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GIBSON, DUNN & CRUTCHER LLP's LEGAL INSIGHTS

Where Have All the Deals Gone?

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Merger and acquisition activity, already depressed in 2008, has only grown more so in the new year. The myriad array of proposed federal programs, incentives and regulations presently being debated has increased the uncertainty amongst business leaders throughout the country. This uncertainty appears poised to hobble the economy and continue to impair M&A activity well into 2009, or beyond. Nearly every publication that tracks M&A activity has reported significant decreases across most sectors and industries. *The Wall Street Journal* went as far as to say "M&A Went MIA and May Stay That Way," citing fear among business communities as the reason why 2008 fourth-quarter deal volume dropped 53% from a year earlier.

Many commentators have argued that collapsing asset values have revealed new opportunities and numerous M&A journals assure us that a significant amount of money remains on the sidelines, waiting for those opportunities to reveal themselves. Some experts estimate that there is approximately $1 trillion in private equity waiting to be invested. Additionally, there are many strategic players that have little or no long-term debt and substantial amounts of cash to put into acquisitions. So, where are the deals?

The answer is that there remain a number of barriers to a return to robust M&A activity. While the devastated credit markets are an obvious cause, there are several other contributing factors. Amongst these factors are the prospects for increased regulation, concern that market valuations may fall considerably further and the lack of foreseeable exits for financial buyers.

The culprit probably most often identified for the dramatic decrease in M&A activity is the frozen credit market. The prior model of deal-making during the height of M&A activity is not sustainable in the current environment as there is difficulty in obtaining even modest leverage for transactions. The ability to lever a balance sheet, without other significant positive attributes, is no longer sufficient to construct a deal. Unfortunately, the current government efforts to resuscitate financial institutions and their lending capacity is likely to have a limited impact as traditional bank loans represent less than half of all M&A lending, with hedge funds, mezzanine funds and others constituting the majority of lenders. Further complicating the issue is that these players are likely to be subject to stiff new regulations restricting, among other things, leverage ratios.

While it has received a disproportionate amount of attention, the lack of debt financing isn't the only issue disrupting M&A activity. The prospects for increased regulation have also dampened enthusiasm for transactions. There are numerous regulatory proposals circulating with respect to matters of taxation, antitrust, securities laws and the operation of hedge funds and private equity funds. While many of these proposals are well-intentioned responses to past regulatory lapses, the current uncertainty is having an undeniably adverse effect on M&A activity.

Another concern for investors that flows naturally from falling valuations is timing. While lower valuations are generally more attractive to a buyer, it is anyone's guess at present how far market values will fall and when we will see the bottom. Of course, no one wants to make an acquisition today, only to find out a few months from now that they have paid an untenable premium. As a result, there appear to be significant investment dollars waiting for the current market volatility to stabilize before making any investment decisions.

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Finally, the lack of available exits is also weighing heavily upon traditional market participants. The dual effect of depressed M&A activity and a non-existent IPO market means that there are no realistic exits for funds that are accustomed to reasonable time horizons on their investments.

Despite all of these obstacles and uncertainties, acquisition and consolidation during a down economy is a good way for strategic players to position themselves to outperform competitors now and in the future—for example, it is often an effective way to gain market share at a relatively low cost. Also, certain industries, such as the healthcare industry, have not been hit as hard by the recession, and therefore prices will likely stabilize more quickly. This may result in increased M&A activity in certain industries before other industries, which may act as an impetus to spur recovery in industries that have been hit harder. In short, there are some reasons for optimism amongst the current chaos.

As the new government policies and regulatory regimes are put into place, the uncertainty that has vexed the market will begin to dissipate and valuations should start to stabilize. Only then will we know if these policies will have a positive impact on the availability of financing and other factors that will lead to an increase in the level of M&A activity later this year and beyond.