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M&A | October 24, 2012 | CFO.com | US

Looming Fiscal Cliff Speeds Mergers

The potential expiration of the Bush tax cuts and the projected economic fallout from federal government tightening have business owners highly motivated to complete pending sales before the end of 2012.

Vincent Ryan

With capital gains and dividend tax rates set to rise in 2013 barring Congressional action, dealmakers are rushing to close merger and acquisition transactions by year-end. Acquirers, especially those in industries that are rapidly consolidating, say the impending changes to the tax code – the end of some business tax breaks and higher rates on capital gains and dividends – has lit a fire under business owners.

Owners of closely held businesses who would record a large individual gain from a sale, in particular, are eager to sell. And the threat to the U.S. economic outlook from the “fiscal cliff” is adding to the pressure.

“We’ve seen a tremendous pickup in volume over the last 45 days,” says Tom Aronson, head of origination at Monroe Capital, a private investment firm that provides senior and junior debt for middle-market merger transactions. “Year-end is always a target, and this year it’s even more because of the potential change in tax rates.” Aronson projects that, once all is said and done, Monroe’s fourth-quarter origination volume will rise 20% this year compared to 2011.

Closely held companies that sell now would face a lower capital gains rate than after January 1. At that point, the Bush tax cuts are set to expire and the capital gains rate for individuals rises to 20% from 15%. Dividend tax rates could also increase in 2013, from 15% to more than 40% for some high-income earners.

Accompanying the potential changes in tax rates are the automatic federal government spending cuts set to take effect in 2013 as part of the Budget Control Act of 2011. The Congressional Budget Office has said that the fiscal tightening could lead to recession-like economic conditions in 2013. It forecast a decline in real gross domestic product of 0.5% in calendar year 2013. In addition, if the fiscal cliff is not addressed, the U.S. unemployment rate will rise again, to 9%, in 2013’s second half, says the CBO.

The potential economic downturn is weighing on the minds of business sellers and buyers, according to executives who addressed the issue on earnings conference calls this week.

Restaurant firm Buffalo Wild Wings is in the process of acquiring nine franchisee-owned restaurants, according to Mary Twinem, the company's CFO. The company is working to close them by the end of 2012. "We feel confident [the deals] will get done before the end of the year, because [the sellers] are highly motivated with the fiscal cliff out there," Twinem said Tuesday.

The chief executive of Waste Connections, a solid waste collection and recycling company with $1.5 billion in sales, echoed the trend. Waste Connections closed five deals last year and to date in 2012 has closed two, including the $1.3 billion purchase of R3 Treatment, a waste disposal company serving the oil and gas industry.

"We're seeing a number of sellers suddenly realize that December 31 comes after November and amazingly decide that, "Man, it's getting close – maybe we ought to be doing something," said Ronald Mittelstaedt, Waste Connections' chief executive. "We're seeing a lot of people sort of sprint for the gate at the end of the year."

But sellers may find they've waited too late, according to Mittelstaedt. "The other thing we're seeing is that [some sellers] have had a … decent deterioration in their business over the last 12 months, particularly if they have any exposure to commodities," he said. So even though Waste Connections has arrived at the "finish line" of a number of deals, he said, the company has "decided to adjust valuations downward for the reality of the current environment." That probably means several of its pending deals will get pushed back into 2013, said Mittelstaedt. "We don't really care what [companies] did, we care they're going to do," he added.

In industries in which the economy recovery has gone slowly, sellers may still be holding out, hoping to post better financial results before committing to a deal price. Airgas, a $5 billion-revenue publicly held distributor of industrial, medical, and specialty gases, says a lot of its target acquisitions (it currently has seven under a letter of intent) are still fighting their way back from the recession with sales volumes below the levels of 2009. They are therefore hesitant to pull the trigger on a deal.

"These companies that are selling are still a long way from getting back to even," Peter Mccausland, Airgas' founder, said on an earnings call Tuesday. "This recession has impacted smaller customers, which are the mainstay of a lot of these acquisitions," he said. "So even though we're going over a fiscal cliff … it's not enough to drive people. … People are waiting to get back to even, and they aren't looking forward to taking the proceeds [from a sale] and putting them in the stock market either, I think."

While acquisitions in the negotiation phase may be accelerated, Monroe Capital's Aronson says M&A volumes in general have not picked up as the year closes. The flurry of activity will end in the next two to three weeks, Aronson says. "[We're] pretty much past the deadline to take a new business out into the marketplace," he says, "especially to have a change of control or sale occur from start to finish."