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Business up for merger and acquisition practice area

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After a dry spell of more than two years, business is up in 2004 for lawyers who do merger and acquisition deals for the middle market, several Chicago attorneys report.

Knowledgeable lawyers can advise business owners of the better contractual terms they can currently get, according to Brian P. Kerwin, a partner in the corporate and finance practice groups at Duane Morris LLP.

For the last couple years, according to Kerwin, "target companies weren't as profitable." Potential buyers were "saving more, spending less."

The slowdown began in mid-2001 and got worse after Sept. 11.

But since late last year, "there's been a real uptick in business work," Kerwin said. "Now investors want to see their money put to work."

Kerwin said he represents both buyers and sellers across the country.

Mergerstat, which tracks M&A activity, reported that for target companies valued at less than $500 million, the second quarter of 2004 was the most active in M&A activity in North America since the second quarter of 2001.

Brian A. Gross, a Chicago attorney and investment banker, said several key factors drive the improved M&A climate for middle market companies in 2004.

Capital is abundant. Debt capital is "as competitive as I have ever seen," said Gross, who is managing director of WindLake Capital Advisors LLC, in Chicago.

"It won't continue forever, but lower borrowing costs also naturally help drive higher M&A values" because some acquisitions are financed by loans, he said.

Increased debt capital comes partly from new private hedge funds, insurance companies, and financial services companies such as GMAC, Gross said.

Also, according to Gross, private equity investors are lowering their expectations of return on investment and are willing to pay more for middle market companies.

Gross advised lawyers, "Do not assume that your middle-market clients are fully aware of all the M&A alternatives presently available in the marketplace. Many are not."

Paul A. Gilman, an attorney and a member of the firm of Aronberg, Goldgehn, Davis & Garmisa, said, "The deal flow has picked up. We're working more hours. Our clients are happy, especially those in a mood to dispose of their companies."

Among the factors Gilman cited for the trend is the Jobs and Growth Tax Relief Reconciliation Act of 2003 signed by President Bush in May 2003.

This tax cut temporarily lowered the capital gains tax rate to 15 percent from 20 percent, so that sellers can retain more of the proceeds of the sale.

That rate cut is effective only through 2008.

Also, Gilman said, interest rates for financing are low. "A lot of acquisition is financed by debt," he said. Gilman's practice focuses on business counseling, M&A, and tax planning.

In the current climate, "if the lawyer knows what to fight for and negotiate over," according to Kerwin, the seller's lawyer can get a better deal contractually.

For instance, Kerwin said, regarding the representations and warranties that the seller provides the buyer as statements of the quality of the company being sold and its assets, such assurances typically have a time limit. The time limit ranges from 18 months to three years, Kerwin said, with longer limits for matters such as tax liabilities, environmental issues and employee benefit issues.

In today's seller's market, the length of time the representations and warranties last "can be negotiated to a shorter time period," Kerwin said.

Morever, a buyer will typically want to be sure the contract places no limit on the indemnification the seller is required to make in the event of financial harm from any seller's breaches in representations and warranties.

But the liability exposure that the seller has to bear, which is "often one of the most important issues in a sale transaction,'' can be negotiated to a lower figure when the seller has leverage, Kerwin said.

Also, Kerwin said, "now sellers are able to negotiate more cash from the buyer at the close and less payments over time.''

In the former buyer's market, the buyers may not have been willing to pay all cash at the closing, he said. The buyer might have wanted the seller's company to reach certain post-sale financial goals before the seller got the full purchase price.

Kerwin said he recently represented a private equity fund in raising $160 million in capital and also represented the purchaser of four, wholly-owned subsidiaries of a publicly-traded company in a leveraged buyout for $45 million.

According to Gilman, private equity firms are "getting into the acquisition game on a more prolific basis,'' but corporations even more so.

Mergerstat said public buyers accounted for 59 percent of net new announcements in the second quarter.

"As stock prices go up, public company activity goes up'' in making acquisitions, Gilman said.

He explained that "If a public company's stock price is trading at only 10 to 11 times earnings, there's not much incentive to do an acquisition'' of a middle market company that is itself trading at four to six times earnings.

The opportunity to make money through such an acquisition exists, but the effort and the risk involved can make the deal unattractive. "You like the wider spread,'' Gilman said.

Now with price-earnings ratios rising, he said, public companies are more willing to buy.

Loans are far more easier to get, according to Gross.

Gross said his firm is currently advising a $200 million diversified manufacturer in a refinancing. The firm has "an average balance sheet,'' but five credit providers are competing to make the loans at rates of between 3.25 and 3.75 percent.

"Most middle-market companies have never had an opportunity to take advantage of borrowing costs this low before,'' Gross said.

He said lawyers should advise middle-market clients to revisit their business goals and their plans for who will assume the business down the road.