M & A — Opportunity in the Midst of a Mess

By Brian Deveaux, Leaders LLC

I had the pleasure of speaking at the GAWDA Eastern Zone regional meeting in October of 2008 at the Hampden Country Club in Hampden, Massachusetts. At this meeting I shared my thoughts on some of the potential impacts the current economic turmoil may have on our industry and thought these comments would be beneficial to share with the readers of *CryoGas International*. As this issue goes to press, we note that much has changed since October. These changes make many of my remarks even more important today.

My October presentation began with a few observations on how the economic and political environment had changed since I last spoke to a GAWDA audience at the annual meeting in San Francisco, just one year earlier. I noted that in September 2007 the DJIA was over 13,800; it closed on October 10, 2008 at 8,451 (the DJIA fell below 7,600 on November 20, 2008). *The Wall Street Journal* Prime Rate was at 7.75% in September of 2007; it was reduced on October 6, 2008 to 4.5%. (Today it stands at 4.0%). The unemployment rate was at 4.7%; it rose to 6.1% in October, and reached 6.5% in November. Capital Markets were strong in '07 and debt was readily available at attractive rates. Today, debt (particularly new debt) has virtually dried up. Last year it looked liked Hillary Clinton was going to win the White House (according to Dick Morris). Well, you all know what happened in that regard.

As I spoke in October, I noted that according to economists in the latest (at the time) *Wall Street Journal* forecasting survey, the odds of recession in the next 12 months were 89%. In December of 2008, the National Bureau of Economic Research determined that the US has been in recession since December 2007. US GDP contracted in the third quarter and is likely to contract in the fourth quarter of this year, as well as the first quarter of 2009 — marking the first time US GDP has contracted for three consecutive quarters in more than 50 years. The unemployment rate is expected to reach 6.8% by June 2009.

In October, I also discussed the debt crisis in the US and abroad and explained how it would continue to have a dampening effect on the economy. Lower economic expectations often result in reduced capital spending by businesses, and tighter credit markets reduce capital spending by consumers and businesses. Tighter credit markets have affected sales of state and municipal bonds, delaying infrastructure investments. Reduced retirement portfolios will keep/push more baby boomers into saving rather than spending mode. Continued declines in the housing market will further suppress consumers' ability to spend. High energy prices, particularly in colder markets, such as the Northeast, will further reduce consumer discretionary spending this winter although the recent drastic reductions in energy costs hopefully will free up more money for cash-strapped consumers. While consumer spending is not the best proxy for our industry, it is the main driver of the US economy!

While conditions have eased somewhat since the time of my presentation, the potential impacts of a slowed economy on our industry have not changed and predictions of most economists remain pessimistic.

Many of you are familiar with Alan Beaulieu's diagram depicting the four phases of the economic growth cycle (see Figure 1). In Phase A you are experiencing negative real growth year over year (YOY) but the trend is getting better (i.e. the level of decline is improving); in Phase B, you are growing YOY and the rate of growth is continuing to increase; in Phase C, you are still growing but the rate of growth is slowing (e.g. YOY growth in the prior month was 10% but the current month is 8%); and in Phase D, you are once again declining YOY, and the trend is getting worse.

Based on discussions with numerous GAWDA member companies, I would argue that we crossed over the "peak" from Phase B to C some time during the 2nd or 3rd quarter of 2007, and that we have remained in Phase C through the 3rd quarter of 2008. Looking forward, however, I believe we are headed into Phase D (if we are not already there) and while this may not result in negative revenue growth for all companies (particularly those that are passing on price increases), it will likely result in declining product volumes and declining cash flow.

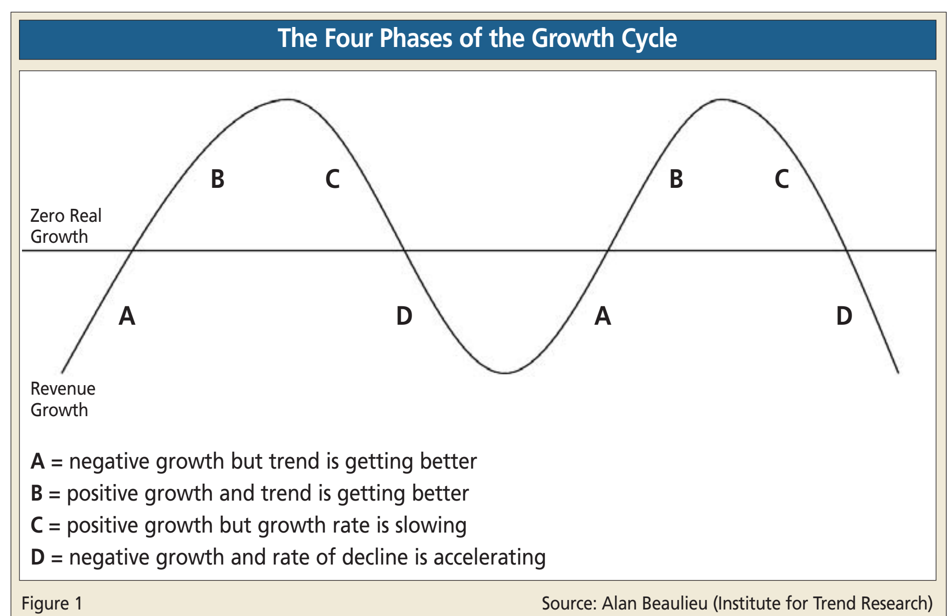

Figure 1 Source: Alan Beaulieu (Institute for Trend Research)

MOVING FORWARD

So what does this all mean for businesses in the industrial, medical and specialty gases and cryogenic equipment industries? As with any change in the economic cycle, you need to educate yourself as best you can on what to expect, prepare to mitigate the potential downside impact, and be opportunistic in taking advantage of any opportunities that the changing environment might present.

Educate — The mere fact that you are taking the time to read this article suggests that you understand the importance of keeping up-to-date on the latest trends and expectations in your industry. As such, I will not spend any additional time addressing this subject.

Prepare — During times of rapid economic expansion, like the period we experienced over the past several years, it is easy to lose focus on capital spending and expense control. The attitude during the boom years is often, "whatever it takes to keep the customer happy." As the economic cycle shifts, particularly as rapidly as I suspect it will, expense control and effective utilization of cash become paramount. This is even truer in an environment when credit is tight. In past economic downturns, many of you have relied on bank lines of credit (LOC) to get you through the tough times — you probably still have a line of credit available to you that is not fully drawn down. Be aware, however, that many banks have revised their lending criteria over the course of the past year, and when it comes time to renew your line of credit this year, the terms of the LOC, including the amount you can borrow, may have changed. Be prepared for this possibility and take action to mitigate its potential impact. As always, CASH IS KING.

Be Opportunistic — Shifts in the economic environment often create opportunities. One such opportunity is in the area of mergers and acquisitions. While the frenzied pace of mergers and acquisitions in the industry has slowed somewhat, the M&A environment remains strong for both buyers and sellers. As a potential buyer in this market, there may be opportunities to acquire a competitor that is not as financially strong as you and that may have difficulty getting through this next economic cycle. As a potential seller in this market, the past several years of good results should have increased your revenue and cash flow, and there are many buyers that remain active in seeking acquisitions based on multiples of cash flow. In addition, there are always other factors to consider when thinking about a sale. One such factor is potential changes in the tax environment.

Four Scenarios of a Hypothetical Acquisition

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Post-Synergy EBITDA	$1,500,000	$1,500,000	$1,500,000	$1,500,000
Purchase Multiple	5.0	5.0	5.0	4.6
Purchase Price	$7,500,000	$7,500,000	$7,500,000	$6,840,000
Senior Debt Multiple	2	3	3	1
Amount Borrowed	$3,000,000	$4,500,000	$4,500,000	$1,500,000
Equity Required	$4,500,000	$3,000,000	$3,000,000	$5,340,000
Interest on Debt	8.5%	8.5%	7.5%	7.5%
Post-Synergy EBITDA	$1,500,000	$1,500,000	$1,500,000	$1,500,000
Interest Expense	-$255,000	-$382,500	-$337,500	-$112,500
CapEx	-$500,000	-$500,000	-$500,000	-$500,000
Pre-Tax Cash Flow	$745,000	$617,500	$662,500	$887,500
Pre-Tax Cash Return on Equity	16.6%	20.6%	22.1%	16.6%

Figure 2 Source: Brian Deveaux, Leaders LLC

As I have written numerous times in the pages of *CryoGas International*, I feel too many business owners focus solely on the purchase price, or multiple at which they sell their business, when what they should really focus on is how much money they receive after taxes. There seems to be a common misperception that if you have not completed a sale transaction by the end of 2008, you have missed the window of opportunity to maximize value in a sale. You might then have to wait for several (or more) years for the next opportunity to exit when values are at their peak.

Airgas CEO Peter McCausland was recently quoted as saying, "It doesn't matter whether it's a fill-in or an anchor acquisition for us … we're out working hard trying to drum up prospects." He also added, "I would caution you against assuming we can buy these companies really cheaply, because the prices for good industrial gas distribution companies are pretty inelastic. They're not like general, run-of-the-mill manufacturing companies, where you may get a 500-basis-point spread on the multiples. We're talking about a range of one-and-a-half on the [earnings before interest, taxes, depreciation and amortization] multiple for purchase price." In other words, the difference between the peaks and valleys in valuations is not that great.

While it is anyone's guess as to if, how and when tax laws will change under the new administration, the conventional wisdom seems to be that there will be changes. Depending on the specific changes that are made, and when they take affect, it is conceivable that any potential increase in value from now until the next "peak" in values, could be completely negated (on an after-tax basis) by changes in tax laws enacted between now and then. In other words, we may still be at "peak" when it comes to after-tax values.

IMPACT OF CAPITAL MARKETS ON M&A

In my 2007 GAWDA presentation in San Francisco and in subsequent articles regarding the topic of mergers and acquisitions, I presented a theoretical example of how the ability to borrow money can impact a buyer's return on investment from an acquisition. In each of those cases, I presented scenarios illustrating how a buyer's ability to borrow more money to complete an acquisition theoretically increased the return on investment. With capital markets having changed so dramatically over the past year, it seemed more appropriate for my presentation in October to address the opposite scenario — in other words, how does a tighter credit market theoretically impact a buyer's return analysis when considering an acquisition.

Figure 2 shows four scenarios of a hypothetical acquisition using different assumptions about a buyer's ability to borrow money at certain interest rates: Scenario 1 is pre-

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sented as the baseline and assumes that a buyer can borrow 2 times the Post-Synergy EBITDA that was used as the basis for establishing the Purchase Price; Scenario 2 illustrates how the buyer's return on investment increases based on the ability to borrow more money — from 2 times EBIDTA to 3 times EBIDTA; Scenario 3 illustrates how the buyer's return on investment increases based on the ability to borrow the money at a lower interest rate.

Scenario 4 illustrates how a buyer's analysis might be impacted based on a reduction in the availability of debt — from 2 times EBIDTA to 1 times EBITDA. In Scenario 4, rather than adjust the buyer's return on investment based on the reduction in available debt, I have assumed that the buyer's target return on investment is the same as it was in scenario 1 — 16.6%. In order to achieve the 16.6% return on investment when borrowing only 1 times EBITDA, the buyer's Post-Synergy Purchase Multiple must be reduced from 5 to 4.6.

While this is an overly simplified example, it serves to illustrate the point of how changes in the cost and availability of debt could theoretically impact how a buyer analyzes an acquisition. Fortunately, many of the M&A transactions that occur within our industry are not predicated on the availability of debt, thus the recent dramatic change in credit markets should not, in and of itself, have a major dampening affect on M&A activity.

TO SUMMARIZE

We are headed for an economic downturn that has been in the works for some time but that has been slow to impact our industry. The global credit crisis will hasten the downturn and deepen its impact. How deep it will go and how long it will take to recover is uncertain, but it will not likely be a quick recovery. Cash will be even more important than it has been historically given tighter credit markets. Use cash wisely — control expenses and capital spending. Be opportunistic — consider an acquisition or sale of the business as a strategic move in the current environment.

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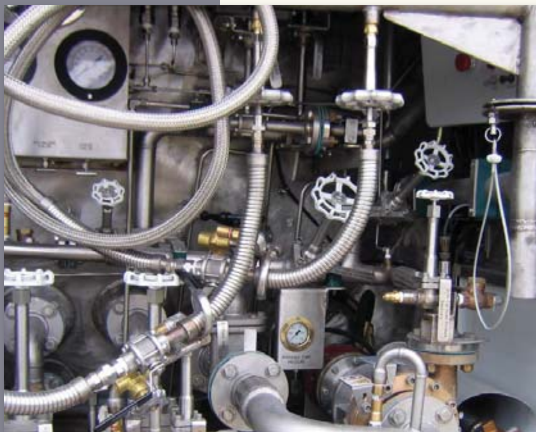

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