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Investment bankers get creative

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Strategic buys are dominating the mergers and acquisitions landscape as private equity players and institutional investors eagerly wait on the sideline for debt markets to open up, making deals more palatable — and lucrative.

This scenario has dogged investment bankers in Phoenix for nearly two years since the peak in 2007, when business valuations hit unsustainable highs, followed by the crash last year, hastened by the collapse of Lehman Brothers in September.

With that monumental bankruptcy, the global financial crisis took root. Banks, dealing with their own blunders and losing billions, stopped providing credit, jamming the gears of business investment.

The days of record returns and selling a company for eight times its EBITDA are over. Earnings before interest, taxes, debt and amortization is a metric used by private equity firms, M&A players and investment banks to value a company and gauge cash flow. The higher the EBITDA, the more valuable the company.

“I think sellers are really beginning to understand we’re not getting back to eight,” said Paul Jevnick, managing director of **Greene Holcomb & Fisher** LLC, which maintains headquarters in Phoenix and Minneapolis.

It’s taken awhile for that to settle in, particularly among the older generation of business owners who built their businesses over decades with sweat equity. For thousands of them, their company is all they know.

Buyers are far less nostalgic. When the market tanked, so did their offers.

“They see values way down, and they adjust what they’re willing to pay immediately,” Jevnick said. “Buyers’ and sellers’ expectations are dislocated.”

Bridging the gap

It’s difficult to bridge the gap when this happens, so advisers are crafting a mix of nontraditional financing mechanisms to get deals done.

After Lehman folded, **MasTec Inc.**’s $215 million all-cash offer to buy Fargo, N.D.-based Wanzek Construction Inc. was in serious jeopardy.

GHF renegotiated the deal in December, using a mix of $60 million in cash, a $55 million seller’s note, 7.5 million shares of stock and a two-year earn-out. The deal, which was finalized in mid-December, saved the Florida contractor millions. If it had been unable to secure financing, it would have been penalized $15 million after singing a letter of intent.

In a seller’s note, the seller lends the buyer part of the proceeds. In return, the seller gets interest, perhaps principal payments, and eventually gets paid off.

An earn-out is similar to an incentive-based contract in sports. When a valuation gap exists, the buyer agrees to a base amount plus an additional purchase price that’s contingent on the company hitting various thresholds, such as top-line sales numbers, net income, EBITDA or another profitability metric. If it’s a Web business, it might be page views.

“It’s less risk for the buyer,” said Barry Lutz, co-managing director of **Green Manning & Bunch** Ltd., who co-manages the firm’s investment banking division in Phoenix. “They’re not as willing to pay as much as sellers want.”

In June, GM&B completed a corporate divestiture for American Civil Constructors, a portfolio company of Chicago Growth Partners, to Progress Equity Partners Ltd.

Dallas-based Progress Equity, a big strategic company, only wanted to acquire the landscape maintenance and services division. The transaction had the added challenge of simultaneously raising debt and obtaining bonding in a tough lending and surety environment, Lutz said.

The deal was structured though a mix of mezzanine and equity financing. Mezzanine financing gives the lender rights to convert to an ownership or equity interest if the loan is not paid back on time and in full.

A dramatic shift

Until credit becomes more available and uncertainty abates in finance circles, private equity players won’t jump into the ring. In many instances, they’re opting for minority positions rather than buyouts or majority stakes.

“Right now, the equity is being very careful,” said Tom Fencl, who co-manages GMB’s Phoenix office with Lutz.

Industry insiders estimate that U.S. private equity firms are sitting on $350 billion to $500 billion. Guy Downing, managing director of Scottsdale-based **Columbia West Capital** LLC, said middle-market deals of $5 million to $100 million are seeing action now, despite low valuation multiples.

Last month, Downing’s team put together a deal for Baywood International Inc., which sold subsidiary Nutritional Specialties Inc. to Nutra Inc., a Nutraceutical International Corp. subsidiary, for $8.3 million. The deal is subject to shareholder approval.

The company intends to develop a new line of tea beverages and grow the brand while recapitalizing its balance sheet. Baywood was under some pressure to restructure and pulled the trigger after garnering a fairly attractive multiple of four times EBITDA.

“It’s shifted pretty dramatically for strategic guys,” Downing said of M&As. “Well-capitalized guys are viewing this as an opportunity.”

So are public companies, particularly smaller-cap firms that want to use capital to grow, pay down debt or increase earnings per share.

In the past three months, the Phoenix office of **DLA Piper** has represented underwriters in four equity public offerings and is pricing a fifth. The Chicago-based global law firm helped raise more than $300 million in those deals for Imax Corp. ($70 million); DG FastChannel ($56.1 million), a Texas digital media provider; and San Diego-based Maxwell Technologies ($20.2 million), which manufactures energy storage devices.

“Growth companies are the ones people are starting to rotate to,” said Steve Pidgeon, DLA Piper’s co-managing partner and lead counsel on those transactions. “These are the kinds of deals the market is looking for.”