

2012: The Perfect Storm?

A collision of forces suggests that 2012 could be a year of record M&A activity

“A Perfect Storm: An expression that describes an event where a rare combination of circumstances will aggravate a situation drastically...The term is also used to describe an actual phenomenon that happens to occur in such a confluence, resulting in an event of unusual magnitude.”

Heads up! Save what you're about to read so you can call me on it if I'm wrong. I'm going out on a limb, albeit a sturdy one in my humble opinion. This writer believes we are on the verge of witnessing a *Perfect Storm*, particularly the latter meaning of the term as defined above, in the form of potentially rampant volumes of merger & acquisition related transactions throughout 2012. The *Storm* will not discriminate, touching essentially any and all industries. And about the only thing that will derail its likelihood is the dreaded double-dip recession, which also in this humble scribe's opinion, becomes increasingly less likely by the week.

In contemplating this Perfect Storm, let's start with the most precious of commodities: cash. There's simply lots of it sitting around these days. Yes, if anything's apparent coming out of this recession, it's that the gap between the "haves" and the "have-nots" has widened. Big time. Mind you, this is not a good thing, but it is a fact. Among the wealthy, both individually and corporately, the amount of liquidity in the global financial system sits at record levels.

For context, it's interesting to point out how we've gotten to this level of pent-up liquidity. By any measurement, this latest recession was the worst since this country's Great Depression. And as we all know now, its grip was and continues to be global. And regardless of the technical definition of a recession, for most it feels like we're still in it. Thus, while we're technically out of it, a cause of feeling like we're still in it, or that another is around the corner, has been the hoarding of cash and other liquid assets. Why don't unemployment levels tend to improve? Because corporations aren't yet convinced that hiring more people will equate to revenue growth and thereby generate an adequate return on their cash. The current system liquidity levels, mind you, have largely resulted from efficiencies rather than growth. So companies have experienced increased profits, albeit without corresponding revenue growth, and as profits tend to be the greatest driver to valuation, they've enjoyed the rise in their stock prices, and generally have sat on their cash. There's one large problem with that, however. Without growth, those profits can only get so high, which means that corporate valuations will soon hit a ceiling that can't be broken through by any other means than fundamental growth. To achieve growth, you must spend. And trust me, the people and corporations holding the cash do want to spend.

If you routinely follow financial medium, you know that the measure by which public companies and their respective management are judged is their stock price. Plain and simple. Move it up, sustainably, you're good for a very long time. Anything else, your days are numbered. One of the best ways to move your stock price up is to increase profits. If you're used to doing so through efficiencies, great. But you can only keep that up for so long. And the only other way to sustain profitability growth is through growing the business. Growing revenues. This leads to another force that will make for this Perfect Storm. That is, how can you grow revenues in an environment where many still are reeling from a recession? People remain reluctant to buy, whether it's on behalf of themselves or their company, and whether it's a product or a service. Fear still rules the day. This is making it very hard to generate

internal sales growth for companies of all sizes. So what results when you have companies lined with unprecedented levels of cash, the need to generate growth, and virtually no ability to harbor sustained organic growth? A push towards external growth, or outside means by which to seek meaningful growth, including mergers & acquisitions, joint ventures, partnerships, and the like. Understand that these trends don't simply create a desire to seek external means by which to grow, they fuel a need to actually do it. Holding cash in today's economy, with low interest rates and declining currency values, is akin to boating up stream without paddles. You're going nowhere but backwards. And in this climate, if you're going backwards, you're vulnerable.

The net effect of these buying forces, if you will, will create what should be an unprecedented amount of competition for "good" deals. In other words, while there will be a market for subpar companies to sell, these forces won't result in buyers paying a premium for underperforming businesses. They will, however, result in buyers paying premiums for good and great businesses.

But these are all buying forces, and an active M&A market must have sellers as well, right? This is another ingredient to the Perfect Storm, for there won't be a short supply of sellers. What forces will drive business owners to move towards selling? Several. First, demographically speaking, a large percentage of today's business owners fall into the baby boomer category, having grown up in the 50's and 60's and today approaching their 60's and 70's. Nearly all of these folks will be looking for a liquidity event within the coming years, triggering in many cases, the sale of their businesses. What makes this event likely to take place in 2012 for many of these owners is a collision of the aforementioned buyer forces and the expiration of the Bush tax cuts at the end of 2012. These tax cuts, effectively trimming the capital gains tax rate, were put into effect in George W.'s first term, originally were supposed to expire in 2010, but then were extended through 2012. Most don't anticipate another extension, meaning taxes will rise post 2012. And when considering something as significant as the sale of one's business, the economic effect of higher tax rates will be meaningful; meaningful enough to push those already planning to sell in the next few to five years or so to do it now.

Mind you, those looking to benefit from these various dynamics won't be confined to just baby boomers. Opportunities to capitalize will be open to all, and will certainly be taken advantage of by business owners of all ages and circumstances. Think about it; over the past almost four years, businesses have operated in one of the toughest climates of all time. Things appear to be getting somewhat better, but competitively speaking, it's as tough as ever out there. And it's hard to say that things will ease up anytime soon. Couple that with what will be this finite window of opportunity, you can bet that a good share of business owners will jump at the opportunity to monetize their businesses at good to premium prices.

So what, if anything, does all this imply for business valuations? I think they will rise in 2012, although not by as much as most sellers would hope. This relates to one of the aspects that I think will be particularly intriguing about this window of activity. Since there will be forces of equal intensity at play on both the buying and selling sides, pricing swings, both upwards and downwards, will be tempered. That said, I do believe we'll see healthy premiums paid for good companies.

So as a business owner, what should you do right now? Well for those of you that aren't even thinking about selling, probably nothing. However, if you think you could be a seller within the next two to three years, 2012 very well might be the year to act. After all, Perfect Storms come along only so often.

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