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One-on-One / With

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“Frothy” M&A market won’t get blown away soon



HITER HARRIS CO-FOUNDER AND MANAGING DIRECTOR, HARRIS WILLIAMS & CO

Prior to co-founding Harris Williams & Co, Mr. Harris was with Bowles Hollowell Conner and Co. Previous experience includes positions with the investment banking group of First Union Corporation and Crestar Bank.

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With nearly US\$174 billion in private equity money raised last year, M&A, especially among mid-market companies, has rarely been as robust as it now, says Hiter Harris, co-founder and managing director of advisory firm Harris Williams & Co. Even with prices and multiples getting a little “frothy,” an increasingly global customer base and healthier strategic buyers all mean M&A should remain strong through this year. The following are excerpts from a speech Williams made on mid-market M&A and from an interview.

“Deals that are done in the middle market may not end up on the front page. But we think it’s one of the most dynamic markets. When you hear about statistics regarding M&A, it’s usually the billions of dollars done or billions raised. In fact, 74% of the dollar volume is for deals above \$500 million. But what most people don’t know is that 90% of the deals done are below \$500 million. Clearly this has a large impact on the economy, particularly as this middle market continues to grow. We also find ourselves in a very unique time. The private

equity market is setting records; the debt market is as active as ever; the strategic buyers from corporations are very aggressive; and cross-border transactions are setting records. I have heard that this is the hottest M&A market ever.

Individually, middle-market companies serve small, niche markets. They are too small to make the Fortune 500 list; but, put together, they have an incredible impact. Think about the number of companies that were family – or individually owned – that moved into the private equity world. This is a major recasting of corporate ownership of this country.

The new owners have brought in new management teams, renewed manufacturing efficiencies, and product innovations. These companies have been transformed. They compete more effectively on a global basis; and they provide ownership for the employees and management and build wealth for a lot of individuals.

All signs are pointing up. I know you have heard about this being a frothy market. What this does is drive multiples. We have found that multiples of our deals year-to-date are up almost 30% over the same period last year, which is remarkable. If you add to this the

active credit market, this provides less expensive debt for the deals generated. The fun thing about these frothy markets, particularly in a competitive debt market, is that you start hearing about all of these terminologies you don't hear about in a down market: stapled finance; second-lien loans; holdco debt; highyield debt and hedge-fund debt. This shows you how competitive this market is that they have come up with these new products. It means more capital at more favorable terms to get deals done.

This is all with the backdrop of a very robust economy. This leads to strategic buyers who are aggressive and willing to pay for the right assets. In general, we have observed in deals where there is a corporate buyer, that those suitors are paying about 30% more than private equity buyers. But it's based on these being must-have, unique assets. Here are a couple of examples. (Energy control systems maker) Power Measurements (PMI) was a company we sold to Schneider Electric. PMI had a technology Schneider needed in their company. They could take PMI and multiply the size of it just applying it through Schneider's business. It was a special asset, they had to have it and they paid 19.4 times to get it.

(Water treatment equipment distributor) USABlueBook was a company that was attractive to Home Depot. USABlueBook was the largest company of their kind, a very unique property; Home Depot had to have it and what they can do with a special asset is multiply the size of it through their platform.

But it's not that these buyers aren't smart. They are very savvy. They have very smart deal guys. They are running private equity-type models to understand how their competition is viewing acquisitions and they also know that making acquisitions is vital to their growth. If you are a corporation and your organic growth is only 3% to 7% and you are trading at a 20 times price earnings multiple, you have no choice but to acquire. These guys are fueling this market through this aggressiveness.

Finally, in regard to cross-border transactions, China and Europe get most of the attention. But the M&A activity is very widespread across the world. In a study done by our European partners Close Brothers, they found there's a substantial increase in acquisitions being made by India-based companies. In 2002, there were 3 transactions done by India-based companies. In 2003,

there were twelve; in 2004, 15; then 42 in 2005. In the four months of this year, there were 29 transactions by India-based companies. About half of those were US and UK-based companies. It is not just China; it's not just Europe; it is very widespread."

Q: What industries are private equity buyers most interested in?

A: It's very diverse, particularly in the middle market. There may be private equity groups that specialize in certain areas whether it's healthcare or technology. But more of what you have are generalists that may have certain skills they specialize in: it may be manufacturing, it may be distribution; it may be energy; it may be healthcare. Those are groups within their firms versus firms that are solely focusing on certain areas. All the frothiness is in most every industry. Technology is up; healthcare is up; energy is up; manufacturing is up; distribution is up. So it's very broad-based.

Q: Given that many middle-market companies get sold between private equity firms, how much value can a private equity firm extract from a company if it's being sold again and again?

A: These companies that are sold two, three, or four times are usually top-quality companies with good management and good systems. They are just good, growing companies in the right markets. You might not find the unsuccessful ones selling as often. Also, each private equity firm may have their specialty in how they manage their company. One may be really good at operations. So a company in its growth phase may have pains on the manufacturing side. So they connect with a private equity group that could really help them do that. Maybe the next phase is how to tackle the global economy. So another private equity group is really good in China, or India or Vietnam or outsourcing. Maybe they have their operations set, they are a global company, but they may need to increase top line growth. So the next firm specializes in sales and helps them with that.

Q: Any examples of companies that have benefited from multiple owners?

A: (Drywall taping firm) Ames Taping Tools, whom

Cortec Group owned twice, is an example. Cortec is really good at corporate operations and manufacturing. They really excel at hands-on consultation with management teams in running the business. Ames was a fast-growing company and Cortec was able to help them do that.

Q: With multiples growing so much from a year ago, are prices too high?

A: Clearly, they are at a cyclical high. Clearly, there is a greater chance that they will go down than they will go up. But, if you look at the cycle over time, they are probably about the same multiples as the late '90s. Some people say that this is the hottest market ever known to man. I generally agree with that. But there are reasons why this market is still stable. One of those is that we have been here before. It's not any hotter than the late '90s. But we think it's more stable because it's more liquid.

Q: How many of your buyers are corporations?

A: About 60% are sold to strategic buyers.

Q: Why aren't these corporations just growing these businesses organically rather than doing acquisitions?

A: Home Depot is an example of that. Home Depot can take a special asset and blow it out. They can take a \$100 million revenue company and, with their thousands of stores across the country, grow that to a \$500 million revenue company. Their acquisitions, such as USABlueBook, are related to their core business and very synergistic, but off in a different direction. They can take an acquisition and overlay it on their regular business.

Q: How many of these companies that you represent on the sell-side have something so unique that a corporate buyer can't enter the market itself?

A: I'd say a really good number are special, unique assets. But there are a number of things that can make it unique. It can be a technology; it can be a market position. If you have a 60% market share of a certain product or service, that's very hard for a competitor to displace; that's very unique. When you sell a company like that, there are corporate buyers that have an

interest in that and it's really compelling to them. They know this may be the last time the company ever comes up for sale. So if you want to be in this market, where we have 60% market share, this will be your only chance to enter this market. Price really is a secondary feature.

Q: Is there an increase in corporate buyers as compared to last year?

A: Much greater increase than a year ago. Corporate balance sheets are clean. Equity prices are up so they are in a better financial position to acquire. At the same time, Wall Street is pushing them for growth. All the variables are just right.

Q: Are you getting more corporations approaching you for acquisitions or are there more companies out there interested in selling out?

A: We routinely have corporations approach us since saying 'this is what we are looking for. Call me if you find it.' On the sell-side, we have companies that want to know who they should belong to and we will set up that process.

Q: How is the competition for mid market deals? Would a slowdown in large deals mean more poaching of middle-market deals?

A: That's the theory. But it's really difficult for a bulgebracket firm to come down to the middle-market. Everybody knows that they are only there temporarily. As soon as they land a billion-dollar deal, they are out of here. If you are a seller and this deal is really important to you, you want to know your team is working hard for you. If you hire a bulge-bracket firm that dips into the middle-market, as soon as they have a bigger deal, they are out. The chances of us leaving during the six-month course of a deal are zero.

Plus, they don't know the middle market. We have our own database of 2,000 potential buyers, a good many of them are in the middle-market. If you are in the bulge bracket, you don't know those guys. You wouldn't know who to call.

Q: If the economy starts slipping, what effect will that have on M&A?

A: This market is so much more liquid than it used to be. Even in a downturn, we think there's going to be M&A activity. Sellers may not be as happy with the outcome as they would in a frothy market, but we think there's still going to be liquidity. If you look at the distressed debt side, some of these companies will fail, and lenders will force a sale. It may not be a happy sale, but it will be a sale. We think there's enough money out there to buy those companies. We think the market will still be active.

Plus, the middle-market is just more resilient. If you look back at statistics from '01 and '02 when everyone thought the M&A market was on its knees, the middlemarket was reasonably healthy. If you break it down by industry, each industry follows its own beat. We could have a terrible M&A market overall, but we could have a great energy market. It's the same with healthcare, technology, building products and consumer products.

Q: Are you going to build up expertise in those areas?

A: We're building out our restructuring group and our distressed debt group. We're building out healthcare; we're building out technology; we have a building products group and a consumer products group. We have done a lot of energy even though we don't have a formal energy group. We have at least three energy deals in our shop right now. Transportation logistics is a new group for us. We think we are at the beginning of a cycle for transportation logistics.

Q: What's going on with transportation logistics?

A: What has changed in a number of segments in transportation logistics is amazing. Think of the rail industry. Five years ago, people thought the rail industry would never recover. But look at the dynamics of the oil market and the economics of sending goods over rail. If you look at the coal business, all coal is transported by train. If you think about low-sulfur coal, you get it from the middle part of the country. And since it's low sulfur, it takes twice as much to burn. That means you have to have almost twice the rail cars to transport it. More traffic on the tracks means the tracks wear down and the cars wear down. So the rail industry is in a perfect

storm.

Think of the changes taking place in the trucking industry. Ten years ago, the biggest complaint shippers had was losing their semi-trailer. But now there are GPS and bar code scanners. Now if a container sits in a yard for more than a day, a computer will read it and it will move. Ten years ago, it would be sitting there for three weeks before someone figured out where it was. We think we are at the beginning of another such cycle.

Q: Will a slowing housing market cool activity in building products or consumer products M&A?

A: We're seeing the residential housing market slow down now. That's the focus of the Fed's interest rate changes. Its interest rates moves have cooled the market, but cooled it into a sustainable level. As long as we have reached a sustainable market, we think there will continue to be M&A in those sectors.

Q: Since the energy industry requires such scale, where does the middle-market play in that industry?

A: It won't be in exploration and production because those are huge companies that have to do that. But the products that go into that are huge for us. Offshore rigs can now control five wells. We sold a company last year that made the tubing that goes down each of those wells (Rath Manufacturing, bought by Gibson Tube). The products and services that go into that market are often done by middle-market companies.

Q: As for technology, wouldn't the large technology firms have good enough insight into the market and not need an intermediary firm?

A: They typically would. But our client is the family – or private equity-owned company. They know they want to sell. They may know that these three corporations would be interested buyers. But they hire us to make sure there are not other buyers, to package the company professionally, and to negotiate a deal. The big companies may go to the sellers direct. But more times than not, the sellers come to us and we help them through the process.

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