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IDD

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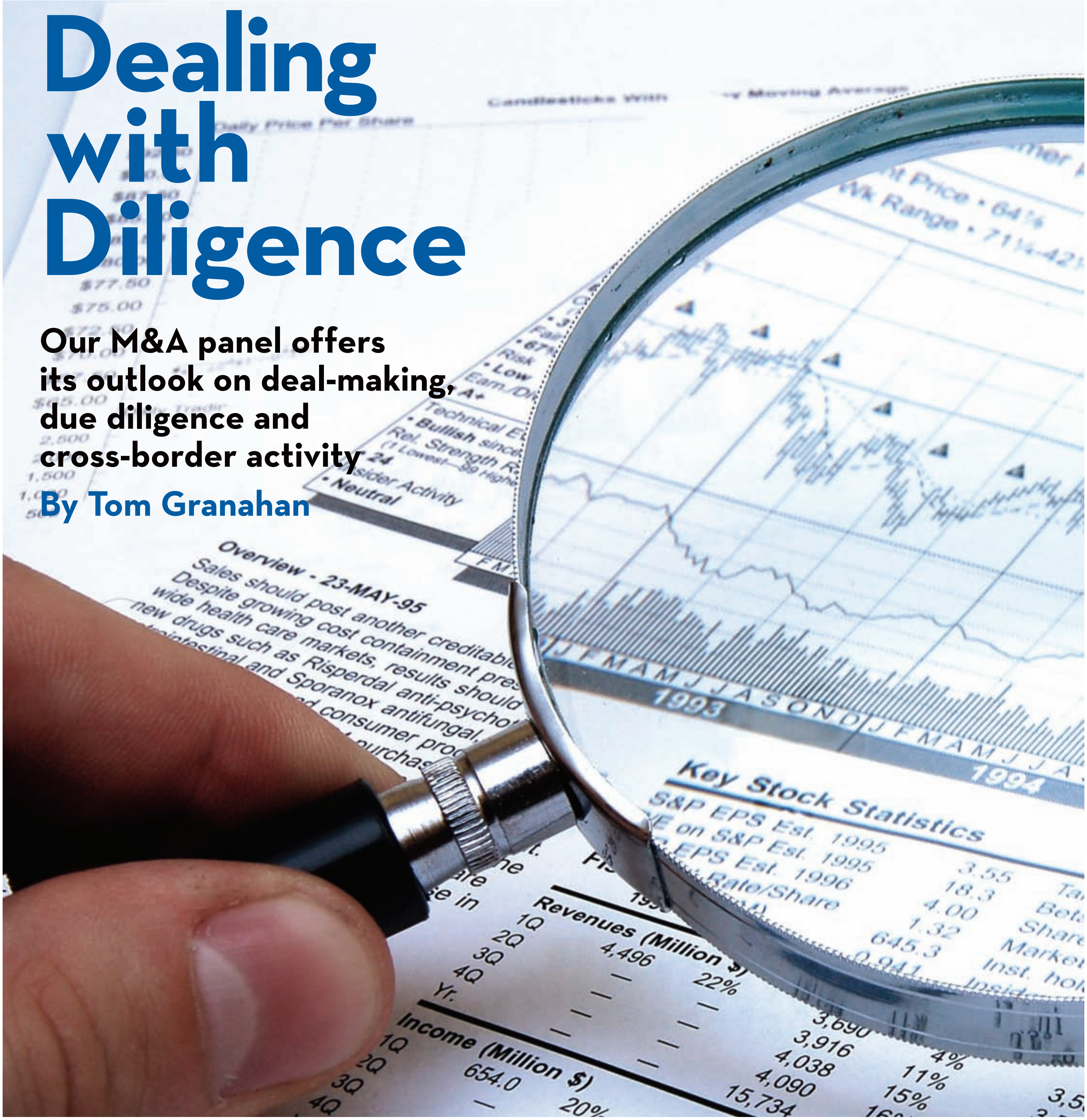
Earnings Guidance Conundrum

Dealing with Diligence

Our M&A panel offers its outlook on deal-making, due diligence and cross-border activity

Dealing with Diligence



Our M&A panel offers its outlook on deal-making, due diligence and cross-border activity

By Tom Granahan

It has already been a few weeks since the first-half M&A numbers came out, and even after suitable time for digestion, they're hard to fathom. A mind-boggling $2.6 trillion of deal making took place in the first six months of the year, shredding the year-ago total of $1.7 trillion, and the second quarter alone saw nearly $1.7 trillion in announced deals.

Alas, there have been some signs of chinks in the funding armor of late, most recently the move by bankers for **Chrysler Group** to postpone the sale of $12 billion of debt in connection with the split of the company from **DaimlerChrysler**, its German parent.

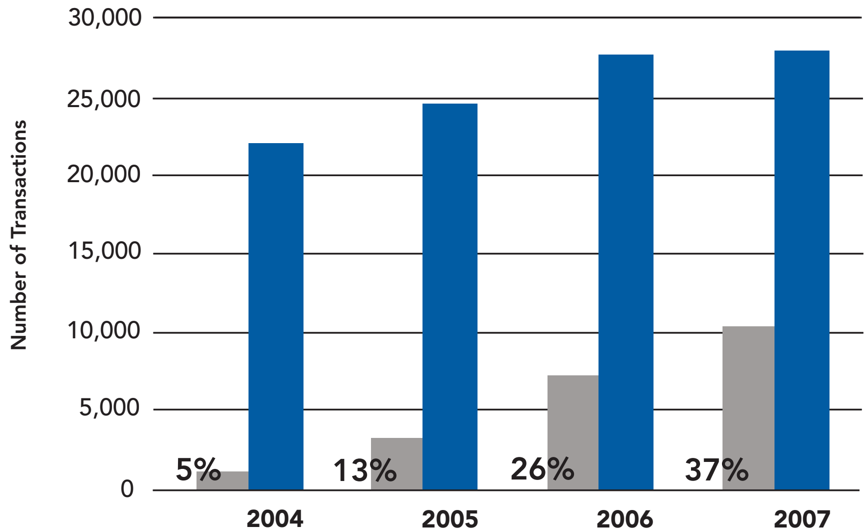
What better time to discuss the latest trends in M&A, including how deals are getting financed and how companies are conducting due diligence in a lighting-fast market? So *IDD* recently sat down with a panel of experts to discuss those issues and a host of others. Joining us on the roundtable were **James Abbott**, a partner in the business transactions group at the law firm of **Seward & Kissel**; **John Hompe**, managing director at **Keefe, Bruyette & Woods**; **Patrick Hurley**, managing director at **MidMarket Capital Advisors**; **Richard Hyman**, managing director at **Bowne Virtual Dataroom**; **Robert Landis**, a partner in sourcing & origination at **The Riverside Co.**; and **Michael Maxworthy**, a partner at **Marlin & Associates**.

It was a diverse group, but there was some consensus, particularly in the belief that the low cost (and easy availability) of money was the driving factor in the ballooning number of deals getting done. Pushed by accommodative debt markets and cash-rich buyout funds, the M&A market is likely to power on, though perhaps not at the same frenetic pace as in the recent past.

While there was concern about the multiples at which some transactions are taking place, there also seemed to be a realization that buyers are getting more sophisticated; it's not "a dollar and dream" these days, but a thorough understanding of where target companies are in the entire business process. Indeed, a growing number of private equity firms are moving away from the generalist approach and are now focusing on specific industries.

Of course, Europe's contribution to the first-half numbers was impressive, and the cross-border trend is seen continuing. In the first half, transactions that involved at least one European company as target or acquirer made up 47% of total volume in the first half, versus 38% of all mergers done in 2004, according to **Thomson**. Part of that goes back to the sheer amount of money that is available and has to be invested, but it is also the result of companies having such an overwhelming share of their region's market that they need to expand elsewhere.

Not Your Parents' M&A



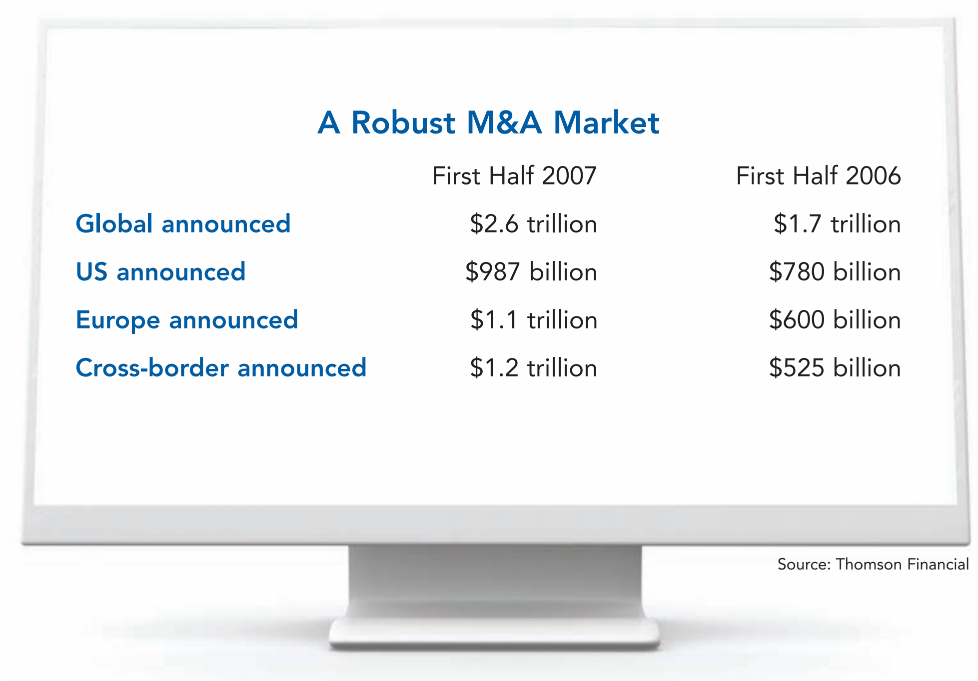
	2004	2005	2006	2007
Global VDR Transactions*	1,100	3,200	7,200	10,500
Total M&A Volume	22,122	24,528	27,800	28,000

*Comprised of Only Dedicated VDR Providers

Source: Bowne

As the conversation turned to the different ways companies are conducting due diligence in such a robust and global M&A market, it became evident that the expansion of virtual data rooms has changed the game dramatically. The use of these VDRs has grown rapidly in recent years, particularly in the US, and the participants generally spoke of the disappearance of physical data rooms. At a time when more deals come with an international flavor, the savings involved in not having to transport a team of bankers and lawyers overseas is clear. Meanwhile, European firms seem to be behind in the adoption of VDRs, but as the number of deals getting done there expands, it appears likely that VDR adoption will grow with that trend.

As for what sectors of the market appear to be ripe for more M&A, information technology and healthcare received strong backing. Among small and middle-market IT names, the action may likewise heat up, as firms that have gotten past the major downturn in the early part of the decade may be ready to move on. **IDD**



A Robust M&A Market

	First Half 2007	First Half 2006
Global announced	$2.6 trillion	$1.7 trillion
US announced	$987 billion	$780 billion
Europe announced	$1.1 trillion	$600 billion
Cross-border announced	$1.2 trillion	$525 billion

Source: Thomson Financial

IDD Roundtable

Due Diligence in a Global Market

The M&A market remains white hot, with transactions taking on an increasingly international flavor. On July 11, *IDD* sat down with a panel of experts to talk due diligence, virtual data rooms, and whether the current pace of activity is sustainable. An excerpted conversation follows.

IDD: We're coming off a record first-half performance in M&A activity, led by a host of factors - private equity, Europe and the cheap cost of money, among other things. Is it going to end anytime soon?

Landis: I did a little bit of looking at some of the numbers over the past couple of years. And if you look at what drives the market, it's money, and availability of money. If you start looking at who the investors are, you see a lot of investors shifting away from venture capital, and they're shifting all of their weight into raising capital and putting money into this market. So you've got a lot of cash still coming in. You've got banks that — let's just say they're a little bit looser than perhaps many of their credit committees would like in terms of stringency on covenants. They are willing to maybe provide another multiple or two than what they would have done three or four years ago. Whether that is wise or not, time will tell. There is just a tremendous amount of cash sloshing around. Multiples are rising. So the number of deals we're seeing in the market, me personally at the lower end, I am seeing about 15-20% more per month than I did last year. They're not all good deals, I might say, but a lot more people are saying this is a great time to sell. It may not be a great time to buy, but it's a great time to sell.

Abbott: When we talk about loose credit, it's not just the banks, because really the banks have been supplemented dramatically by the CLOs, so you've got hedge fund managers and others who are investing in debt and are not nearly as stringent as bank committees used to be. And I think that's a change from what we're used to in the past, because these loans are getting spun out, and they're getting gobbled up by CLOs. The high-risk pieces of those CLOs, we will see how they turn out, but right now that is where a lot of money is coming from.

Hompe: The activity in our space is driven a little bit more by interest rates and insurance cycles, and I would say the supply of sellers, as you pointed out, is very high in the insurance space; anything related to property and casualty insurance. I would say the banking space is reasonably high as well because of interest spread compression, and I would say some of the other financial sectors less so. In life insurance, we are seeing less activity. In non-bank financials and consumer finance, we see some activity. That tends to be driven by the phenomenon that you mentioned, the availability of money. And maybe through the sale of **General Motors Acceptance** and **Sallie Mae**, companies like those, that is more driven by the availability. But certainly in the property and casualty and in the banking space, it's the preponderance of the sellers that is creating the activity.

Hurley: I don't think there is any question that M&A is not at the end of anything. We're at a point where there is going to be a resetting of the market. But what has happened to date has really only been what was expected, what people said was going to happen. The megafunds went out, raised a tremendous amount of capital, and have spent it. And now you've got another level of infrastructure in the deal community that didn't exist 10 years ago. All of the ownership groups are adjusting to this new force in the market, which is an ownership set of the private equity community that doesn't have a long hold period. So there is going to be a turnover of properties at a higher level than possibly could have been expected even in the '90s. And what we saw in 2000, 2001, was deal activity driven by companies that didn't have revenues. All of these companies, even if a number of deals in today's docket are going to be restructured, they're all companies that are still going to be around. They're not likely to go out of business. They'll have financial restructuring, but all of the operational restructuring that has taken place in the last few years has made a much stronger army of companies out there. So it's not going to end. And all of the activity that has either recently been completed or is still in the pipeline has a ripple effect as people react to deals that have been completed and spinoffs that come out of those deals that are completed. So we're going to have plenty of activity. It's just that we're not going to have dollar comparisons by quarter that are going to continue to go up. It's not practical for anybody to expect that.

IDD: In the middle to lower end of the market, are deals getting done at reasonable multiples now, or are they getting out of whack?

Hurley: I'm not sure what "reasonable multiples" are anymore.

IDD: Maybe that answers the question.

Landis: When people ask, "Is this a reasonable multiple," I think it really depends on what you think you can do with a company. People will say, well, how much will you pay? And my first question is, well, what are the growth parameters of the company? If you are doing your job right, you are modeling the company under hopefully conservative parameters, and then you say, if I sell this company in five or six years or whatever your hold-time is, and I have a reasonable return rate, am I going to get that return? I think most private equity funds before the banks tightened up were looking at

30-35%. And now most are modeling somewhere around 20%. You have to look at both cash-on-cash and IRR. If you could pay nine times and you believe the growth rate is high enough, then maybe it's a reasonable rate.

Hompe: For balance sheet-based businesses, we're not seeing aberrations in terms of price. I would say the cash flow-based businesses are the ones people are lending against, and I would characterize as high. They're 8 to 10, 8 to 11 times Ebitda versus the historical average of 6 to 8. That's the availability of money. The amount of equity put in is probably not that different. I don't get alarmed by it because I understand where it is, but I don't expect it to remain that high forever.

Maxworthy: I think the buyers nowadays are just smarter. They're actually understanding better, aware where the fit is, where the company is, where they can take the company. That's part of the reason the multiples are so much higher. They're not buying companies like back in '99, 2000, that had a dollar and a dream. They are actually buying proven companies with revenue models. The best kind of deal you can do is with a company that has paying customers. You talk to them, they've got ideas where to take the company, how it fits into the sales process. You're going to see multiples that are much higher. The private equity guys, they're smarter now, too. They're combining their back offices; they're combining their sales operations. They've gotten smarter over the past five, seven years.

Landis: That's right. More and more private equity firms are migrating from being generalists to starting to focus on a certain industry. And they may not necessarily say we're only going to do this in this industry, but they're allocating people within their firms to always look at deals within that industry. So as you get more comfortable with a firm in a particular industry, you may be willing to pay more because you can actually see that the risks are not insurmountable. That there is a payout far beyond what you normally would have done five or six years ago, when you just said six times or nothing. So I think they're willing to pay more because they can then put that in their model, and you can get back your 20-25% return.

James Abbott

John Hompe

Patrick Hurley, Jr.

Richard Hyman

Robert Landis

Michael Maxworthy

Tom Granahan, IDD, Editor (Moderator)

Photography By Alanfil

M&A Roundtable

IDD: So you can make the argument that the historical multiples are not nearly as important as the true understanding of the business in an environment that has changed?

Landis: Yes. I think we're getting smarter, and we collectively, as private equity firms, are getting smarter about assessing the risks. If you don't understand the risks, you say "no." That's a smart strategy. But if you do understand the risks, you can model them hopefully and certainly appropriately, and you may still get your 20-25% return, and still pay a turn, a turn and a half, maybe two turns more than you used to.

IDD: The cost of money has been mentioned several times already. Given what's going on in subprime now, how much concern is there about that widening out and starting to impact the ability to get some deals done?

Hurley: I think you have to be concerned right now. If you look at junk bonds at 8-9%, it can't stay there. You can't have 250 to 320 [basis points] over Libor in buyouts that are at 10%, 12% and 14%. It's not the cost that is going to be a problem, because that 250 can become 350 to 400, and the deals will still get done. It's like Bob said, it's the availability. So much financing now is done on the basis of term loans that don't have to be paid for seven or eight years, and the hope is that the growth occurs during that period. So if that capital is not available, then everything gets ratcheted down a notch. It's not the cost, it's the availability.

Abbott: That's right. And you're seeing a reduction in that because the bridge loans are being called on some of these big buyout deals. They're not being able to put out the debt on a first syndication, so they've got to make the bridge loan, and that's showing you the liquidity is not there.

Landis: I think it was three or four weeks ago, several deals came to the market with a high-yield component, and they couldn't get done: the deals got pulled. And maybe that was an aberration, but that's the first time that has happened in the past couple years that three deals consecutively within a week got pulled and had to get restructured because the high-yield investors just weren't there. And it's not because of the lack of liquidity. There is a tremendous amount of money sloshing around between CLOs, the hedge funds and just regular investors willing to put money into high yields.

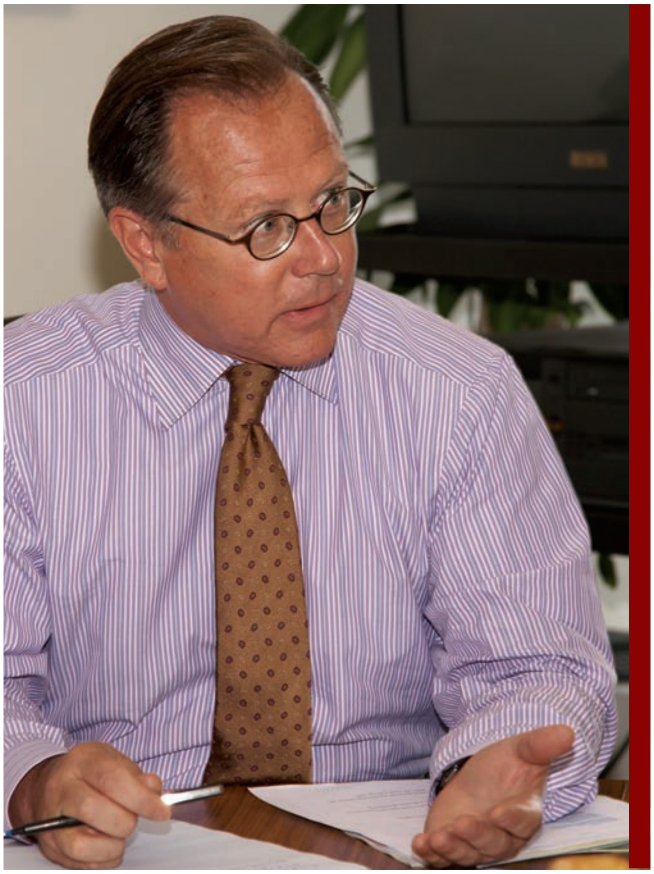
Due Diligence

IDD: Let's change our focus to the "due diligence" process. The phrase has worked its way into our everyday lexicon, which got me thinking: What exactly does "due diligence" mean? Is there a specific legal definition, or does it simply mean, hey, we kicked the tires, we saw what we liked and we bought?

Abbott: The legal side of due diligence is not nearly as exciting and interesting necessarily as the financial end, and how well the buyers can actually model where the business is headed. It's a lot more important than making sure the contracts say what you think they do, although that is an important part of what they ask me to do, but you know, it is one aspect. We talked a lot here about things that were about the foreign buyers coming into the market more aggressively, which they are now, particularly with the exchange rate, but also with some of the things that online due diligence allows to happen, which was a lot harder to do in the old-fashioned way. But, no, I don't think there is any clear definition of "due diligence."

Hyman: To me, in simple terms, it's doing your homework on a deal. And of course, it can create reasons not to do the deal, or it can show some hair on the deal, potentially influencing the deal terms. Generally speaking, to me it's doing your homework, whether it's on the legal side, on personnel, on software, technology, code, what have you. It runs the gamut of doing your homework on the deal before you close.

Abbott: It's interesting, though, because "due diligence" could be finding something wrong that makes you not do the deal, or makes you go back and renegotiate a price, but for someone that does it well, it may be finding value that allows you to outbid someone else who hasn't done their homework.



IDD: Can anyone recall a deal that got done or did not get done as a result of the due diligence?

Landis: I can think of an example of both. Besides bringing the lawyers in for the traditional due diligence of the documentation and litigation issues, and bringing the accountants in for either a cursory review of the books or a more in-depth review, particularly for a 363-auction-type transaction, you're going to do a lot more forensic due diligence. We sometimes bring in operating consultants, and we have someone on staff full-time to see if they can determine either cost savings in their operations or the way they run the operation or other ways to improve the working capital structure. And within a day, particularly somebody who understands how a plant runs, is saying to you right away it's a pristine plant and there's very little improvement, or they just see it as a sandbox for them to make major improvements in cost savings. And we're not talking about staff reductions. We're talking about greater efficiencies in plant layout, maybe better route management, if you're in some type of logistics boat with that company. And we came up with an opportunity to save almost $700,000. And that certainly gives you a lot more leeway. When you're bidding six, seven, eight times, it gives you a lot more stretch. Of course, you don't build that it in your model, but it lets you know that — if you need to stretch a little in price to get that deal, you can.

On the other hand, we've done some due diligence on background checks on people, which we did not used to do. We did cursory background checks, but now we tend to do more; a lot of private equity firms tend to do a lot more checking into individual backgrounds, and it is usually based on bad experiences in the past. So we spend time doing that, and we found a couple of instances where [someone in management] is not somebody who we wanted to be associated with, is the best way to put it. And maybe that company did well, and we walked away, but it was a decision that we made, that it just wasn't worth the risk, because all these deals boil down to good management.

Maxworthy: We recently helped a private equity shop, and one of their portfolio companies, buy another portfolio company. What happened during due diligence was the company that they bought had many different divisions, many different products, and through due diligence we came to the conclusion that the company itself just wasn't doing enough cross-sale with its products. They did the analysis, and we figured out how to essentially take advantage of that. And that is in a sense, found money to the private equity guys. Put it together with the portfolio products, it was a no-brainer to do that deal. And then another deal we did about five years ago, we were hired by a hedge fund to essentially do due diligence and help them buy a public company. And through due diligence during the management presentation, you could just get the feeling that the management wasn't strong enough. They did not want to be there at all. And with that, we walked. Within five minutes of the management meeting, we walked.

Hurley: I think most of the upside comes in the form of commercial due diligence, which is different from finding a piece of real estate that is undervalued. It's "what else?" We've worked for this particular CEO who never stopped saying, "what else, what else do you have for me?" And if the sales guys would say, well, we'd be able to fill in this product line, he'd say, "What else?" The manufacturing guys say we will be able to move it into our plant, he'd say, "What else?" I think that's where the upside comes on the operating company's standpoint. And today most of the private equity firms are dealing with managers that are highly incentivized to make changes. If there is no real push to make the changes, people coast.

Hompe: One trend I've definitely seen with the emergence of private equity is that the legal due diligence and the financial due diligence is handled largely by outside parties; it's very professional, very straightforward. But the private equity firms don't probe as deeply into the business due diligence side because they feel they're aligned interests, and they find either an existing management team that they like or a new one that they're going to put into place. So I find that in that sense, the nature of due diligence has changed over the 20 years I've been doing this, and that management is critically important, but the buyer's core competency is judging management more than it is judging business. I'm sure there are exceptions, but as I think about the deals I've been in, and the diligence that I've seen, particularly when I have been representing the seller, I see that clear trend emerge.

Virtual Datarooms

IDD: So, given the fast-paced nature of M&A now, and the tremendous number of potential buyers, companies have changed the way they conduct due diligence?

Hurley: Well, there is no question that virtual data rooms have changed everything, that professional ownership has changed everything. Nobody waits to receive a list anymore.

Hompe: I would agree a lot has changed, but I am not sure the cycle time has changed appreciably, with the speed at which the transaction happens. Certainly, the convenience, particularly for the buyer, is a lot greater than it once was. The availability of information is probably a lot better. But I am just not sure the actual time in which you do a deal has collapsed that much.

Maxworthy: About 50% of my deals are overseas, and before we did VDR, it was a pain just to get entire groups together in a room in a lawyer's office with an associate for two or three days. It would take weeks to put that together. Now I can sit there and I can track who is in, I can track who is going to print what, who I let in, and essentially, we can only take a few days. And they can get into it at their leisure with VDR. It takes weeks off the time to do deals.

Hurley: It really all depends how quickly the seller wants to get things accomplished and takes the steps necessary to make that information available.

Hyman: As far as getting through the due diligence process, you're right — the deal owner can control the speed at which due diligence is conducted and information is flowed to the prospective buyers. But at least you can give access, 24/7 access globally via a secured Web site. The days of the traditional physical data room are really past. And now, leveraging the technology can speed the diligence process and enable better user, dealer, owner controls and user rights management, which is pretty powerful.

IDD: So the use of VDRs is pretty much ubiquitous now?

Maxworthy: Yes.

Hyman: In the US it is. In the US, our data show that the majority of the deals are done via virtual data rooms. Europe is now adopting it, and we are seeing more and more deals in Europe. And we've seen an uptick in Asia, as well. I'd say Europe and Asia are a little behind in the adoption rate than in the US, but it's coming.

Hompe: The primary circumstances where you wouldn't see it would probably be a negotiated transaction, where you want to convey to the other side that they're the only party. It's the way to enforce it. But certainly, if you're speaking to more than one potential buyer, I don't remember the last time I didn't use it — it's probably been three years since I've seen an actual, physical data room.

Abbott: And that's true down to small-time transactions.

Landis: Is there a cutoff based on deal size? Because for smaller deals, we sometimes still see paper. We have a microcap fund that deals with $1 million to $3 million of Ebitda. Those are pretty tiny deals.

Hyman: The pricing is tiered, so we try to make it attractive for all size deals. It's primarily driven by the size of the data room. The number of pages that go into the data room is the primary cost component.

Hurley: So the break point is mindset rather than financial.

Hyman: Yes. We've seen a number of small deals, cross-border deals particularly, where you are saving travel between Europe and the US, and it pays for itself with that alone, aside from some of the other benefits.

IDD: Are companies still somewhat reluctant to trust these sensitive documents online, or is that no longer an issue?

Hyman: It's no longer an issue. As long as you're working with a trusted provider that has reputation and the capability, it's not an issue.

Maxworthy: I think one of the hurdles of bringing in a VDR is with very small companies. Most of them are owner-operated, started by a guy in his garage 20 years ago, and you've got to educate them. They've never been through a deal. They don't know how to do it. They're worried about information getting out there on the Internet, essentially. He might prefer the interaction with a lawyer.

IDD: I bet you don't hear that too often, Jim.

Abbott: It's nice to hear it, but we don't see it very often any longer even in relatively small transactions. Sellers of businesses are retaining pretty sophisticated help even at smaller deal values. And those people will tell them that the right way to get it done is just set it up in a VDR. For us, the convenience of having different people access it in their own time frames is extraordinarily helpful.

Hyman: With VDRs, it's more than technology, too. It's not just a secure Web site. There is a big service component to it: 24/7 customer service and consultative project management really help not only the seller, but also the buyers. For any sort of issue, the service component is vital.

IDD: The use of VDRs in Europe isn't as widespread. Are they more deliberate in their due diligence process, or is there something else at work?

Maxworthy: No, I don't think that they're more deliberate. It's just that not as many deals have happened or do happen in Europe, so they're not used to VDRs yet. They're starting to build it up, and they are starting to get used to it.

Hompe: I think we just find that the diligence is a little slower, but it's more a function of inexperience than it is being a different nationality. We sold three banks to Spanish banks in the last nine months, and one of them was an experienced acquirer and that went fast, as deals often do. And the other two had not made an acquisition in the US before, and it went slow. It wasn't a function of a risk tolerance. I think it was lack of familiarity.

Hyman: As Michael said, this is a new offering that has really been out there for just a few years, and it has taken off in the US, and now Europe is very busy, and Asia is getting very busy. So the adoption rate is increasing there and catching up to the US.

Maxworthy: Part of what helps is that a VDR is not just for deals. I know boards of directors that use it for some of its sensitive materials. I know a legal firm that uses it. It's just not for M&A deals anymore, and knowing that will help drive the education.

Hyman: Absolutely. We're seeing post-deal data repositories. When the transaction is over, we always will make available an archival copy of everything that transpired in that data room in a format the customer wants. But more and more customers are opting to keep the data room up, and we turn that into more of a repository- type application. They have that information available for acquisition integration, merger integration activities, maybe an expected subsequent transaction even a couple of years down the road. They keep it all online, keep updating it, instead of having to reload it at some later date.

Hurley: We were negotiating for a Swedish buyout firm. They had purchased a business in Finland, and part of the combination of our client and their Finnish client was going to be stock in the new entity. So we said, well, we need to do some due diligence on your business even though technically you're buying our business. And they said, OK, we'll Federal Express the disks over. They sent over a set of disks that were the data room for their purchase of an imaging business from GE. It was right there; the whole data room was sitting right there. It was just delivered routinely because they had copies.

IDD: So, you would think as deal flow in Europe and elsewhere internationally picks up, the use of VDRs overseas would likely grow with it?

Hyman: Yes. It's also of benefit in the event there is a postmerger issue. Let's just say there is asbestos in a plant, and one side claims they were never told about it. Well, the other side can say they actually can see that you accessed that document that talked about that, and they allowed the document to be printed, and it was printed. So whose fault was it that they didn't read the document? You know, postmerger mitigation of risk.

Hurley: It's even more than that. Even with disclosure, you can say you did disclose it, and you required that someone represented that they had visited every document that they considered to be important. So it's more than just convenience. It's a form of insurance policy.

Abbott: Not if their lawyer did a good job. I haven't gotten any buyer clients that are saying, 'I'm not making any claim for anything that I could have found in the data site.' I mean, it's a nice thing to argue on sort of a fraud basis, but the purchase agreement is going to have reps and warranties which tie the schedules that are not anything that happens to be in the data site, unless a lawyer is being awfully sloppy or it's a deal that is so attractive that people are buying it as-is, essentially. Certainly there are deals without reps and warranties, without much protection. But I've had lawyers that throw in a clause saying, 'Anything that we've showed you is off limits to claim on' and that I cross out real quick, if I'm a buyer.

Landis: But it gives you some moral ground to negotiate.

Abbott: Well, it does help. I am sure it does in the sense that while my legal document may not provide the claim, you're going to get in front of a trier of facts, who is either an arbitrator or a jury, and they're going to be swayed by fairness or some degree of who was or wasn't up and up in the transaction, regardless what the legal document says. You're right. And most things get settled.

IDD: Do you notice a real difference between the way a strategic buyer does its due diligence as opposed to a financial sponsor?

Hompe: I do find differences. Oftentimes with the strategic buyer, it's not the full-time job of everybody on the deal team to be processing transactions. When you actually get employees of strategics out of their office and in a room in some remote location, they focus all of their time. And when they're at their desk, they're doing their day job and doing this at the same time. So I haven't necessarily seen the efficiency translated to increased speed. I do find that they, again because they don't do this for a living, don't do it with the same degree of frequency, that maybe they're just slower adapters to it and not as facile with it. And I guess that's understandable.

Hurley: Larger companies have corporate development folks who are focused. But if it's the CFO running the deal, it's when he finds the time.

Hompe: There will be some members of the team, but typically there is not a full-time team that only does deal due diligence, unless it's a gigantic company. But typically they'll draw on someone from HR, someone from legal, someone from accounting, someone from audit, and it won't be their full-time job. The management visits, in the days when there was a physical data room, did get a focus of their attention. And now I find that less so. So they're sometimes not as fast-moving as the financial players, who are just more experienced and trained and focused.

IDD: There's a certain school of thought that says hostile, or unfriendly, deals ultimately work out better than friendly deals. Any thoughts on that, and is it more difficult to conduct due diligence in a hostile deal?

Hurley: I think it's much more difficult to do your diligence in a hostile environment, because people are not inclined to be cooperative.

Abbott: When a public company contacts another hostilely, you're dealing with a public company situation, and you're left to due diligence with the public documents and what's available. There is financial information, there are public documents, but you're very

likely not getting anything that is below that surface. In a friendly deal, you'll sign confidentiality agreements. Again, the target's management may well think they're dealing with their new boss. You're going to get to a lower level of information, which again, you would think would allow more data that would allow a fair assessment of upside or value. But I don't know. At the end of the day, someone statistically could show you that the hostile deals work out better. Maybe it's poorly managed companies that are not playing, that are getting attacked on a hostile basis, so there is more upside.

Hompe: There is probably more wholesale change rather than marginal or incremental change. That should be the explanation.

Hurley: If you've got a friendly deal, people are likely to not be challenging each other as much. If you have a hostile environment where someone has decided that it's so important to them that they're going to deal with that additional complication, then that wholesale change may result in something that creates a lot of value. So I think you've got a hostile environment if you want to break up a company.

Hompe: For someone to exert the effort that is required to do a hostile deal, they have to see a very attractive financial opportunity. It may be an attractive opportunity that is probably undermanaged. The combination of those two just means that, by its nature, it is going to be properly managed, a higher financial return, and people are willing to go through the extra pain and aggravation to reap those benefits. So it may be definitionally almost that a hostile deal is going to be better.

Cross-border Activity

IDD: We talked about cross-border deals and Europe heating up. Any thoughts on how the dollar getting beat up might impact cross-border deals in the future?

Landis: It's funny, I was looking at some numbers the other day, and the cross-border activity since 2004 has doubled. In 2006, there was $4 trillion of M&A, and about $1.3 trillion of that was cross-border, which is about 32%. That's the highest percentage in the past four, five years. It was around 26-27% percent in 2003, '04 and '05. So despite the fact that the dollar has gotten weaker over the past couple of years, the number of cross-border deals has increased. And then you say, well, then it is all Europeans or somebody else buying into the United States. If you look at it that way, I think the numbers are that about $203 billion of acquisitions were made going outside the United States. And the United States was still the largest country. Of course, we're one of the largest countries in the world, but a tremendous amount of activity is going on outside the country. So, really, I was surprised myself of those numbers. I would have expected that it might have declined, but it hasn't. If the dollar weakened, maybe it will change, and you will see more inflow than outflow, but the United States is still a huge buyer. And essentially almost 30% of what the United States is buying was in Canada or the UK. Conversely, coming into the United States, it was Canada 20%, and then 33% was the UK and France coming into the United States.

Hompe: I find with non-US buyers' model acquisitions, they don't really build any currency benefit into them. If they're buying at a certain exchange rate, they assume that in their model. They don't have it return to norm. So intuitively it's appealing, but I find in practice it doesn't seem to drive that much. I think supporting this data, you have financial institutions, in my case, that have such large market shares in either their country or their region, if they have to go outside the US, it's very attractive, and for the reason they said, it's large, and it's fragmented. Compared with most countries in the world, it's very fragmented. It would seem that currency should be an explanation, but I haven't seen it.

Abbott: I think that's right. It's much more the availability of funds and the expansion of market that is required by a company that is growing out of its home market. We're seeing a lot of activity. We just closed a deal with a company from India, and there is lot of outbound activity from India. It's not currency-related, although part of it is. There are some changes in the foreign exchange regime that allow the Indian companies to come overseas more, but it's mostly to pursue the biggest market in the world, the US, or because their stock market is so overheated that they can buy assets and they'll get a great multiple on their home stock prices as a result of doing it, or they have very ready debt capital. I mean, in India, there is a very low interest rate. If you borrow it the right way there, it's a lot lower than it is here. I think it's a lot of factors other than currency.

Hompe: We sold two insurance companies to Israeli buyers, and it's that exact situation, a very highly valued stock market, which created an arbitrage, you know, buying an asset in a market where the companies were being valued on a liquid basis.

IDD: Are there any special legal challenges in doing cross-border M&A?

Abbott: Most of the challenges with cross-border M&A are about regulatory and business-cultural-related issues, familiarity with just doing deals regularly and the way they're done in our country. Certain industries where there are regulated foreign ownership rules, Exxon-Florio, if there is anything that could be defense or national security related. But it's more those issues, and I think most of them have always been there. Again, a proper VDR is a very secure way to handle data. Foreign countries do, like the British-European Union. They have some very tight data control regulations, which companies need to be concerned about. But not so much in the M&A process as in running their businesses after they're concluded.

Hompe: One thing I have learned that does differ is disclosure standards. In the US, we're quite familiar with what our own disclosure standard is. But in the UK, in Israel and in Spain, the three countries where I've done something recently, there are much different standards as to what is disclosed and when it is disclosed. In Israel, transactions are disclosed before there is a definitive agreement signed. In Spain, the definitive agreement is not disclosed. And in the UK, there is a very narrow standard — and we're reading it now in the couple of transactions going on — there is a very narrow standard by which things are disclosed.

Abbott: It's an interesting process with India because they have their board approve the transaction on sort of a no-name basis, and they inform the stock exchange, but the target's name is not included until after the closing. So there is a stock exchange requirement of disclosing that the board has approved a transaction, but without names attached. And of course, if it's a private seller on the other side, they're interested in when is it going to be disclosed that their business is being sold, and does the world have to know how much they just got paid and other factors. Country by country, the degree of disclosure and the timing can vary a lot.

IDD: Has anyone had any experience with a deal overseas that did come back with some surprises from a legal standpoint?

Landis: We had one that was a small note, but it delayed the closing for a couple weeks. We bought a company in the UK that had small little entities in France and Italy — and when I say small, two or three employees. The laws in those countries, the seller might have been aware of it, but I think our lawyers were, but they didn't focus on it . So each little country has its own nuances, and that slowed it up. You had to have a meeting with two people, however it worked out, and then it had to be recorded, approved by the entire government, and sent back.

Abbott: It's challenging sometimes to get a whole deal to close at the same time because some of these countries have specific issues. I've certainly seen transactions where people have gotten frustrated with that, and said the heck with it, let's hold off, we will buy that part later, let's get our deal done. And some of them are as inane as that. There is some government filing and notice period or something with a union or other required approvals. Of course, in a lot of the European countries, there is lot of focus on the labor situation.

Hurley: And it can depend on whether the buyer has other activities in those countries. Most of the big buyers today are multinational, and they're already selling into other markets. And sellers very often don't realize that there is an approval in Germany that may not be a rubber stamp until it shows up in an agreement or maybe a markup of an agreement. But privately held sellers are often surprised to have multinational companies that have requirements for approvals, which doesn't exist if you have a newly formed entity that is set up by a private equity firm. Then it's good to go.

Taxing Situation

IDD: Switching gears back to the US and the private equity side, do you think the talk in Washington about potentially taxing private equity firms and GPs at a higher rate might curtail deal making?

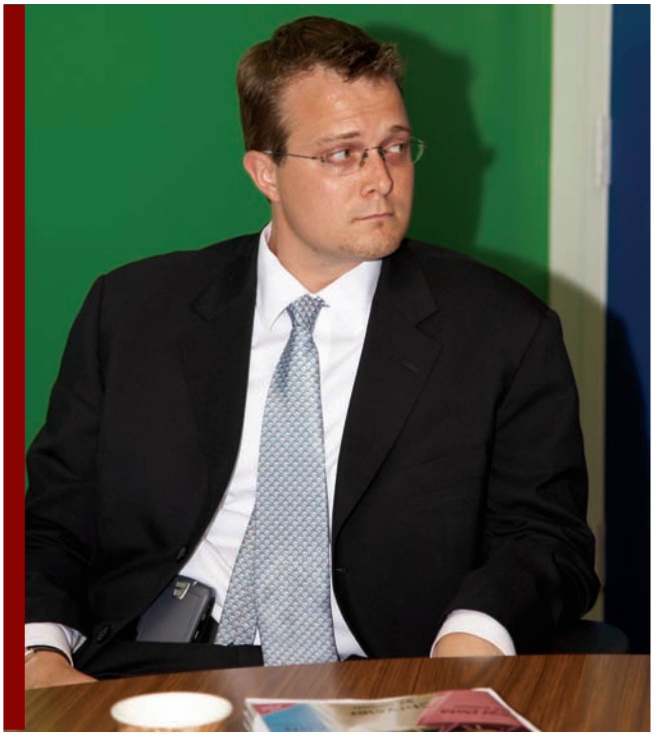
Hurley: I don't think so. Nobody is talking yet about closing down master limited partnerships that have been driving oil and gas pipelines for a long time.

Landis: It could put a damper on certain aspects. People might be a bit more conservative in the number of transactions they are going to do because if they have to work twice as hard to make the same amount of money, maybe they'll spend more time being more selective. I think it's going to be more difficult for new funds to come into the market, because it's just one more hurdle for them to realize a profit somewhere down the line, and the profit is going to be smaller than what they've anticipated, so it may be of less interest for them to set up a new fund. So the incumbents that are already in the market, all the 1,100 or 1,200 private equity firms in the United States, may be sort of grandfathered just because it's going to be more difficult for new entrants because they're not going to have that cash base to continue. They're going to have to wait even longer to build up and accumulate.

Hurley: Everything gets more complicated the closer you look at it. Now we're just bashing people who are getting rich because they're doing big deals and getting big returns. I think there will be some kind of a fix. It will discourage people from going public. This will probably pass.

IDD: Being that we've talked so much about the cross-border deals and the global aspects of things, what besides the easy money around the world and market share do you think is driving the global side of M&A? Is it simply they have tapped out all the resources they might have in their own particular country and now have to expand their footprint?

Landis: I think that as people get bigger, they want to expand. We did that in '91 when we opened up in Eastern Europe, and now we're in Western Europe, and now we're looking to expand in Japan. But our strategy is to be complementary to each other. One of our goals is to be the largest private equity firm at the lower end of the capital market worldwide, or at least in the target areas of Asia, Europe and North America, but in the past five, six years, you've got **Summit**, **TA**, **Oaktree** and **Sun Capital** all opening offices in London, and **American Capital** did London, Frankfurt and Paris. So I think they have seen a successful strategy in the United States and said, why not also in Europe to get bigger? I think all of them have been successful in their own right by doing that. So I think it's the opportunity to go into other markets and try to replicate within the local environment what you did back in your home country.



Maxworthy: I think the money is also driving that. There is so much money out there to be put to work. There are new opportunities the closer you look, different countries, different products, different products inside other companies. It is amazing the amount of money out there.

IDD: Are there any particular sectors that you think are ripe for the picking in M&A?

Landis: You've seen a lot of activity in healthcare, healthcare services, med devices and biopharmaceutical. Many of those require more specialization than what a general private equity firm has, but you see a lot more people focused on that. I've met some new entrants in food consumer products at the very small end, and they're excited.

Maxworthy: I do think that the IT space will continue to be a hot market for some time, and I think the private equity guys and VC guys are helping drive that. Not only is there a lot of money, but there are a lot of very large information-based, information technology companies that have been bought over the past couple of years. That wasn't the norm back in the early '90s and mid-'90s, and they were scared that they didn't understand it, they stuck to what they knew. And now that they understand it, they could put a large amount of capital to work on these companies and build them up with the buy-and-build strategy, and exit after the five to seven years, and that more money will flow into that. I agree that the middle market, the lower end of the middle market, is even a hotter space inside IT. Companies that survived the downturn from 2001 to 2003, they're tired, they want to get out. They built great companies, and they've learned their lessons, they have good top-line growth, they're profitable, and they see the fitness with some of the companies they're talking to. Deal flow will continue to be hot in that market.

Abbott: We're seeing a pickup, and I think it will continue, in deals within the investment management space. We work an awful lot with fund managers, hedge funds, private equity funds, and they're linking up, acquiring each other, they're being acquired by bigger bulge-bracket firms, and we think there will be a lot more of that. Tax law changes may improve that situation. It becomes more difficult to operate while making a good profit, but within our office, we've got lots and lots of fund management firms that are doing deals, not with somebody else's money, but among themselves.

Hurley: I think you look to all the new platforms that have been formed in the past 12 months and think ahead, who their bolt-on acquisitions are going to be, because they're going to be out there beating the bushes, looking for things to add, that they will be able to cut out of and add new customers. So I think what has already been active is likely to continue to be. There is no question that if my biggest competitor gets bought, I sit there and say, well, what am I going to do about that?

Stub Equity

IDD: There have a couple of recent deals - **Harman** and **Clear Channel** come to mind - done with so-called stub equity. Are we likely to see more of that?

Abbott: It's a newly revived trend. Certainly, there were deals done with stub equity years ago, KKR back in the day, and now more recently with Harman. I don't think it's something you'll see an awful lot of because it is a bother for the equity sponsor to still have this public — well, this group of shareholders that they have to answer to. Normally, the stub equity will trade over the counter, and it's not very liquid. So your retail investors wouldn't keep it. The people that are attracted to it are probably institutional holders, like hedge funds or other institutions, that see the upside that the buyout fund is going for and would like a share in that, and perhaps including it in the deal is an inducement against negative shareholder activism against a deal that looks attractive to the buyout fund. You see it more in Europe, and in Europe, you have institutional shareholder bases that are normally protected legally a little more than the shareholders are here. I think it's reflective of some of the hedge fund and other arbitrage-type investors that may be holding shares and may not just be taking whatever offer is a certain percentage above market from when a deal is announced. But I don't think you will see an awful lot of it, because it is a complexity. It also reduces the capital that the buyer has to put in. On some of these very big transactions, you can leave a billion dollars of investor money in from the existing shareholders. That's one piece of your capital structure that you don't have to fill. I think they're interesting, certainly as a lawyer they're very interesting, because the transaction is not just your straight transaction. But I don't see it as a trend that will become common.

Hurley: A lot of these deals are going to come back to the public market eventually. So why not keep it warm, and keep a group of investors out there that are likely to be supportive after you've made the changes you intend to.