CORPORATE
BOARD MEMBER®
An NYSE Euronext Company

2010 SPECIAL SUPPLEMENT

Board Focus on M&A

Industrials

Industrial Sector Cautiously Optimistic

Corporate industrials have seen a pickup this year in transactions, and many companies hope to build more steam for 2011 as they strategically focus on their core businesses.

Hunter Holliday
Partner
Alston & Bird LLP

Jim Lavelle
Managing Director
Houlihan Lokey

Bill Peluchiwski
Senior Managing Director
Houlihan Lokey

It looks like August was one of the busiest months for overall M&A activity across all sectors in the United States for 2010. What deals are on the watch list in the industrial sector?

Bill Peluchiwski: In the industrial sector, there is a very large deal in Canada as BHP Billiton goes after Potash Corp. with an unsolicited bid in a hostile format. That's probably the most notable deal on the forefront. There are other deals that have been happening, such as Pactiv Corp., as well. So you've got quite a few people out there looking at transactions, but the BHP deal is probably the most active one.

Hunter Holliday: There's no question from a legal perspective that M&A activity is picking up in 2010. We're definitely not back to the 2006 and 2007 levels, but we might be close to the 2008 level. Toward the end of 2008, and especially throughout 2009, the industrial sector was in a downturn and raw material prices were way up, so M&A activity was stifled during that time. Buyers with access to cash were willing to make acquisitions, but sellers didn't want to sell on depressed numbers in late 2008 and all throughout 2009. We're seeing a lot of activity now, particularly in packaging, chemicals, electrical components, and fabricated metals. We're also seeing a lot of interest in U.S. industrial sector companies seeking partnership or joint venture opportunities in China.

Peluchiwski: I'll echo Hunter's sentiment relative to cross-border opportunities. Obviously there are a lot of people still looking to have a China or Asian play, and we have seen quite a bit of that kind of activity. For example, we're seeing a lot of inbound inquiries relative to what I would term Fortune 500 U.S. businesses looking to expand their Chinese capabilities. A lot of them are already in China and many are doing joint ventures, and right now they're looking to revisit their investment theses as to whether they should be wholly owned subsidiaries as opposed to joint venture partners. So there seems to be a little bit of a change on that front. We're also seeing a lot of outbound investments. It's a high-growth area. Similarly, I would also add India as another area where we're seeing people look for additional growth opportunities. Some of that is M&A and some of it's organic.

But going back to your question about the various sectors, we see other active areas in industrials. You mentioned the chemicals side, which would be the Potash deal. We haven't seen much activity on the metals side, other than some of the mining sectors. There has been a bit of activity in natural resources occurring as these developing nations, and the major companies in those nations, look to lock up resources around the globe.

Jim Lavelle: I would note a few things. One is that just a couple of weeks ago, a very interesting cross-border deal was announced. It was an approximately $800 million revenue divestiture for Emerson, which sold its motors and controls business. Interestingly, the sale was made to a Japanese group called Nidec. That was a pretty high-profile transaction in the industrial marketplace playing off some of the themes Bill just talked about, obviously Japan being different than China, but there is the Asian link and it represents a well-respected U.S. player reallocating its portfolio to concentrate more on technologies and markets that are core to its future development. Also in the pipeline, according to press reports, are a number of dual-track transaction approaches that various companies are pursuing where they're looking at the IPO markets as well as M&A. This is taking place in Europe, as well as in the U.S. One high-profile deal that has been in the press is the German company Norma, a highly successful holding and build-out of the 3i investment group. Norma has reportedly appointed a banker and will look at a dual track.

Peluchiwski: I'll talk globally not just specifically on industrials, but on issues that cut across all sectors as to why M&A activity is going to be very robust. Some of what we are hearing about is the private equities selling, as Jim mentioned. Some of that is tax-driven from a calendar-year perspective because of the changing tax laws in the United States; although I think it's also a function of corporations sitting on a great deal of cash, thus the high-yield markets and the overall borrowing markets have opened up for the right types of credit. So if you think about the amount of cash sitting on the sidelines in corporate America that's earning very little, we think that's one of the driving factors. They've really squeezed out all the cost in their organizations and maximized their earnings based on the current book of business, so the way they're

> "There's more upside in this economy than downside, and though there's still a bit of uncertainty, the upside is stronger, and I think that weighs in people's heads as well."
> — **Bill Peluchiwski,** Houlihan Lokey

going to show growth to the equity markets is by doing deals. We think that's going to be a catalyst for why the deal business will continue. And obviously it's a meaningful aspect to the industrial companies as well. They're seeking additional growth, and because of all their cost reductions it's not going to happen internally, so they have to look either organically overseas or through acquisitions, and I think that's a big factor in why we're seeing increased activity levels.

What other major themes have you spotted as far as strategic players and private equity for this year?

Holliday: For strategic players, we're seeing two things. They're either looking to divest noncore assets and focus more on their core businesses, or they're looking to shore up market share in their core businesses and increase revenue through acquisition. For private equity funds, we are seeing them struggle in auctions to compete with strategic buyers. They have significant war chests and are

trying to compete with all-cash acquisitions by strategic buyers.

Lavelle: You have seen, and you're probably going to continue to see, some very good corporate acquisitions of targets, be they other public companies or be they private companies, in part due to what Bill was saying. Cash has really built up for these businesses. They have very strong balance sheets, and they've been filling "white spaces" in their own product offerings via acquisitions and new product development to better utilize their distribution networks. The other thing that Hunter talked about and we see occurring are divestitures. Divestitures are happening now, rather than six months or nine months ago, because at these larger public companies, CEOs wanted to see that both the prices and the market had settled down. They didn't want to have fire-sale pricing. Now that there has been more stability, even though it's been choppy of late, that is starting to unleash some of these divestitures. We have had numerous inquiries over the past two or three months—many, many more certainly than we had six or 12 months ago. And the last point I would make relates to private equity. These players have been sitting on the sidelines in their buy-side role for, in some cases, two years and more. As we have discussed, we've come through a very, very bad time in the economy, but some companies have performed markedly better than others. Now, those strong performers are the kinds of companies that are attracting a lot of private equity interest and can now get the capital to do deals.

Peluchiwski: I guess I'll point out the obvious, which is that we have seen pricing continue to trend upward from a valuation perspective, so companies are not being bought on the cheap like the ones that had to sell during the downturn. So companies are being bought at fair prices. In fact, I'd argue that pricing is really no different than it was before we started this current economic cycle. As a result, that pricing tends to attract sellers to the market, and that drives the divestiture activity.

How is the financing market looking right now?

Peluchiwski: I would say it depends on what type of business it is and how well it fared in the economic downturn. Industrial sector businesses did fairly well in the downturn because they were able to cut costs and make adjustments. Though their revenues may have declined, they were more likely to maintain profitability. I would say that, with the caveat that it depends on the business type, the financing markets have come back pretty strong, especially at this point in time. However, it changes monthly. It depends on how the markets are open or not open, but we're in situations where we're seeing staple financings on some of our deals coming back at five and a half times for an industrial business. I would say the normal range is more in the three and a half to four times category. But we are seeing that stretch, and it's been a lot more aggressive recently.

Holliday: We're seeing somewhat of an uptick in financing for private equity transactions. Commitment letters are required for auctions, and banks are starting to give them again. Instead of the retrenchment we've seen from banks over the past couple of years, we're seeing them jump back in the market, but with somewhat less aggressive financing than we saw in 2005, 2006, and 2007. For example, banks are looking for private equity funds to contribute at least 25% to 30% equity, and sometimes even higher. That's nothing like the 10% required equity contributions we used to see. The bank commitment letters we're seeing have more reasonable financing margins (i.e., higher) and more reasonable leverage ratios (i.e., lower) than we saw prior to the recession. However, there's one financing term that has still been showing up in some commitment letters we see—and this has been a bit of a surprise to us—and that's "equity cure rights," meaning that if a private equity fund's portfolio company breaches its financing covenants, the private equity fund can contribute equity to cure the breach. That was a surprise to us, because we didn't expect those types of covenants to continue to be in some commitment letters.

Peluchiwski: I think there have been three stages in the LBO cycle. Back in the late '90s and early 2000s, and even before that, we saw 10% to 20% equity investments. After that last restructuring in 2001 and 2003, we saw equity commitments increase to the 25% to 30% range. I would say in this downturn what we're seeing in equity is closer to the 40% level, which is a lot more equity. If you want a high level of leverage, you've got to put a lot more equity in. We are seeing that trend partly because a lot of people backed away from those deals when they thought there was an equity sponsor behind them. They got burned once and then they got burned once again in the latest downturn, so I think there's a strong motivation to have enough skin in the game. But I would agree with Hunter that we're seeing quite a bit of activity, and people are coming back and lending money. One of the concerns we have is that because of the overall consolidation in the credit markets, are there enough bodies to support the deals? That's probably the biggest hold up, trying to get lenders at presentations if they are private-equity owned. There are a lot of deals out there right now, and there is a huge need for lending activity.

"Most of the divestitures we're seeing now in the industrial sector are not as a result of large, transformative deals that forced divestitures for antitrust reasons, but simply because sellers want to get rid of noncore assets." — **Hunter Holliday,** Alston & Bird LLP

There's been a lot of talk lately about the possibility of a double-dip recession. Will this impact the M&A market at all?

Lavelle: Bill and I have been spending a lot of time in Europe as part of our responsibilities. When you speak to the executives in Europe, they are much more pessimistic than U.S. executives, and there is more concern in Europe that we may indeed go into a double-dip recession. Now obviously the macroeconomic news has been in the forefront during the last two years, but particularly over the summer months and into the election season. Of late there has been more sentiment here in the U.S. that the recovery is going to be more muted going forward, maybe for the next couple of years, but certainly for the next year. And that is injecting more caution among executives when they look at deals. So no one can tell if it's going to be a double-dip situation, but certainly there's not a lot of optimism that corporate earnings will grow at a 10% or 20% rate in the next year or two. And that, I think, is going to impact the financing markets to the point of what Bill was saying before, where about 40%—we've actually seen in some cases as much as 50%—of the total capital in a transaction come in as equity, which is very different from the pre-crisis days.

Peluchiwski: We saw the recovery in industrial accounts back in December before most people saw it. The first quarter was surprisingly strong, and the second quarter was also very strong. So in some ways we're not seeing the same pace of activity right now, but we're not seeing a decline, either. I guess I would only say that from a run-rate perspective, we don't necessarily see the double dip, but we see a slowing of the recovery. I think we saw a huge pickup in the first half of this year, and now that pickup is substantially slower, but to suggest that it's going to drop back down…we just don't see that from our clients. That's an important distinction. When I think of double dip, I think it has to drop back down, and not just simply slow down.

What about divestiture activity in the sector?

Holliday: From a legal perspective, back in 2006–2007 we were seeing many larger-dollar deals, and with those deals we saw a lot of forced divestitures in the industrial sector by the antitrust regulatory authorities in the United States and Europe. During that time, we represented a number of buyers acquiring assets that were required to be divested to a third party prior to closing. Most of the divestitures we're seeing now in the industrial sector are not as a result of large, transformative deals that forced divestitures for antitrust reasons, but simply because sellers want to get rid of noncore assets. I follow the chemical sector pretty closely, and this year we saw Dow Chemical's divestiture of its polystyrene business. The new company is called Styron, and Dow divested it to Bain Capital for about $1.6 billion. That was one of the largest deals in the industrial/chemical sector in 2010.

Peluchiwski: Well we know some that will be in process. I'm not sure we can talk about them yet, but I think the reasons for the divestitures were covered earlier in terms of attracting sellers and noncore assets.

Lavelle: We haven't talked about it much thus far, but in the marketplace right now, the most important thing is that the earnings multiples companies are going for are actually pretty powerful. Obviously 18 months ago multiples were very, very low when you looked at it on an LTM basis because values had plummeted and earnings were still relatively high, looking in the rearview mirror. Since then we've watched earnings in the industrial sector decline, then rebound quite strongly. So we think earnings are going to be relatively stable, and the valuation multiples that companies will be able to get on those earning streams will actually reach the levels they were at before the crisis, or in some cases even above that. One example is Emerson and ABB. They were in a very high-profile battle for a company in Europe that traded on the London Stock Exchange called

Chloride. It was a very competitive contest and that company went for a very, very high multiple of earnings. A number of deals Bill and I are involved in are going at probably 20% and higher premiums— on a multiples basis—versus where they were even in the pre-crisis era. So that's another reason why large corporations are thinking about and/or divesting businesses at this point in time. They're not going to be embarrassed by the value they get.

Peluchiwski: We did a divestiture for the European operations of a large Fortune 50 U.S. company, and from where we started the process to where we signed the deal, there was about a 30% increase from the beginning of the year to where we

> "There have been a lot of lessons learned by boards in terms of how stable their businesses are, how volatile they may be, how exposed they may be, how capably they are managed etc., which was eye opening for many boards."
>
> — **Jim Lavelle,** Houlihan Lokey

thought we would end the year. So you're seeing appreciation in processes, and you're seeing people who are looking at that and saying, "You know, this is a good time to take advantage of that." There's more upside in this economy than downside, and though there's still a bit of uncertainty, the upside is stronger, and I think that weighs in people's heads as well.

Speaking of looking inside people's heads, what about the outlook of boards of directors? Do you think it's cautiously optimistic?

Lavelle: Well, like the others participating in this discussion, I have spent a lot of time with public company directors, and for the most part, they've learned a lot over the past few years. In some cases they've learned that their companies are not as well insulated as they thought they would be from the industrial cycles or even the financing markets. For example, many capital goods manufacturers couldn't sell many products in late '08 and early '09 because their customers could no longer get financing to pay for the capital goods. Everything was interwoven. And in some cases they've learned they need to improve on the soundness of their balance sheets; the strength of their management teams, not only at the top level but at the secondary and tertiary level; governance issues; or their internal communications. So I think there have been a lot of lessons learned by boards in terms of how stable their businesses are, how volatile they may be, how exposed they may be, how capably they are managed, etc., which was eye opening for many boards. I don't know if the others agree, but I think it's been a pretty big learning period.

Peluchiwski: I think directors are a lot more sensitive and conservative than they were before this whole recession started because the speed at which the downturn occurred was remarkably fast. I will say that boards today are much more nimble than they ever were before. In the industrial community, when you look at what happened at the end of 2008, the reaction time for large industrials was fascinating. I've been doing this for a while, and was surprised at how people reacted so quickly in terms of cutting expenses, cutting costs, shutting operations, reducing head count, and taking fixed costs out of the system. So the speed at which large industrials reacted was remarkable, but I still think the severity of the downturn made boards a lot more sensitive to their business, as Jim mentioned. I think in some ways this was able to happen due to the technology investments in all these systems. That paid off during this recession, as these companies had much better information on a global basis than they'd ever had before. So I think that's one of the elements that weighs into the board's mindset.

Some people have predicted that there will be a year-end consolidation spree. Do you agree or disagree?

Lavelle: Personally I agree with that. I think you're going to continue to see transactions happen not only at the end of this year, but over the next couple of quarters. In a somewhat cynical manner, a lot of CEOs and CFOs are watching this muted recovery, and they are seeing an opportunity to buy earnings and fill in some gaps in their own product or service offerings. We all talked about how interest rates are so low, and how the balance sheets for these companies in many cases are really very, very strong. So converting cash into an operating business that provides its own cash flow and fills a strategic gap is very attractive. So I think you're going to see more of that carry on, not only between now and the end of the year—although you're certainly going to see some of those—but for at least a quarter or two after that.

Holliday: Interestingly, despite M&A activity being down in 2009, we saw consolidation at the end of last year. Many strategic buyers had available cash, valuations were about as low as they would go, and the strategic buyers wanted to close deals by the year's end. We are expecting another round of consolidation at the end of 2010, but perhaps for different reasons. We are seeing a lot of privately held businesses, especially family-owned businesses, looking at selling those businesses before the end of the year in anticipation of the increase in the capital gains rate. I don't know how significantly that will affect the sector, and I don't know if I would call it a consolidation spree, but I think we know that people are looking at the increased capital gains rate and potentially selling prior to the end of 2010.

We touched on cross-border activity. What about global M&A volume in the industrials sector?

Lavelle: Well I guess I'd say that when you think about M&A today, most people are thinking globally anyway. In today's environment, people aren't thinking about their competitors down the street, or in the same state, or even in the same country. They're thinking about competition on a global basis. So if you think about what you can do, you really should be thinking about everything globally. We run our business from that perspective. Whether it's in Asia, Europe, South America, or the United States, we really think about it from a global perspective in terms of who are the buyers and sellers and what works for them strategically. So in almost all our discussions, we think about it in those terms. And it lends itself in the industrials space more so because so much has been shifted overseas from a production point of view that you really have to think about your competitiveness on that level. That is how we look at it and why so many of our deals are, in fact, cross-border, or if they're not consummated cross-border they certainly involve at some point international buyers from India, China, Europe, and the like in our transaction processes.

Peluchiwski: Clearly we live in a global world, and we're going to see more and more of this happening.

Sponsors

CORPORATE
BOARD MEMBER®
An NYSE Euronext Company

Corporate Board Member, an NYSE Euronext Company, is the leading information resource for senior officers and directors of publicly traded corporations, large private companies, and Global 1000 firms. The quarterly publication, *Corporate Board Member* magazine, provides readers with decision-making tools to deal with the strategic and corporate governance challenges confronting their boards. Corporate Board Member further extends its governance leadership through an online resource center, conferences, roundtables, and timely research. The company maintains the most comprehensive, up-to-date database of directors and officers serving on boards of publicly traded companies listed with NYSE Euronext, NYSE AMEX, and The NASDAQ OMX Group Inc. stock exchanges. **www.boardmember.com**

ALSTON+BIRD LLP

Alston & Bird is a national law firm with more than 800 attorneys providing a full range of services to domestic and international clients conducting business around the world. The industry knowledge and regulatory capacity of its 250 corporate, regulatory and policy attorneys bring critical value to client relationships. The BTI "Masters of the Deal" list, a survey of law firms' corporate relationships, ranked Alston & Bird 5th among U.S. law firms. Alston & Bird has been ranked on FORTUNE's "100 Best Companies to Work For" list for eleven consecutive years, including placement in the top 25 for seven consecutive years. The recognition speaks to the culture of the firm and the environment in which the firm practices law. **www.alston.com**

HOULIHAN LOKEY

Houlihan Lokey is an international investment bank with expertise in mergers and acquisitions, capital markets, financial restructuring, and valuation. The firm is ranked globally as the No. 1 restructuring advisor, the No. 1 M&A fairness opinion advisor over the past 10 years, and the No. 1 M&A advisor for U.S. transactions under $3 billion, according to Thomson Reuters. Houlihan Lokey has 14 offices and more than 800 employees in the United States, Europe and Asia. The firm serves more than 1,000 clients each year, ranging from closely held companies to Global 500 corporations. **www.HL.com**

CORPORATE
BOARD MEMBER®
An NYSE Euronext Company

5110 Maryland Way, Suite 250
Brentwood, Tennessee 37027
(800) 452-9875 • www.boardmember.com