Capital, good rates make for a ‘frothy’ M&A environment

It is estimated by Pitchbook Data among other sources that private Equity groups are currently sitting on about $450 billion in available capital that needs to be invested. In addition, I have personally spoken to several banks and lending intuitions, all of them are more than eager to lend money at historically low lending rates and favorable borrowing terms.

If you combine the availability of debt financing to support acquisitions along with $450 billion of capital available, then take modest leverage ratio of 50 percent debt to equity, you have about $900 billion seeking acquisitions in the U.S. right now.

Now consider that public companies and larger private companies have recovered from the recession area of late 2008 and many are seeing earnings greater than those of pre-recession times. This means strategic buyers have a lot of cash sitting on their balance sheets.

These companies are seeking to grow and their cash on hand combined with a favorable lending environment make the buy vs. build decision easy. They want to buy and typically will pay a premium for good companies with synergistic attributes to their businesses.

Finally, we have 78 million Baby Boomers in the U.S. who will need to retire over the next 25 years, It is estimated this will generate $8 trillion to $10 trillion in transactions during that time period.

Why haven’t we already seen this “frothy” M&A activity? Obviously, there are a number of factors that create and prevent M&A transactions from closing.

The most prevalent issue in the last couple of years has been a valuation gap between buyer and seller expectations. While plenty of lenders are anxious to lend money, they must be more conservative with the amount of leverage that they invest into a given deal (roughly 50 percent debt:
Equity compared to 67 percent pre-recession area).

This has created lower valuations than many sellers were offered 5-10 years ago. Understandably, sellers have been holding out for pre-recession EBITDA multiples.

In 2014, that gap has been narrowing, in the first quarter of 2014 Pitchbook Data reported that $108 billion was invested in U.S. companies, this is the best first quarter we have seen since 2008.

Currently, I see more capital in the market than strong, clean businesses that are available for sale. This is creating a bidding situation in that multiple buyers are competing for the same business, driving valuations back up. If a business has low customer concentration, good margins, and steady growth that will continue. that business can expect to be paid a premium purchase price in today’s market.

At Focus Capital Advisors, we are talking with more and more small to medium sized business owners who have worked very hard to get their companies to this attractive position. These business owners are now in a position to convert that hard work into cash through a partial or complete sale of their business in a “frothy” M&A market.

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