

The Metrics of Mergers & Acquisitions

PART III

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Part I of this three-part series addressing the Metrics of Mergers & Acquisitions (see *CGI* March 2007), defines some commonly used M&A terminology; highlights some of the factors that are driving today's active M&A market; and discusses some of the factors that drive the M&A metrics involving public company transactions. Part II, focuses on some of the additional factors that influence private company transaction metrics and illustrates why the determination of a good purchase multiple is ultimately in the eyes of the beholder (see *CGI* May 2007). This final installment of the series drills down further into some of the specific factors we see driving the current market for mergers and acquisitions within the gases and welding supply distributor base.



THE DRIVING FACTORS

When asked about the factors that drive M&A activity in general and within a particular industry, I typically group them into three categories: Supply Side Factors; Demand Side Factors; and Market Factors.

Supply Side Factors — There are many factors that drive the “Supply” of businesses that are “for sale” or that would consider selling at any given point in time. Among the most common drivers of Supply are:

- **Demographics** — As the economies of countries develop, new industries are often born and many new businesses are formed within these industries at the same time. Therefore, as the industries continue to evolve, succession from one generation to the next often occurs in waves, and the statistics indicate that with each successive generation, a sale outside the family becomes more likely.
- **Industry Trends** — Within every industry, trends occur over time that either promote or suppress consolidation. For example, industries that are subject to increased regulatory scrutiny often find themselves in periods of increased consolidation. For the small business owner operating in these industries, the minimum costs of “opening the doors” each day continue to escalate, often to the point where it is simply not economical to continue to run the business at its present size. That owner is faced with the dilemma of GROWING, SELLING or DYING.
- **Tax Conditions** — As I mentioned in Part II of this series, what *should* matter most to a business owner selling his or her company is the after-tax proceeds that are generated by the transaction, not the purchase price. Therefore, expectations regarding anticipated tax changes can play a role in the timing of the sale of a business.

Demand Side Factors — In order for there to be a market for mergers and acquisitions, there must be buyers as well as sellers in the marketplace (*i.e.* Supply and Demand). There are many factors that drive the number of prospective buyers in the market at any given point in time. Among the most common drivers of Demand are:

• **Industry Trends** — As mentioned above, trends occur within every industry that either promote or suppress consolidation. For example, technology is one trend that can drive the demand for acquisitions within any industry. As companies make major investments in new technologies, the payback on these investments can be accelerated if the technology can be implemented across a broader revenue base.

- **Shareholder/Investor Pressures** — Whether for the right reasons or not, pressure from shareholders and investors often drives the demand for acquisitions. This is especially true when the market conditions for M&A are strong (see below). Strong market conditions can create a frenzied mentality of needing to “keep up with the Joneses” in making acquisitions.
- **New Players Entering a Market** — As industries mature and economic cycles change, new categories of buyers often enter into the M&A equation within particular industries. For example, many “old economy” industries that were considered too mundane for most private equity investors in the technology days of the 1990s are now looked upon quite favorably by many investors, given their typically strong recurring revenue models and asset intensive nature.

Market Factors — Within every economic and political cycle, there are general market factors that influence M&A activity on both the Supply Side and the Demand Side. Among the most influential factors in this area are:

- **General Economic Conditions** — The strength of the general economy, and certainly within an industry sector, can play a significant role in the pace of mergers and acquisitions. On the Supply Side, most sellers know that they should sell when times are good, as this typically means that revenue and cash flow are at their peak. On the Demand Side, strong economic times usually mean that companies build up cash on their balance sheets, cash that can be used to fund acquisitions as a means of growth.
- **Capital Markets** — The term Leveraged Buy-Out (LBO) first gained notoriety in the 1980s when the “corporate raiders” of the day were seen by many as villains. What that era highlighted for many investors, however, was the power that leverage (*i.e.* the ability to fund a large portion of an acquisition with borrowed money) can have in improving the return on equity invested in an acquisition. When lenders are willing to provide a significant amount of the funds needed for an acquisition, the amount of equity required to complete the acquisition is reduced, the risk to the equity sponsor is lower, and the return on equity is typically increased. This so-called “leverage effect” can increase the number of potential bidders for any target, and can also have the effect of driving up valuations. This is especially true when capital is both readily available, and relatively “cheap” (*i.e.* interest rates are good).

THE DRIVING FACTORS FOR GAWDA DISTRIBUTORS

Given that so many of the readers of *CryoGas International* are

owners or managers of gases and welding supply distribution businesses, we thought we would use this final installment of the series to address this market segment in anticipation of my presentation at the GAWDA Annual Convention in San Francisco in September. As we continue to build our M&A experience and knowledge in the industrial, medical and specialty gas distributor market, we see a number of common factors that are driving M&A activity within this particular market segment.

Supply Side Factors — On the supply side, the most common driving factors are:

- **Demographics** — Like many industries that flourished in the decade following World War II, the industrial gas and welding supply industry has a “boom” of second generation owners that currently are, or soon will be, considering their succession plans. With this generation of owners, who generally had children later in life, but are considering succession earlier than their predecessors, the next generation is simply not ready, or not interested in taking on the burden of ownership. As such, a sale to a third party often becomes the most viable option for succession.

- **Industry Trends** — There are a number of trends occurring in the industry that are challenging the economic viability of the small and medium sized independent distributor. Among the more pressing factors in today’s environment are:

- **Product Supply and Pricing** — Availability and pricing of product is becoming an increasingly difficult challenge for not only the small distributor but for all distributors. Shortages of helium, argon, and nitrogen (in some markets) are creating significant challenges for many distributors, and when product is available, increasing prices are eroding margins on this traditionally attractive part of the business.

- **Rising Insurance and Energy Costs** — It seems that insurance costs have been rising faster than inflation for decades and it does not appear this will change any time soon. Class action litigation, health insurance, worker’s compensation, and natural disasters seem to be impacting the gases and welding supply industry as much, if not more than many other industries. In addition, as an industry that is heavily dependent on energy for production and distribution of its products, rapid increases in energy costs are also taking a toll on margins.

- **Increasing Capital Requirements** — The capital intensive nature of the industry, which has traditionally been seen as one of the positive attributes of the industry, is becoming more of a challenge for many independent distributors. The cost of cylinders and bulk tanks has increased significantly in the past several years as steel prices have skyrocketed. While it can be argued that this increases the value of the existing asset base, it also requires more cash to continue to “feed the monster” — cash that is becoming increasingly scarce due to the cost pressures noted above. In addition, trends such as the migration toward microbulk systems are requiring significantly larger one-time capital investments to remain competitive.

- **Increased Regulatory Requirements** — As we learn at each

GAWDA SMC and Annual Convention, the FDA and DOT, among others, continue to increase the regulatory requirements for operating within the industry. The systems and procedures necessary to comply with these requirements add additional complexity to operating a business - complexity that is often too much for small businesses to absorb.

- **Tax Conditions** — As highlighted in Part II of this series, the timing and structure of a transaction can have a significant impact on the after-tax proceeds that are realized by the selling shareholders. For example, the reduction in the dividend tax rate passed in 2003 has had a significant impact on the after-tax proceeds for some sellers

that sold their businesses after passage of that bill. Using Scenario B from Part II as an example, the reduction in dividend tax rate from as high as 38.6 percent at the federal level to the current rate of 15 percent, meant an additional \$590,000 in after-tax proceeds to the shareholders in Scenario B (more than a 40 percent increase). With so many GAWDA members still being C-Corporations, and so many transactions being done as asset purchases (as opposed to stock purchases), this is a very real factor for our industry. While it’s anyone’s guess what will

happen with taxes in the coming years, it seems clear that the overall tax situation will get worse, before it gets better.

Demand Side Factors — The number of buyers actively seeking acquisitions in the industrial gas distributor market has increased dramatically in the past several years. This is the result of several factors:

- **Industry Trends** — As noted above, certain trends within the industrial gas and welding supply industry are pushing consolidation in the industry. On the demand side of the equation, significant investments being made in capital assets are driving the need for those assets to be fully utilized. For example, in addition to Microbulk Systems, significant investments are being made in automated cylinder fill plants, specialty gas labs, palletized production/distribution systems, and other “big ticket” items that often require substantial volume to support the investment. The fastest way to add substantial volume in a particular region is through an acquisition.

- **Shareholder/Investor Pressures** — The pressure for CEO’s to continuously grow the top and bottom lines of the businesses they run is immense, especially for companies with some amount of public ownership. One of the fastest ways to grow, certainly on the top line, is through acquisitions. In times of increased M&A activity, this can create strong competition for high quality businesses. This is clearly one of the factors driving the recent activity within the industry.

- **New Players Entering a Market** — In the not too distant past, the presence of private equity investors in the industrial gas and cryogenic equipment industries was not something that was broadly seen. While the returns on equity in the industry have always been respectable, they simply were not high enough when compared to the seemingly endless opportunities in the technology sector. That thinking has changed. As evidenced by significant investments recently made in the industry by the likes of Gladstone Investments, Caxton-Iseman, First Reserve, PNC Equity, RAF Industries, and

other well respected private equity investors, the asset intensive nature of the industry, its relative immunity to being outsourced, and its potential for growth by acquisition, have made it a market of interest for many private equity investors. For companies that are large enough or unique enough, and who have access to private equity buyers, it can add a whole new dimension to the demand side of the M&A equation.

Market Factors — Like most industries, the general market conditions for mergers and acquisitions influence activity within the gases and welding distribution industry. The factors impacting the industry most today are:

- **General Economic Conditions** — It is generally agreed that the past several years have been good ones for the average distributor. 2006 was a year of solid growth for most companies and, according to the 2007 Business Forecast by *Gases And Welding Today* (Winter 2007), 2007 should see continued growth. As noted above, strong economic conditions typically increase both the Supply and Demand for acquisitions, and this is certainly true within our industry.
- **Capital Markets** — Liquidity in the capital markets is very high and we are beginning to see an increased interest on the part of more traditional lenders to put money to work in the industry. They are finally coming to understand what business owners in the industry have known for decades — there is a lot of security in cylinder and tank assets that do not depreciate much over time. This increased availability of debt (at relatively attractive interest rates) allows more companies to be competitive in the acquisition arena and thus is driving up demand for quality acquisition opportunities.

CONCLUSION

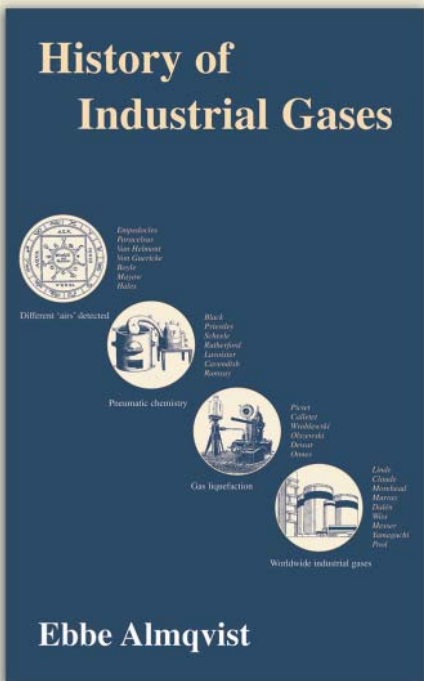
So what does all this mean for the average GAWDA distributor? Well, to use an already overused phrase, we appear to be in the “Perfect Storm” of mergers and acquisitions. Conditions on the Supply Side, Demand Side, and in the Market are all perfectly aligned to create a period of intense M&A activity in the industry.

Whether or not you think consolidation in the industry is a good thing is up to you. But it is a reality that each business owner must face up to, and understand the way in which it affects your business and its value.

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