 billion of the transactions in the first half of FY07 was from two one-off deals, the size of which are unlikely to be repeated in the current environment, it suggests levels of private equity activity in the current year are likely to revert back to around the 2004/05 level. Anecdotally, it would also be our observation that current level of debt funding being offered into transactions is somewhat similar to that evidenced in 2004/05.

Figure 4: NZ Private Equity Transactions (By Value)

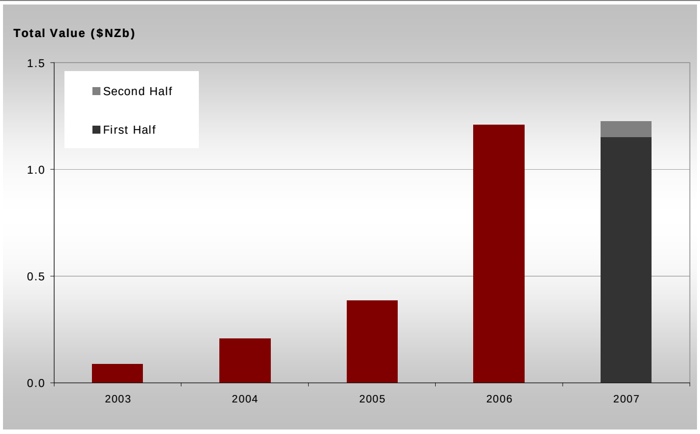


Source: Cameron Partners M&A Database

As noted in our September Insight Series paper the amount invested into private equity (and venture capital) between 2003 and 2006 increased significantly. However, this investment levelled off in 2007. Our data suggests this is likely to be a result of:

- The much greater use of leverage (versus equity) by private equity firms in the first three quarters of 2007 compared to average levels in 2006.
- The dampening impact of the credit crunch on M&A activity generally in the last quarter of 2007.

Figure 5: NZ Venture Capital and Private Equity Activity

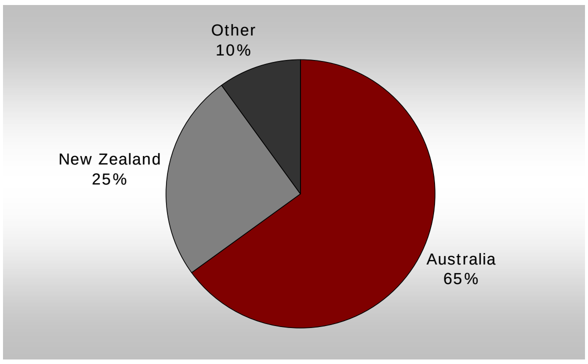


Source: The New Zealand Venture Capital & Private Equity Monitor – NZVCA and Ernst & Young

Our previous Insight Series paper highlighted that the overwhelming majority of private equity transactions, both by value and volume, were undertaken by Australian players. In 2007, Australian private equity players continued to be the most prominent acquirers in New Zealand, both by value and volume.

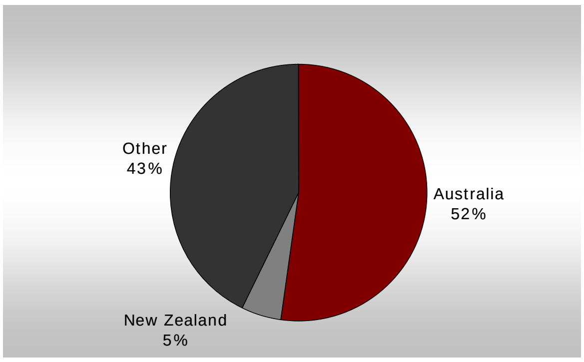
- New Zealand private equity players have typically participated in smaller low value transactions.
- Australian private equity players have participated in a broad spectrum of transactions by size and type.
- Non Australasian private equity players have participated in relatively few transactions but accounted for almost half of transactions by value; a direct result of the Yellow Pages transaction (over $2 billion in value).

Figure 6: Source of Private Equity in 2007 (by Volume)



Source: Cameron Partners M&A Database

Figure 7: Source of Private Equity in 2007 (by Value)



Source: Cameron Partners M&A Database

In 2007, private equity was a prolific acquirer in the Food & Beverage sector, continuing the trend evidenced in 2006. Private equity M&A in the Food & Beverages sector comprised around a quarter of all the private equity transactions in 2007. Other targeted sectors included Services, Retail and Construction & Engineering.

The Outlook and Implications

The structural forces and regional influences outlined in our September Insight Series paper continued to drive M&A activity in New Zealand during 2007. This is evidenced by the:

- Overwhelming proportion of consolidation transactions in 2007 (85%).
- Continuation of M&A activity in the unlisted mid-market space (SMEs).
- High level of activity among Australian based acquirers.
- Increasing number of bolt-ons being attached to previously acquired (standalone) 'platforms'.

Recent M&A activity has been significantly affected by the credit crunch. The credit crunch has reduced the availability, and increased the cost, of debt funding for acquirers generally and particularly private equity.

We expect the credit crunch and the time taken for vendors in the unlisted sector to adjust their value expectations (in response to the higher cost of capital and the forthcoming economic downturn) to continue to have an impact on M&A activity in the immediate future.

Nevertheless, we expect M&A activity to soon recover and resume its secular trend for the following reasons:

- The continuation of the structural forces highlighted in our September Insight Series paper.
- The emerging economic downturn placing pressure on firms to consolidate to capture scale benefits necessary to remain competitive and profitable.
- The reduced availability of bank funding and the economic downturn which will see a significant increase (in the SME sector) of distressed sales and owners seeking capital partners to recapitalise their businesses.

Private equity firms in the Australasian region will remain well-funded and active, notwithstanding the reduced levels of leverage available to them. Many of the players have already acquired platforms in, and/or developed in depth knowledge of, 'under-consolidated' industries. They will resume and continue to increase their active role in New Zealand M&A activity. Given the significant drop in the market capitalisation of many NZX listed companies, we expect that more of this activity will be directed to 'public to private' transactions in line with global trends.

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