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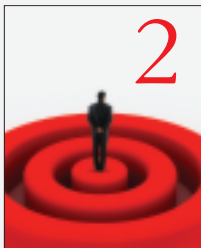
2008 SPECIAL SUPPLEMENT



# Board Focus on M&A

*A Closer Look at Industry Trends for 2008*

# Contents



## INTRODUCTION

### Board Focus on M&A

*With commentary by Jerry Leamon, global managing partner, Services and Mergers & Acquisitions, Deloitte Touche Tohmatsu and Chet Wood, managing partner, Merger & Acquisition Services, Deloitte & Touche USA LLP.*



## CONSUMER BUSINESS

### A Slow Year for Consumer Business M&A

*Private equity and strategic buyers dominate the broad consumer business industry, where, despite the threat of a recession, the luxury goods sector is expected to fare well.*

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## FINANCIAL SERVICES

### Market Uncertainty Sets the Stage for Financial Services M&A

*Our experts discuss the trends shaping the financial services deal landscape, including how many organizations are looking to preserve capital and reduce risk by selling noncore businesses.*

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TECHNOLOGY, MEDIA, TELECOM

## Convergence, Changing Technology Drive TMT Deals

*Product innovation, convergence, and cost control are among the many factors driving activity in the TMT sector, where volume is expected to pick up in the latter part of 2008.*

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UTILITIES AND ENERGY

## Steady Deal Flow Anticipated for Utilities and Energy

*High energy prices and strong cash flow, along with continued interest from foreign buyers due to a weakened dollar, have helped create a favorable deal environment.*

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# Board Focus on M&A

## Although the question on everyone's minds is whether or not the economy will downshift into a recession,

most analysts agree that such a downturn would only moderately impact M&A activity in 2008. In some instances, it might actually fuel activity as stronger players shop for deals in an opportunistic environment.

2008 will be an interesting and challenging year for most industries, according to the group of leading financial, legal, and advisory experts who gathered this spring to discuss M&A trends within four major U.S. industries. The results of four separate roundtable discussions centering on growth strategies and M&A within the technology media telecommunications (TMT), utilities and energy, financial services, and consumer business sectors are featured in this edition of *Corporate Board Member's Board Focus on M&A* supplement, co-sponsored by Deloitte, Alston & Bird LLP, and Houlihan Lokey.

While deal pace is not expected to break records or yield many blockbusters, M&A activity across most sectors should move along at a moderate clip in 2008. Distressed and nontraditional M&A activity may pick up, especially in the retail sector, which is influenced greatly by the spending habits of the middle-market consumer. Deal drivers will include companies' need to raise capital and reduce risk by shedding noncore businesses, such as Banco Popular selling its U.S.

consumer finance business to AIG. In the broad TMT sector, convergence is a major driver. As technology advances at an increasingly rapid pace, companies are beginning to realize they need to be in a much broader industry segment in order to succeed, although they may not have the necessary technology, products, distribution networks, or content to do so. This may result in technology companies searching for synergies with available partners to allow them to broaden and strengthen their current offerings.

"While deal volume and value have retracted from the heights of 2006 and the first half of 2007, private equity partnering opportunities with sovereign wealth funds and other foreign investors will contribute to the deal activity of 2008," says Chet Wood, managing partner, Merger & Acquisition Services, Deloitte & Touche USA LLP. "Furthermore, private equity may look to reinvest in their existing portfolio companies, identifying and executing strategic acquisitions that will bolster portfolio value in preparation for the return of a sellers' market."

Private equity played a large role in many deals in 2007, particularly in the consumer business and TMT sectors, and will continue to do so in 2008. Steady deal flow is also expected in the utilities and energy sector, where large private equity players will likely turn their interest to the unregulated power subsector, given favorable market conditions.

Foreign interest will also continue to emerge, as U.S. assets are relatively cheap across most industries. Thus, global expansion both here

and abroad will continue as more companies develop strategies that leverage their resources worldwide.

*“While deal volume and value have retracted from the heights of 2006 and the first half of 2007, private equity partnering opportunities with sovereign wealth funds and other foreign investors will contribute to the deal activity of 2008.”*

— Chet Wood, Deloitte & Touche USA LLP

“Notwithstanding recent events in the credit markets, global deal activity in the longer term (five or more years) is likely to continue its positive trend,” states Jerry Leamon, global managing partner, Services and Mergers & Acquisitions, Deloitte Touche Tohmatsu.

“Corporate cash-balance levels are at a 20-year high, so strategic buyers should return to 2005-2006 levels. With over \$3 trillion in assets, sovereign wealth funds will also provide alternative financing conduits, whether through partnerships with private equity or investments in companies that choose growth by acquisition, therefore the deployment of sovereign wealth is likely to have a significant affect on global deal activity,” Leamon says.

So while 2008 may not be the year of the megadeal, there are still quite a few viable acquisition targets, and strategic players, waiting in the wings.



# A Slow Year for Consumer Business M&A

*Private equity and strategic buyers dominate the broad consumer business industry, where, despite the threat of a recession, the luxury goods sector is expected to fare well.*

### **Lindsey Alley**

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On the retail side, our expectation is that, in general, the sector will be negatively affected across the board in 2008. We think restaurants will significantly underperform. Certainly the vast majority of retail concepts are more discretionary versus staple oriented.

The only sector that will continue to perform well, both in terms of general economic performance and M&A activity, is luxury goods. There will be significant, high-profile transactions within luxury goods across all categories: retail, consumer, and personal care. A luxury brand such as a Louis Vuitton, Chanel, or Tiffany will continue to perform well and will see a lot of interest from the private equity and strategic community over the next 12 to 18 months. There's still a lot of money out there, so the negative impact of a possible recession is mostly focused on the middle-market consumer, as opposed to the high end of the market, at least for the next year to 18 months.

**Alan Behr:** Much of the luxury market enjoys a certain immunity to all but the most brutal economic trends, such as a 1930s-type crisis. The luxury market will likely continue to be robust in many ways, and M&A activity will continue to take place. That is because markets undergo market-based shifts regardless, to a very large extent, of the surrounding economic conditions, and most of the major luxury brands have moved from one narrow sector into providing a variety of goods. That goes for retail as well. Remember, Harrods started as a green grocer, and most other department stores started out as simple dry-goods merchants. We can take those to be early examples of product diversification. So we will likely see a continued, relatively good performance in the luxury goods market compared to the rest of the consumer goods sector. I say a relatively good performance, because even if you have a lot of money, you might just conclude that you don't need that second yacht.

**Jeff Bakutes:** I agree. One additional point is that many times, when companies want to resuscitate their stock prices, consumer businesses will dispose of their noncore assets and undergo product rationalization. That will most likely continue, which will obviously add to deal volume

### **What is your take on the general M&A outlook for the consumer business sector for the coming year?**

**Lindsey Alley:** In looking at the M&A environment in the consumer business sector from a broad perspective, we are finding that discretionary consumer product companies generally fare poorly as we approach a possible recession. The question really is, will there be a decline in the overall economy?

In a challenging market, both private equity groups, as well as entrepreneurial and public companies, will often see valuations decline—to the extent that they will hold off on selling. Whereas in a good market, with strong brands and discretionary spending, valuation multiples are significant. And so over the last three or four years, there have been some very high-profile deals in the discretionary consumer sector that have gotten done with attractive multiples. But we expect that trend to decline pretty substantially over the next 12 to 18 months.

On the flip side, in the staple consumer sector, with the food industry being perhaps the best example, we see a fair amount of activity despite a struggling economy. In fact, analysts suggest that some of the best stock performers in a tough market are classic food companies such as General Mills, Wrigley, and Kellogg. There tends to be decent M&A activity in these staple consumer sectors that are need-based, rather than luxury-based.



and activity. Looking ahead throughout 2008, it's going to be a slower M&A market, and we're just going to have to wait and see how things develop in terms of the economy and marketplace.

**If we enter an economic recession, which industries within consumer business will be most greatly affected?**

**Behr:** We have a low savings rate in the United States, which is sometimes cast as a sign of consumer confidence. Countries with high savings rates show a certain amount of pessimism with regard to the economy and government, so the argument goes. If you have a low savings rate and a recession hits, you're going to cut back on your luxuries first, especially if you are not in a higher income bracket. That includes passing on Friday nights at the Olive Garden and putting off home renovations, if they are not critical. So if the economy worsens, we should expect to see prudent decisions to trim expenses, which will cut across many income brackets, to a certain degree. That being said, everyone at some point has to change a light bulb or fix a leaky sink. Eventually, some of those expenditures must be made.

**Alley:** As far as specific sectors in consumer business, sporting goods will take a hit, along with lawn and garden equipment and housewares and accessories. Those are the types of categories that will be significantly impacted by a recession, for the reasons that have been stated. Household products and cosmetics may be less affected as they are a little less discretionary and more need-based.

**Bakutes:** Specialty apparel, department stores, and similar retailers will certainly be impacted the most. When you look at the holiday sales season, weakness in the retail sector was fairly widespread, and I expect that will continue in 2008.

**Behr:** Mass-market, big-box retailers have been able to hold on to margins in recent years by shifting production to China and, to a certain extent, by using online facilities that, in many cases, are more cost-effective than traditional storefronts. Those changes have been assimilated into the

market and there is no way to repeat that benefit, so they'll have to take their current numbers as their respective starting points and ride the wave with them.

**Alley:** On the restaurant side, we tend to see the middle get squeezed. So in a challenging economic environment, you see high-end restaurants such as Morton's not as affected as, say, Applebee's, because many consumers will choose to eat at a quick-serve or fast-casual restaurant as opposed to a full-service establishment. So it will be interesting to see how the fast-casual concepts, which aren't quite fast food but are somewhere between fast food and full service, fare. What we're expecting to see, and what we've seen in previous recessions, is that the McDonald's of the world do all right. The luxury steakhouses, unless we have a deep recession, also tend to do all right. But everybody in the middle gets squeezed.

**Behr:** I agree. It's been a number of years since the last U.S. economic recession, and quite a bit has happened in the market since then. There has been a shift in point of production and, more recently, an increase in online activities, as well as an interesting and perhaps disturbing alteration in our society: a greater imbalance between the high and the low ends. That middle position, which we've always valued as the central core of the American experience, is more challenged than before to maintain pace. Companies selling into that classic middle-American market may therefore have the biggest struggle in a downward-trending economy due to that proportional weakening. We can contrast that with the comparative ease with which the higher end of the salary scale has moved further upward, effectively immunizing itself from all but the worst catastrophe. Rich individuals may suffer in a bad economy, and everyone can cut back here and there, but the group will do just fine long term.

**Do you expect online spending to continue to increase, and will that be affected in any way by a downturn in the economy?**

**Behr:** People shop online for things that are fairly commoditized—things they don't have to see and touch

in order to buy. It's all about convenience. When I send Christmas presents to family members in Florida, it's easier for me to click on Barnes & Noble's website than it is to walk into my neighborhood Barnes & Noble and ask the clerk to ship them.

**Alley:** I don't follow the online retail industry as closely as I do the bricks and mortar or consumer segment, but in doing some research I found that online holiday sales in 2007 totaled \$29 billion, up 19% from 2006. In fact, 2007 was Amazon's best holiday season in its 13-year history. The busiest day of the year was no longer the Friday after Thanksgiving (Black Friday), but something dubbed Green Monday, which is the second Monday in December. Green Monday has also eclipsed the Monday after Thanksgiving, known as Cyber Monday.

We'll continue to see explosive growth in online spending. It may slow down from 19%, but it really is taking market share from the brick-and-mortar stores, and I think it is out of necessity and potential cost savings. Online sales will be somewhat immune from the effect of the overall economy, more so than the brick-and-mortar stores.

**Bakutes:** I agree. So much of the news and information the younger generation receives is either via cell phones or the Internet, which should continue to drive online shopping. I have three sons and, half the time, if not more, they are choosing to buy something online, as opposed to saying, "Let's go to the mall or to the store to shop."

**Behr:** That's a good point, because the younger generation, especially, has trained itself to do its consumer research online, the way my generation was trained to watch television commercials. It's much easier to bring Dad over to the computer and ask him to consider a purchase than it is to get him to drive to the mall. The benefit for an online company, especially in categories such as consumer electronics and things that do not need a lot of inspection or trying on, is that, other factors being equal, there is a real incentive for Dad just to click "yes" and move on.

**Unemployment rates hit a two-year high in December. How do you see that affecting consumer business in the coming year, particularly with regard to layoffs?**

**Alley:** I think the most significant numbers will come from the specialty retailers and their suppliers. But the state of employment in the vast majority of the states where our clients are is pretty good. It's pretty robust. There are plenty of people looking for opportunities and good talent for retail. There's not a dearth of employment activity in the retail space, and we're not seeing retailers significantly reducing their workforces, other than for the retailers that are closing. Probably the most extreme

example is The Bombay Company, which essentially liquidated 550 stores nationwide and terminated a fairly significant number of employees. So we're seeing fewer layoffs in the going concerns. Instead, what you're more likely to see is that the mid-tier and lower-tier retailers that fail in this environment will essentially liquidate, and that's where there will be significant elimination of employment.

**Bakutes:** We're probably going to see declining sales leading to store closings because certain markets are saturated. Take Talbots, for example, which has announced that it is getting out of its children's and men's divisions, and Pacific Sunwear, which is closing 154 stores. It remains to be seen how unemployment will impact the consumer business sector.

**Behr:** I agree, though I want to add one caveat, which is that we live in a world where brands are everything. The stories that brands tell about themselves are critical, partially because of the electronic media and partially due to evolutionary reasons. A lot of closings are not strictly economically driven, but are due to branding issues and consumer preferences that are trend-driven.

**What were some of the most influential or interesting consumer business deals last year?**

**Bakutes:** The largest deals in the consumer business sector in 2007 were take-private transactions by private equity investors. However, the sector has been, and will continue to be, dominated by strategic buyers. The deal that stands out to me as far as deal size, difficulty in the credit markets, and other issues all occurring at the same time, was when Bain Capital and various other acquirers were looking to buy Home Depot's supply business.

Other examples of megadeals in the sector included KKR's purchase of Dollar General for \$6.9 billion and Warburg Pincus's purchase of Bausch & Lomb for \$3.67 billion. On the other hand, there were numerous strategic deals that were completed as a result of companies seeking top-line growth, geographical expansion, and new product innovation.

**Alley:** One deal that I'm following is IHOP's acquisition of Applebee's. IHOP CEO Julia Stewart has been a hero for this iconic brand. Now IHOP has bought Applebee's, a struggling bar-and-grill chain, and has promised the market that it will refranchise about 500 restaurants over the next several years, and it is trying to do so when the restaurant is not performing well. So that is clearly a deal that is the most talked about in the restaurant industry, and it's one everybody is watching extremely carefully. If Stewart can't pull it off, the results could be disastrous.

Switching over to another acquisition, Coca-Cola acquired Energy Brands, which makes Vitaminwater. Coke is determined to create a new business within this energy-infused water sector. It got into the water business with Dasani and has done a great job with that brand. I'll be interested to see what it does with Vitaminwater and whether it will be able to create a category that people think about when they think about soda and bottled water. Will Coke be able to take energy-infused waters to a new level, as well?

**Behr:** 2008 will be an interesting and, in many ways, challenging year, as will, I think, the rest of the decade. We are undergoing an evolutionary process caused by a change in media and, of course, a change in generations with buying power. The result will be change in the economic environment.

### **As far as cross-border activity, do you see more or less foreign interest in the broad consumer business sector?**

**Alley:** I see significantly more interest from foreign buyers across all three U.S. consumer sectors. We've started to see significantly more interest in retail, particularly luxury retail. There was a very high-profile auction process this year for Barneys, and there were two foreign businesses that were interested. It was fascinating, given that it concerned an iconic luxury brand in the United States and the two final bidders were both from overseas.

As governments have generated income and are looking to put their money to work, they've taken a very interesting approach, particularly in the Middle East, toward using that money almost in a private equity sort of way to invest in the United States. They've opened up to a combination of infrastructure investments and consumer investments. These consumer investments, one could argue, are trophy products for them, similar to what the Japanese were doing in real estate in the 1980s. So we've seen a lot of foreign interest, and I expect that to continue, especially for anything priced more than \$250 million.

**Behr:** I agree there will continue to be a lot of foreign investment interest in the United States as a place for growth and as a place that perhaps understands more aggressive business tactics. The United States is also a favored safe harbor for cash. I do wonder whether we will see a negative impact once, as is inevitable, the dollar recovers from its rather exhausting freefall, from something like 85 cents for a euro to a \$1.53, as of the date of this conversation. So I would add that, as a caveat, I continue to see borders becoming less consequential; if there's a good deal available, people will take a plane or just pick up the phone and exercise their privilege to strike while the iron is hot.

**Bakutes:** I agree, we're seeing significantly more interest from foreign buyers in terms of M&A activity in the United States. We see it in the consumer business sector, but really we see it across various industries, primarily due to declining market valuations and less competition from private equity investors who are not able to actively pursue the same types of deals completed over the last couple of years due to changes in the credit markets. As Alan indicated, the fall of the U.S. dollar has given rise to a lot of interest from foreign buyers. I expect that to continue in 2008.

### **Could you each give a brief recap of the trends you expect to shape consumer business M&A in the next 12 months?**

**Alley:** I think the theme of 2008, and hopefully just 2008, is a blah M&A market for consumer business. In general, I expect consumer business M&A to be down over 2007. The theme of 2008 will be distressed M&A and turnarounds—sort of a hangover from some of the transactions that got done between 2004 and 2007, when there was too much leverage or too high a price paid. This will be the year of the workout. There will be a lot of nontraditional M&A activity and restructuring in this general space, especially in retail.

**Behr:** I would support that. It will likely be a challenging market for the foreseeable future, and there will be an increase in deals resulting from distress situations. That being said, the process never moves in a straight line, and inevitably, the next turn comes. At that point, I think we'll see a resurgence in brand-awareness-based consumer M&A deals, as the public refocuses its branding interests. That can either concern brands at the source level, from goods supplied to retailers, or brands that are retailers themselves. Increasingly, retailers have become more powerful. Those with the most raw power in revenue are likely to be retailers who are their own design and manufacturing sources, such as Gap. That will very likely continue even after this period is ridden out.

**Bakutes:** I think 2008, as previously indicated, will be a slow year for M&A activity in general, and consumer business probably won't be any different. It is possible that some of the very highly leveraged deals that got done over the last few years could certainly run into problems going into 2008. As a result, we could see distressed situations. Some companies are sitting on the sidelines waiting for opportunities to acquire particular brands that they might not have been able to acquire previously because of high valuations. Therefore, I think it's going to be more of a wait-and-see-type situation as things move forward in the markets. It's difficult to predict an outcome, but I don't think it's going to be a robust M&A market by any means.

# Market Uncertainty Sets the Stage for Financial Services M&A

*Our experts discuss the trends shaping the financial services deal landscape, including how many organizations are looking to preserve capital and reduce risk by selling noncore businesses.*

### **David E. Brown Jr.**

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more along the lines of regional banks buying each other. But that will depend upon reaching an agreement on price. We're also going to see more deals like Banco Popular selling its U.S. consumer finance business to AIG. Some organizations will need to raise capital, and so rather than sell the entire institution, they will sell off pieces that are not core but may, for the right buyer, command a premium price, or at least free up capital. I'm not sure how that will affect deal volume, but we may see a different mix of deals.

**Susan Harrington:** I agree we'll probably see a different mix of deals, and that might be driven by a particular region or segment. I think there could always be a special situation where you would see another megadeal, but over the next 12 to 18 months, it's hard to say there will be many of those. Certainly any specific set of circumstances might still result in two large players coming together, even with the current conditions.

**Some of the largest deals in 2007 were in the financial services sector. Do you see that trend continuing in 2008?**

**Sam Das:** First, we really need to take a look at 2007, which was a mixed year for deals. The first half of the year benefited from the deal momentum coming out of 2006. At that time, there were some significant deals getting done in the financial services sector. Wachovia acquired A.G. Edwards and Bank of America acquired LaSalle from ABN AMRO. But as 2007 progressed, we saw several high-profile deals terminated due to the state of the market and credit deterioration. MGIC and Radian decided to terminate their deal, PHH terminated its pending deal with General Electric, and it's looking doubtful that the Sallie Mae transaction will ever be completed. In general, the M&A trend in financial services should remain fairly quiet. Current valuations in the market are not conducive for sellers looking for attractive pricing for the intrinsic value of their franchises, and buyers may be unwilling to pay large premiums, given further uncertainty.

**David Brown:** I agree. I think we'll continue to see some deals, as with Fifth Third Bank's acquisition of Citizens,

**Steve Butters:** As David mentioned, some of the deals we'll continue to see will be along the lines of Banco Popular's announcement and will involve companies getting out of areas that perhaps aren't in their core strengths, for both capital needs and risk reduction. We've also seen an increase in minority investments and PIPE-type transactions, which I would expect to see more of in 2008.

**Brown:** On the minority equity investing side, I would agree with that, although I think many banking organizations are coming to realize that a lot of the folks trolling for minority equity investments are, to a great extent, bottom fishing. So I am aware of lots of conversations surrounding minority equity investments, but the ones you see executed involve the truly desperate.

**Harrington:** I agree with David's comments for U.S. transactions, but I have a different take for non-U.S. situations. Outside the United States, toehold investors may not strictly be bottom fishing, but rather acquiring a public stake to facilitate negotiations with management in hopes of transforming the arrangement into a change-of-control investment.



**What do you think about Bank of America's acquisition of Countrywide, and how will it affect the financial services M&A landscape in 2008? Do you anticipate more deals in the form of rescues, and will larger financial institutions see this as an opportunity to expand geographically?**

**Harrington:** In the current environment it's really hard to say, especially with the events that took place last year. There are many more write-offs to come. So over the next 12 months or so, it's anybody's guess as to who will be left as a strong player once the dust settles. I'm not sure what the Bank of America transaction really says to the state of the overall market. There was news earlier this year of a potential government bailout for some of the bond insurers, for example. But the current environment is in too much of a state of flux to draw any sort of conclusions about trends at this point.

**Brown:** I want to pick up on one point Susan mentioned, and that is the impact of downgrade pressure on the bond insurers. I think to the extent we see more bond insurers downgraded, notwithstanding the capital they've raised through minority equity investments, something clearly must happen, because the bond insurers represent one of those systemic risks that will lead to calls for the Fed to intervene, even though the bond insurers only tangentially touch what the Fed ostensibly has jurisdiction over. I can see potential rescue activity in the bond insurer area, but I don't think any of us know how bad that's going to get or what those rescues might look like. In the meantime, there will be a cascade effect throughout the rest of the financial services industry because bond insurer downgrades affect the market value of everyone's holdings.

**Das:** I'm really not convinced there are many rescue deals on the horizon. I think the exceptions are like the Bank of America/Countrywide deal, where there is a prior vested interest in the company and the buyer is looking to protect that investment, or, as was mentioned, pure opportunistic plays and parties looking for cheap valuations and getting a toehold. An example would be what Citadel Investment Group did with E-Trade. Citadel put in \$2.5 billion and

got E-Trade's entire asset-backed securities portfolio. Deals such as Bank of America/Countrywide are unlikely to be the norm going forward. There is a lot of integration risk involved there, and BofA is looking to extract sizable cost savings. On the flip side, it also reinforces the push for more asset deals so larger organizations can streamline their core assets and divest properties that really don't make sense to hold onto going forward. This will, in turn, free up cash to shore up their balance sheets.

**Butters:** The market turmoil is certainly not over. Financial services companies will most likely be returning to their core operations, and I don't think we have seen the last of distressed deals that will present some opportunities for companies that have the capacity to add acquisitions later in the year.

**With tough conditions in the credit markets and ongoing woes in the housing sector, how are the drivers behind deals changing?**

**Das:** Larger organizations will look for opportunities for earnings growth, especially as the rest of their operations stagnate. However, they may not be willing to pay substantial amounts for it. Regional and niche players, especially the ones that are more capital constrained, will be the more likely candidates to seek out partners to help weather the downturn. But in general, capital management is going to be critical for the broad spectrum of financial services companies. Balance sheet stress will test everyone's resolve, and the lack of a stable secondary market will force many firms to take further substantial losses. I doubt we've seen the full extent of the fallout due to this downturn. Once there is more market clarity, perhaps in a couple of months to a year, we'll see things turn around.

**Harrington:** This credit market turmoil is going to have a chilling effect on those institutions that have been affected the most—the ones we've all read about, and the ones yet to be announced. So with these serial acquirers, I think we're going to see far fewer deals in the short term. It's likely we'll see more of the same as far as the bottom fishers coming in and putting money into very large

financial services companies. But until it all shakes out, it's hard to say where we're going to end up. I think it will be more of what we've seen the last few months.

**Brown:** I agree. I think capital preservation, whether it be obtaining new capital or preserving existing capital, will be the main driver of most transactions.

**Butters:** In addition to the need to preserve capital, we are seeing companies evaluating noncore operations, not only in terms of risk management, but also in terms of cost of capital and expense control. These considerations could generate consolidation-type transactions in certain sectors.

### How do things bode as far as the balance of power between buyers and sellers?

**Das:** It's clearly a buyer's market. Valuations are depressed across the board. Those who have the excess capital can really put it to work. Generally speaking, buyers are going to look to conserve cash and focus on those acquisitions with the best value propositions. The decline in the market has significantly limited buying power right now. Stock can be a very expensive currency given lower valuations, leaving cash as the primary source of funds. But as many of these larger organizations look to deploy their cash, they're only going to do so opportunistically with an eye on managing downside risk.

**Brown:** I agree. The other trend that occurred during 2007 was a considerable amount of litigation involving classic deal protection terms. There were more decisions in 2007 on material adverse change or adverse effect than we've seen in years. There was also a lot of litigation over specific performance and bust-up fees and other sorts of deal protections that lawyers have argued about for years, but during the go-go days, few deals actually involved a dispute over those terms. Whatever sellers and buyers may have learned this past year about how to negotiate those a little more tightly or a little more loosely, depending upon your perspective, it's economic leverage that will still determine how those deal terms shake out in particular merger and acquisition agreements. For instance, if you were to take a look at the Countrywide merger agreement with Bank of America, you would not see any particular fanciness or necessarily aggressive negotiation on either side. It is the classic stock-for-stock merger agreement we have seen for decades now. I think that is reflective of the fact that the agreement needed to be negotiated quickly, as well as a reflection of Bank of America's leverage. And I think you'll see that replicated in many more deals this year.

**Harrington:** There are different dynamics when you're talking about the current market and the lack of liquidity and required capital. Some of the financial institutions

experiencing liquidity issues and/or regulatory capital shortfalls may not be able to negotiate good deals or finance them on the buy side, and in their quest for capital, or as sellers of noncore businesses, they probably aren't in the best negotiating position. Cash is king right now, so those with cash are the ones calling the shots.

**Butters:** I think over the next several months we're going to see more distress situations than strategic-building efforts driving transactions. But as we move into the latter half of the year and into early 2009, before the market really begins to settle down, I also think we'll see an increase in the size and volume of deals being done.

**Brown:** Speaking of the latter part of the year, I'm especially interested in the impact of the implementation in 2009 of FAS 141R, which, among other things, will require expensing of deal fees and closing date valuation, rather than agreement date valuation. Basically this means that for anything that's not all cash, the value can fluctuate, which may be less attractive to buyers. I anticipate we'll see less deal activity in the fourth quarter of 2008 for deals that might close during the first quarter of 2009 than we otherwise would, assuming the market recovers. Overall, I suspect we will see a very quiet November and December in terms of new deals getting signed.

### Is this a favorable market for foreign interests to scope out U.S. financial services companies?

**Butters:** Yes, it appears that some of the European players are becoming more active, given the continued strength of the euro and relative health of the European markets vis-à-vis the U.S. markets, and I think European investments will increase. We've all read about sovereign wealth fund investments, although it remains to be seen if or how much those are going to expand. Asian players are also looking toward the United States, and it is quite likely we could see increased activity in that direction as well.

**Das:** To follow up on that, many of the Japanese banks have indicated they're willing to help out Wall Street firms. Much of the interest will depend on how long favorable exchange rates persist, coupled with their minimal preexisting U.S. exposure. That should prove to be a significant advantage over a lot of domestic investors going forward.

**Brown:** Classically, large foreign financial institutions, and this has definitely been true under the Basel II capital framework, have an advantage in deploying capital over domestic competitors in the quest to acquire U.S. companies. So you can see them being able to justify higher valuations because they have to utilize less capital to make acquisitions. That advantage, together with foreign exchange rates, makes this a pretty attractive

market for foreign investors, assuming they can get comfortable and catch the falling knife everyone else worries about trying to catch.

**Harrington:** Picking up on all that has been said, I think there's a lot of talk right now, but I question how many transactions will actually get done until some of this uncertainty in the market shakes out. I think there's a lot of interest from foreign buyers, but it will most likely be a while before we see a large volume of transactions close, assuming the dollar stays weak relative to other currencies.

**In closing, what does the overall forecast for the financial services deal environment look like for 2008?**

**Das:** Deal activity will likely be slow for at least the first six months of 2008, if not the entire year. Given the continued uncertainty in the market and the overall slowdown in the economy, that trend is unlikely to change in the near term. With that said, buyers in the meantime will have much stronger negotiating ability at the deal table. They're going to need adequate time to assess price based on market volatility and adverse developments. The larger transactions, especially, will be scrutinized heavily by all constituencies, from the markets to regulators. You're going to see much longer times to completion for deals going forward, given increased diligence efforts that will be required to ensure buyers are getting what they're paying for.

**Harrington:** In the short term, we're likely to see a lot of divestiture activity for the large financial services companies that are going into distress mode right now. It's anybody's guess what's going to happen with the rest of the sector.

**Butters:** Picking up a little bit on the nature of transactions, consolidation is likely to continue, probably at a more measured pace, and I think the degree of caution, level of diligence, and regulatory oversight are likely to lengthen transaction periods more so than perhaps we've seen in the recent past.

**Brown:** Sam referred to extended diligence earlier and Steve just now referenced the extended regulatory review. I think we'll see both of these things, particularly where either buyers or sellers, leaving aside their investment portfolios, have historical entanglements of any great size with the mortgage industry, mostly subprime, but not exclusively subprime. So if a buyer or seller is wrapped up in state attorney general investigations or has expensive private litigation, such as the suits filed by certain cities against a number of mortgage lenders over accusations of redlining, those issues will require lots of diligence, and

also will provide a basis for community groups to hang up applications for a longer period of time than we have seen previously in this decade.

# Convergence, Changing Technology Drive TMT Deals

*Product innovation, convergence, and cost control are among the many factors driving activity in the TMT sector, where volume is expected to pick up in the latter part of 2008.*

## **Janine Brown**

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## **Asher Cohen**

*Vice President  
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## **Mike Huffman**

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**Asher Cohen:** My take on 2008, and I always like to look back first, begins with its relationship to 2007, which was definitely a very active year. I can speak more to telecom than the technology and media sectors, but in looking at the telecom side, it is worth noting that despite the amount of activity, there was a decline in the number of sizable transactions in 2007 versus 2006. Now, as to whether or not we're going to see any activity in telecom M&A in the year ahead, I'm sure we will. In just looking at deal flow so far in 2008, I don't see a big change in the drivers pushing board members and management on either the strategic or the financial side. They're still driven to do transactions, although there are more underlying fundamentals that will affect deal activity. If we look at wireless, we have seen a lot of consolidation since 2006, so just by the nature of how many players are left and how many potential transactions are out there, deal volume is expected to be down. Overall, telecom is an interesting sector and one that is very sensitive to changes in technology. There are still lots of reasons, both on the strategic and financial side, to do transactions.

Another way to slice it is in terms of high-leverage deals versus medium-to low-leverage deals. It's pretty obvious that the higher-leverage deals will be very challenging to come up with in 2008. Deals that need to be closed and obviously need to be priced in terms of the debt size are still out there, and you can see this just by the spread encompassing these deals, from Clear Channel to BCE. The market is not confident that these deals are going to get done. So overall, my take is that the telecom sector will still be active, but I don't see it as active as 2007.

## **Could you discuss some of the strategies driving deals in the TMT sector?**

**Huffman:** As mentioned previously, I think a major driver is convergence. Convergence is a topic we've talked about in the industry for years as a future vision, but I believe it is now becoming a reality. A classic example is the iPhone's phenomenal success. If you look at that one little device, does it fall within technology or telecom? With all that content, one could certainly argue that it falls within

## **What is your overall outlook as far as the M&A environment in the technology, media, and telecommunication sectors for 2008?**

**Mike Huffman:** I think 2008 will be a healthy year for M&A in the technology, media, and telecom sectors. While we won't necessarily hit any all-time highs, I do believe it will be a robust market, with various factors such as convergence continuing to fuel this trend. The blockbuster private equity deals that fueled much of the activity in the first half of 2007 pretty well vanished in the latter part of the year and will continue to stay very slow for the first half of 2008. But at some point, whether it's in the second half of the year, or a bit after, activity will pick up.

**Janine Brown:** As Mike noted, in the last six months of 2007, activity was certainly down. Heading into 2008, the questions become, "What does technology and advertising spending look like? Will there be a downturn and, if so, how will that affect M&A activity?" Like Mike, I think M&A activity in 2008 will continue to be robust, but I would be a little surprised if it exceeds 2007's activity. A couple of blockbuster deals could certainly pull it over the line. It may be, however, that we see an increase in smaller deals. So the volume may increase over 2007, but I question whether aggregate value will end up exceeding the 2007 level.



media. One could even argue that it falls within consumer business. So all of these different, and what were at one point disparate industries are converging. This is true across the spectrum. In almost all the companies out there, there is some form of convergence, and the adaptability and acceptance of the markets is accelerating this movement. There are many TMT companies that have stayed in one particular sector that now realize they have to participate in a much broader industry segment, but they don't have all the necessary technology, products, distribution networks, or content to do so. This has resulted in them looking at M&A to attain these.

**Brown:** There are potential divestitures in the media space, especially, that are essentially spinoffs or breakups of media conglomerates. There's a likelihood these will impact the overall market, and strategically, there's certainly concern about the value of the independent parts of these larger entities. I think the globalization strategy is a question for both domestic players looking abroad and global players in terms of what they might be looking for in the United States. Back to Mike's point, with regard to convergence, it seems that within mobile broadband, e-commerce and location-based services are likely to be drivers. And then overall, there is the question of enhancing technology efficiencies, and perhaps we've already seen those strategies at play in terms of some of the acquisitions that have been announced in 2008.

**Cohen:** The way I look at it is twofold: strategic transactions and financial transactions. From the strategic standpoint, our experience is that the deals are mostly driven by scale, particularly in telecom. There are obviously many upfront, fixed costs for most of the strategic-based operators and service providers. As companies grow, a larger portion of incremental revenues flow to the bottom line, so scale is key. Between 2001 and 2004 in the telecom arena, everyone was occupied fixing their balance sheets. Since then, they've refocused on fixing their business plans, and there were lots of shifts in terms of business plans and which customers that operation should target. This is what we've seen driving some of the deals we've witnessed already. In terms of standalone, if you're not one of the

market leaders, it's really difficult to stay on the same track, which has been causing most of these midsize to smaller operators either to buy and grow with acquisitions, or if they are not able to buy, to go out and try to sell themselves. That's what we've seen with many of our clients. They tried to do more acquisitions, and at some point they determined that it might be better to turn around and sell.

**Huffman:** To tag along with what both Janine and Asher have said, what is happening is an overall consolidation within many of these segments. Now, there's product innovation, evolving markets, and the convergence I mentioned, but there's also the cost-control factor. Many of these industries, even tech, are now considered mature industries, so to be more efficient and remain cost-effective, they are, in some cases, looking to combine with other companies. Another factor driving a reasonable amount of activity in 2008 is the weakness of the U.S. dollar compared to other major currencies. I wouldn't be surprised if foreign companies start looking at some U.S. assets as reasonably inexpensive, just based on exchange rates.

#### **What are some of the more noteworthy deals that occurred in the sector last year?**

**Huffman:** In the first two-thirds of 2007, there were a large number of significant take-private equity transactions, such as First Data, Avaya, Alliance Data, Alltel, BCE, and Clear Channel, just to name a few. Now, some have closed and some are pending. As Asher mentioned, if you take a look at the spreads between the offer prices and the current market prices, many investors are betting that some of these deals won't actually close. So again, while there were a number of large transactions in 2007, the volume of large private equity deals really set the tone in early 2007. While I believe the take-private activity will be slow in the first part of 2008, there are a lot of fundamentals relative to TMT companies that make these industries appealing to financial buyers. So when the debt markets settle out, I think the private equity investors will jump back into these industries.

**Brown:** Just in terms of deals, while Mike mentioned a number of private equity deals, on the strategic side there was Microsoft/aQuantive, Oracle/Hyperion, Cisco/WebEx, IBM/Cognos, and there were telecom deals, such as AT&T/Dobson, Deutsche Telekom/SunComWireless, and the Nokia/Navteq deal. This goes back to the earlier question of the strategies driving some of these deals, as well as to the issue of convergence, especially when looking at Microsoft's acquisition of aQuantive. Essentially you're looking at technology converging with ad networks and ad agencies. When one looks at some of the acquisitions that have already been announced this year, it appears we'll continue to see strategic buyers taking the lead, at least in the early part of 2008.

**Cohen:** As far as 2007, private equity was obviously the noteworthy player. The various pending transactions that are still out there such as Clear Channel, BCE, and Alltel are very significant. Telecom was something that private equity always shied away from, given the higher level of capex and the less leveragable types of assets. So I would say the noteworthy theme in terms of telecom deals for 2007 was really not specific transactions, but the emergence of private equity deals in telecom.

**M&A activity in the online media sector increased last year nearly 70% over 2006, driven by both B2B and consumer media transactions. Is this a trend that will continue in 2008?**

**Huffman:** Online media will perhaps be the hottest sector once again in 2008. The foundation is related to convergence, but what is interesting is how quickly this space is evolving. If you think about the devices, content, and mobility that existed just two or three years ago, and compare that to what exists today, it's wildly different, and it will be wildly different again in two or three years. It's no longer only the innovators who are using the Internet to buy things or to look at advertising. It's widespread and fully accepted. There's been a significant decline in traditional advertising and corresponding increases in online advertising as well as overall activity. All of that will continue to drive technology companies, including traditional ones like Microsoft, to be active in this space. Then there are companies such as Google that were born, bred, and thrive in this space and will continue to consolidate and add assets. And there are companies such as eBay that may acquire or divest some of their businesses, and Yahoo, which has been struggling and could very well do a blockbuster deal, either as an acquirer or perhaps even as a target. I think this space is ripe for continued M&A activity. *{Editor's Note: Microsoft's bid for Yahoo occurred weeks after this interview.}*

**Brown:** I agree with Mike. We're going to see an increase in online media deals for all the reasons he mentioned,

whether it's due to convergence or globalization, which also drives some of the activity in this area. In my mind at least, there is a bit of a wild card related to a slowdown in advertising spending. Even if that's the case, the shift from traditional media to online media is so strong, and if one thinks about the strategic buyers and players in this space, it would seem to nonetheless drive considerable M&A activity over the course of 2008.

**Cohen:** I don't have a lot to add, but I do have a couple of points to make. One is regarding social networks. In terms of Facebook, MySpace, and Classmates, we will continue to see deal activity. These obviously represent significant growth within this sector. Another development involves Netflix going into online downloads of movies. That will drive some activity in terms of the underlying technology and related companies, such as the studios.

**Moving over to focus on the software industry, early this year Oracle announced its intent to acquire BEA Systems for \$8.5 billion and Sun Microsystems announced it was going to acquire open-source database vendor MySQL for \$1 billion. Do you see deals like this continuing in the software sector?**

**Huffman:** I think they are a continuation of a trend. Those are two great examples. Oracle acquiring BEA is an example of consolidation in the ERP [enterprise resource planning] space. Companies want to get broader and deeper and have more of a presence and control. The Sun Microsystems transaction is just another example of the innovation we see in technology where a younger, much smaller company develops appealing products, and larger companies want to take advantage of that. So from both a consolidation and innovation standpoint, I think we'll continue to see software companies doing a lot of transactions.

**Brown:** One interesting thing to note about the Oracle/BEA deal is that had it taken place in 2007, it would have been one of the largest software deals. Some of the smaller companies may continue to feel pressure, depending on whether or not we really see a significant downturn in 2008, so some of the larger strategic players may really have an opportunity there. In looking at Sun Microsystems's acquisition of MySQL, it follows a pattern with JBoss being acquired by Red Hat in 2006, and then Yahoo acquiring Zimbra and Citrix Systems acquiring XenSource in 2007. These all harken to the theme of convergence and to the notion of why I think there is continued heightened activity in online media. Ultimately, it goes back to mobile broadband and the Web, in general.

**In closing, is the fear of recession having any impact, negative or positive, on the sector?**

**Huffman:** I believe that if we do have a recession it's not going to have much of an impact on M&A activity in the TMT space for a couple of reasons. Many transactions will be driven by bellwether companies—the IBMs, Oracles, Ciscos, and Googles of the world. These are companies with a lot of cash and stability, and they're going to be doing deals in the coming years. They might actually view a slight downturn as an opportunity and take advantage of some of the dislocation and uncertainty and be even more aggressive. The flip side is there could be a bit of uncertainty as companies evaluate timing, and they may think that if they hold off for three or four months, they can get better pricing. I don't believe a small downturn will deter the big guys because they have a vision of where they need to be in a couple of years, and they'll go for it unless a larger shock to the system happens.

**Brown:** I agree, and wonder whether a slowdown could actually drive more M&A activity as a growth strategy if organic growth slows, particularly since so many strategic players have been the ones making acquisitions in the TMT space. For the financial players, the credit crunch is not necessarily what's driving acquisition activity within the space. If a U.S. recession materializes, as we discussed earlier, it may actually encourage overseas buyers to make a play.

**Cohen:** In summary, I will reiterate what I said before. Deal volume will decline, but I don't think that's going to be due to a recession. I think that will be driven more by the credit environment and by virtue of having a smaller number of players in the sector. Those will be the main drivers for 2008. I don't see a recession as a factor in terms of how management or boards will make decisions related to deal activity. Although some of the general market is starting to flatten or even decline, select segments in the telecom arena have been experiencing stronger growth over the last few months.

# Steady Deal Flow Anticipated for Utilities and Energy

*High energy prices and strong cash flow, along with continued interest from foreign buyers due to a weakened dollar, have helped create a favorable deal environment.*

### **Steven J. Agresta**

Partner and Group Leader, Energy Practice Group  
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### **Jim Dillavou**

National Energy Industry Leader  
M&A Transaction Services  
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### **William Hardie**

Managing Director  
Houlihan Lokey

**William Hardie:** As far as power generation assets, we'll continue to see a fair amount of transaction activity. The capital market support for that sector has recovered from the disruptions of the summer of 2007, and people are relatively comfortable continuing to invest in the sector, so we should see some movement of assets there. Aggregators are achieving cost synergies by building out their portfolios. We expect to see those aggregators continue to take advantage of some of the regulated businesses that will extend their generation portfolios, as well as others on the financial ownership side who, having been involved on a three-, four-, five-year time horizon, are looking to liquidate their investments. On the oil and gas side, the commodity price environment is very helpful to the M&A business. The ability to buy assets at prices south of where the commodities are trading creates opportunity, and we expect to see that trend continue as well.

### **What is your general outlook regarding energy deals in the coming year?**

**Jim Dillavou:** I think activity will remain strong in the energy industry. Of course, all M&A transactions require leverage, and energy deals aren't immune to the current issues in the credit markets, which may put a damper on some activity. But for the most part, we continue to see a high level of interest and several buyers looking at and working on deals.

**Steven J. Agresta:** I agree. I'm most familiar with the utility sector, and I think the last year has shown that private deals not only can get done, but can get by state regulators. There have been a number of things in place to stimulate an uptick in utility deals for several years, but the failure of a couple of private deals a few years ago put a chill on the sector. Now that we've had two or three successful deals, I expect to see more going forward.

The biggest deals in the last year were TXU, Duquesne, and NorthWestern going private. Before that, there had been failures in Portland, Oregon, and in Arizona, which the private equity world learned from, particularly how to deal more effectively with state regulators. Thus, the next round of deals was approved. So I think, along with the other reasons stated, we'll see more transactions and consolidation.

### **Given that oil surged toward \$100 a barrel earlier this year and natural gas prices rose, how do high commodity prices affect deal activity, types of transactions, and the volume of M&A transactions in various subsectors?**

**Agresta:** I think the answer is subsector specific. There are subsectors, such as utilities, where high oil and gas prices won't have much effect except to the extent that oil prices would affect the overall economy. There are certainly other subsectors that are more directly tied to energy commodity prices where it would have a big effect on stock valuations, and therefore on currencies available for transactions.

**Dillavou:** I agree. If you look specifically at volume, the deals get more expensive in much of the industry. But pricing factors have also opened up the whole area of alternative energy. So between that and some of the related legislation, there is a lot of interest in those types of transactions. However, there's a limit to how many alternative energy assets are available in the United States, and some look more like start-up deals. I think high prices have certainly contributed to a strong overall environment in the energy industry, which has helped create a favorable environment for transactions and interest in the industry.



**Hardie:** The high commodity price environment will certainly impact the E&P sector. As I mentioned, the ability to buy assets at prices lower than what commodities are trading for creates a good dynamic for deal activity. This also bodes well for the oil field service sector, as people become comfortable that there will be a renewed effort at extracting reserves through secondary and tertiary recovery methods, which means the service companies should remain busy, thus M&A activity in the oil field services sector should be relatively robust as well. Then with respect to the commodity price impact on the generation sector, obviously high gas prices mean coal-fired and other dark-spread generating businesses will continue to do very well, which means their values will go up, and as a result, there will be M&A interest in those assets. That should also have an effect on people's interest in pursuing renewables. High commodity prices, from a political perspective, always get Washington interested in renewables, whether they be biofuels or wind or things of that nature, because of their effect on consumers and voters. So there should be some activity in the renewables area as well.

### What are some key drivers of M&A for utilities and energy companies?

**Agresta:** I'll take a shot at utilities, but first, a bit of background. Due to local monopolies, the utility industry never was allowed to figure out what its optimal scale was until about the mid-1990s when there was a wave of consolidations, and even those consolidations didn't get to the point where optimal scale became obvious to the players. Then there was a pullback from those consolidations due to the California energy crisis. So we've got this industry that historically was split up on the investor side into about 100 monopolies of various sizes trying to figure out what the optimal size is, both from a cost point of view and a regulatory risk point of view. On top of that, we now have a situation where the dollar is weak so there's a big incentive for non-U.S. companies to come in and buy. As I mentioned earlier, there also appears to be a trend of state regulators being cooperative. So I think all those things are likely to produce the higher deal rate we've discussed.

**Dillavou:** Part of what has allowed both private equity and foreign buyers to become active is legislation that's been in place for several years creating the Public Utility Holding Company Act (PUHCA), which has made it easier to get those deals done. While I think it's been shown that deals can happen, getting approval from state regulators still will not be easy. It will most likely require a specific situation, and potential buyers will have to pick those transactions carefully to find the right environment. But there is also a real prospect for consolidation in the industry and good reasons for it to happen. There's a need for substantial investment in new plants, particularly as we see increasing pressure to shelve older, more polluting plants, and investment in the infrastructure around transmission and distribution. So those factors should lead to a continued move toward consolidation. I don't think there will be a high level of activity, but rather, steady deal flow that will grow over time.

**Hardie:** With respect to the regulated utilities, obviously the most significant driver in their ability to pursue acquisitions is the regulatory environment in which they operate. Most states these days are still interested in reducing the cost of power, and continue to evaluate or implement the separation among generation, transmission, and distribution because they believe doing so will drive economies for the benefit of the consumer. So we haven't seen a lot of active utility buyers in the generation space, although there have been exceptions where there are assets that are particularly well positioned geographically for a certain utility, and an asset will come on the market that will serve its load needs quickly and easily at a value that is attractive relative to the alternative of building a new power plant or what can be achieved from the market. The utility buyer, in competition with the merchant buyer, is always at a disadvantage from a regulatory approval perspective, although utility buyers are at an advantage from a cost-of-capital perspective. So sellers must weigh all that when determining who the right buyer is. With respect to merchant energy companies, I think they will continue to be the buyers of choice and certainly the most successful buyers. Interest rates are likely to decrease during 2008 as a result of macroeconomic forces, which reduces

merchant energy buyers' cost of capital and means they can be more aggressive in pursuing assets to build out their portfolios. As I mentioned earlier, portfolio buyers are looking to add to their portfolios in geographic regions where they have assets to drive cost synergies, and we expect that trend to continue.

**Agresta:** I'll add as a footnote that my non-U.S. clients have shown up ready to shop but are completely unaware of the importance of state regulation in the United States. That issue has required them to climb a steep learning curve, and it is an impediment. They'll show up saying, "Well, PUHCA's gone, so we can do a deal, right?" And the answer is, "Well, maybe you can do a deal. Let's figure out which states you might be able to work with."

**Dillavou:** On the nonregulated side, we've discussed what prices have done and how that's created interest, but there are several other factors worth considering. Companies in the industry have had strong cash flows. They now have the cash they need to invest and are ready to spend it, so there's a strong level of interest among strategic buyers as well as from the outside, which I'd say is probably the strongest level of interest from private equity that we've seen. A number of industry-specific funds have continued to raise significant amounts of capital that is now available for investment, and even though some parts of the economy haven't looked that good, the energy industry is probably less at risk if the United States were to enter into a recession. Therefore I think we will continue to see a lot of activity taking place and a lot of interest in assets that come to market.

**Agresta:** With regard to the regulated side for non-U.S. buyers, U.S. asset prices look really cheap, and that's a big attraction.

**Dillavou:** We've also had the evolution of the master limited partnerships in the United States, which are tax-advantage vehicles that have garnered a lot of interest. They have ready access to cheap capital, so they continue to buy assets and shop heavily. They are truly in growth mode.

**As you know, one of last year's largest deals was Kohlberg Kravis Roberts' \$31 billion purchase of TXU. Do you anticipate that private equity dollars will continue to play a large role in 2008?**

**Agresta:** There are a lot of attractions in the utility sector for private equity, including the fact that the prospect of carbon regulation is going to be a big upside. It's difficult to crank that into valuations right now because we don't know what the carbon regulations are going to look like. That creates an opportunity to pick up assets that are not fully valued at this point. So my guess is the answer's going to be yes, there will be more private equity activity.

**Dillavou:** As I touched on previously, I do think there will be increased private equity involvement in the industry as a whole. When we talk about the KKR transaction as being utility-specific, there's certainly a level of interest. We don't really know how quickly that's going to pick up and how soon private equity will really be active and able to make those kinds of investments successfully. But certainly in the unregulated power subsector and throughout the rest of the energy industry we will see continued activity and a high level of interest. The large private equity players will continue to look at these kinds of deals and may be more focused on energy than they have been in the past, given the market conditions. And again, we have energy-specific private equity funds that are also actively looking.

**Hardie:** My instinct tells me equity players generally see the process KKR went through in its acquisition of TXU as being relatively difficult, and as a consequence, it's probably not high on the radar screen for most private equity buyers. The regulatory environment and the politics KKR had to put up with in that deal will continue to serve as a barrier to private equity being a real active participant in the utilities space. That said, if there are attractive assets or attractive utility businesses at values that make sense, then you would expect people to weigh the transactional friction of a utility deal against the potential returns, and there may be a situation where those returns will still make sense.

**Agresta:** I would suspect that the credit issues will have more of an effect on the giant deals than on the midsize deals. So it's unclear to me whether we'll see another \$30 billion TXU kind of deal in the next few months.

**Has the number of foreign buyers increased or is it anticipated to increase in the next few years? How about the reverse—are U.S. buyers interested in foreign markets?**

**Hardie:** I am a firm believer that both macro as well as industry-specific trends that exist will continue to attract foreign buyers. A weak dollar as well as the opportunity to invest in infrastructure assets here in the United States are two very positive dynamics that will draw the interest of foreign buyers. On the regulated side, we'll probably see some resistance to foreign buyers of regulated assets, but an opportunity will always exist for merchant generation to be attractive to foreign buyers without the political hurdles associated with a regulated asset.

**Dillavou:** I'd certainly agree with Steven's earlier comments about U.S. assets being relatively cheap. That, of course, may make international assets more expensive, although much of the energy market is a global market. Certainly given the nature of the market, there are a number of U.S. buyers that will be looking at international

projects because of their global reach, particularly in the service and exploration businesses where we will see a fair amount of international activity going offshore. We also have a kind of dichotomy. While there are some countries prone to geopolitical risk—making them less favorable for investment, there also are a number of economies that have become much more stable, thus providing new opportunities. So I think we will see increased activity from U.S. buyers as they look to expand into these regions.

### Could you give some specific examples?

**Dillavou:** Throughout parts of Asia and South America we've seen economies strengthen, and even in places like Mexico the economy has become much more stable, so it's a better investment climate for buyers as they consider going international. Then there are other economies, such as Venezuela's, that investors are avoiding, as the geopolitical environment has not been suitable for M&A.

**Agresta:** I certainly agree with Jim that currency valuation is only one factor; a big factor, but only one factor. It will attract certain kinds of buyers to the United States because our currency is relatively cheap, and it will inhibit others from going abroad, but it won't inhibit everyone because there are lots of other strategic reasons to place investments overseas in areas that are not shut down by expensive exchange rates.

### Could you describe the relative valuations within the major energy subsectors?

**Dillavou:** First of all, if we are talking utilities, because they're regulated operations, we've said the activity level is not going to be that high, so I would expect those valuations to remain fairly steady. And because regulated operations have a steady return, any drop in interest rates will have a positive impact on valuation. With respect to the E&P business, where we have high prices, we should continue to see a strong market, but I don't think prices will be that high or out of line in relation to the underlying commodity prices. Most buyers are not taking the view that prices will escalate significantly. In fact, they're discounting current levels when looking at valuations. Throughout the rest of the sector, particularly in the midstream areas and in the service sectors, business has been strong and valuations should hold up well. Again, the overall environment in the credit market will be a limiting factor in looking at valuations. Buyers will have to physically pay for acquisitions with more equity.

**Agresta:** It seems to me there's a potential for a shift in relative valuations once the United States has carbon regulation. It's almost certain we will have carbon regulation, but what's not certain is whether it will be effective and, therefore, whether it will change valuations

across the sector. But I think that's a big question mark sitting out there that we'll begin to understand the answer to in two to three years, though it will probably take another three to five years after that to see the full answer.

**Hardie:** Generally speaking, we've seen generation asset values trend higher over the last 12 to 18 months, and with the interest rate environment that's likely to exist over the next six to 12 months, I would expect that trend to continue. The commodity markets, to a large measure, control where people see oil and gas businesses trading, and thus where those M&A deals will get done. So I think that's really a function of where commodities move, and my guess is as good as anybody's. We've seen a lot of weakness in the valuations on ethanol businesses, as there has been a glut of those companies recently. I think that's a temporary thing. That market will sort itself out, find equilibrium, and then, because of the political environment, I expect continued upward movement once some stability in the market is achieved. The same is true for the rest of the renewables. They've continued to have strong valuations, aside from the ethanol businesses suffering recently, because of the overbuilding that's taking place.

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