

M&A Action Perks Up: The Year Ahead

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With the markets appearing to be more stable and 2010 projected to be a year of slow growth rather than declines, fashion, retail and beauty observers can expect more merger and acquisition activity, as well as restructurings focused less on bankruptcies and more on amendments of credit facilities.

Michael Appel, a director at AlixPartners, doesn't foresee a high level of bankruptcies in 2010, although he expects vendors to continue to face pressure as consolidation among retailers continues. The good news is he doesn't see any indication of inflation just yet.

"Retailers have increased the efficiency of supply chain management, while the value orientation of shoppers is not changing back to the pre-2008 days. That means both vendors and retailers will be hard pressed to increase prices," he said.

However, with cash preservation remaining a top priority, retailers and vendors should jump at the chance to get the best credit terms available.

"Those who are proactive will start negotiating earlier and those that worked on improving performance [will have] excellent results. It's not that different from before, but now more companies will be rewarded for running their business effectively," he said.

Jim Decker, head of the financial restructuring group at Morgan Joseph, said, "What we have seen over the last 18 months is a serial game of kicking the can down the street. Most of the work in the restructuring world involves amending and extending credit agreements."

Decker said the last 12 months were fraught with uncertainty. "No one knew what things were ultimately worth, which is earnings in the future. But the downdraft was so great that people's models of future revenues, let alone earnings, were thrown out in the trash. You couldn't evaluate anything and you also [became] skeptical of the forecasting."

Distressed companies often have to decide whether to hold on, liquidate, sell or restructure, but in 2009 that decision was weighed against the possibility of making an ill-advised move based on a near-term, extraordinary economic event, he noted.

"Many companies decided to revisit the situation six or 12 months down the road

and then make a decision. It works so long as the company has ample liquidity to survive. If there's no liquidity, such as The Bombay Co., which ran out of cash, then there's no real ability to kick the can down the street and the company goes straight to a Chapter 7 liquidation," Decker said.

He is predicting a revival of M&A activity, but not necessarily distressed sales through a Chapter 11 tour of bankruptcy proceedings. Deals are more likely to occur with strategic buyers active in the midmarket range where transactions are pegged at \$1 billion and below. To be sure, lenders still are hoarding cash, and the restructuring expert explained that may ease once they shore up their own balance sheets and take write-downs on losses still on their books.

One sector to watch in 2010 is commercial real estate, an industry where \$1 trillion in loans are expected to come due in 24 to 36 months. Decker said those loans may be difficult to refinance since many are "underwater" and the underlying assets may not generate the cash flow they once did that in turn helped to pay down the debt. Even that kind of distress, he said, may not lead to that many bankruptcies.

"What you'll see is the handing over of the deed in lieu of bankruptcy. There'll be changes in ownership, with the lenders owning the property due to their secured claims. They will ultimately sell the properties," he said.

Joseph Pellegrini, managing director of the consumer retail team at the R.W. Baird & Co. investment bank, said strategic buyers will be looking at "companies that weathered the storm really well from a brand perspective. If you're growing in what I consider an ugly environment, a strategic will say, 'They're doing something special and they're connecting with consumers.'

"A lot of brands have lost their way," he continued, "and they'll face bigger challenges getting back. Before a strategic buyer looks at a challenging situation, they'll look for stabilization first."

William D. Busko 2nd, managing director at Consensus Advisors, an investment banking and advisory firm, expects a more robust stock market in 2010, giving way to greater M&A activity for the year.

"The stock market rebounding gives people a more positive mind-set, a sigh of relief that the world is not cratering," Busko said.

One shift from years past might be firms' openness to partnerships, joint ventures and mergers as opposed to outright acquisitions, the banker said.

Busko noted that for joint ventures and partnerships, where valuation remains the biggest issue, one will also see a greater use of earn-out contracts over an average of two to three years as a way to monitor the assumption of risk. Firms such as Li & Fung use earn-outs, Busko said, explaining these are companies willing to pay out

the dollars so long as certain performance criteria are met. In that event, the former owners still get the money, just not up front.

Joint ventures in particular could be an interesting mechanism to facilitate an ownership change in an environment where lending might be hard to get.

“Joint ventures can be cashless transactions, where the exchange involves equity or some other form of assets, such as expertise,” Busko noted.