

Dealmaker

Providing business owners and managers with M&A market insight Vol. 3, No. 6 Summer 2008

Valuation: 2007 and first-quarter 2008 key trends and drivers

By **Jonathan Cooper and Erik Egerer**,
Grant Thornton Corporate Finance LLC senior associates

Valuation levels for mid-market companies increased slightly during 2007, but have stabilized or fallen slightly during the first quarter of 2008, according to Grant Thornton Corporate Finance LLC's (GTCF) annual and first-quarter analysis of mid-market valuation trends.

While the majority of announced transactions have limited financial information disclosed, the analysis reviews approximately 145 M&A transactions announced in 2007 with enterprise values up to \$200 million.

Approximately 30 such transactions for the first quarter of 2008, recent mid-market lending trends and public market trading statistics for small-cap public companies are also included in the survey.

Given the recent economic challenges in the U.S. market and continuing challenges to the global economy (e.g., oil and commodity prices), GTCF expects valuation levels to remain steady to slightly down over the next three to six months. Investor appetite for quality deals, however, has not diminished and is likely to increase in the near-term, allowing strong-performing companies to continue to command a premium.

Recent M&A market activity

GTCF reviewed mid-market transactions across the consumer, energy, health care, industrials, IT and materials industries.

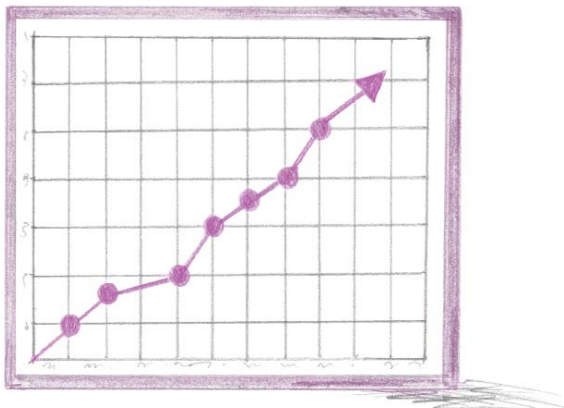
After reviewing the data, several trends appear. First, transaction multiples (enterprise value/earnings before interest, taxes, depreciation and amortization (EBITDA)) continued a generally upward trend across all sectors from 2006 to 2007. Looking at the data for the first quarter of 2008, however, the picture is a bit different. In certain sectors, such as consumer and energy, transaction multiples declined from both 2007 levels and compared with the first quarter of 2007. >



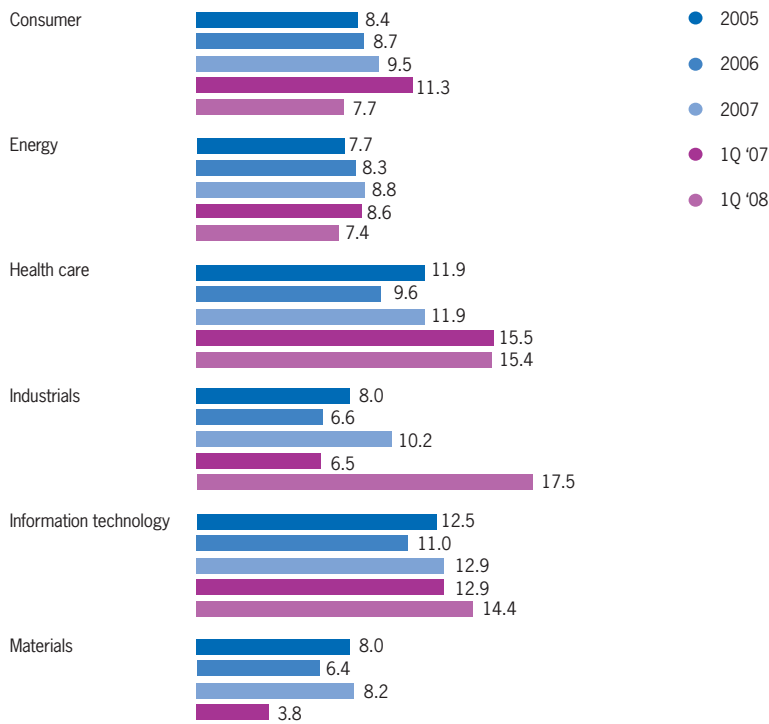
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Historical EBITDA multiples Source: Capital IQ



Recent and continuing coverage of health care in the United States media reveals the central role of this industry in the national psyche. Increasing demand, as well as surging prices for medical procedures and products, continues to attract investors to M&A opportunities in this sector.

On the other hand, the health care and IT industries enjoyed increasing transaction multiples. Such variations are not uncommon, particularly in challenging economic periods. In the industrial segment, only four transactions from the first quarter of 2008 were available for analysis, which skewed the data.

Declining multiples in the consumer market are not surprising given the reduction in discretionary spending and consumer confidence. The decrease in energy sector multiples is a surprise, however, particularly given the surging price of oil. This decrease may be the result of particularly strong earnings in recent periods combined with investor concern over the ability to continue to generate such strong revenue and earnings growth over the next several years.

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Technology multiples have increased as well, led by a number of highly strategic acquisitions with strong potential for synergies.

Mid-market lending

Certain portions of the credit markets have changed dramatically following widely publicized defaults in certain debt instruments, the failure and subsequent sale of one of Wall Street’s most venerable investment banks, and the meltdown of the mortgage market. In the large deal arena, these events have dramatically affected M&A activity. Numerous in-process transactions were either derailed completely or significantly restructured and new transactions are subject to vastly different standards than just a few months ago. >

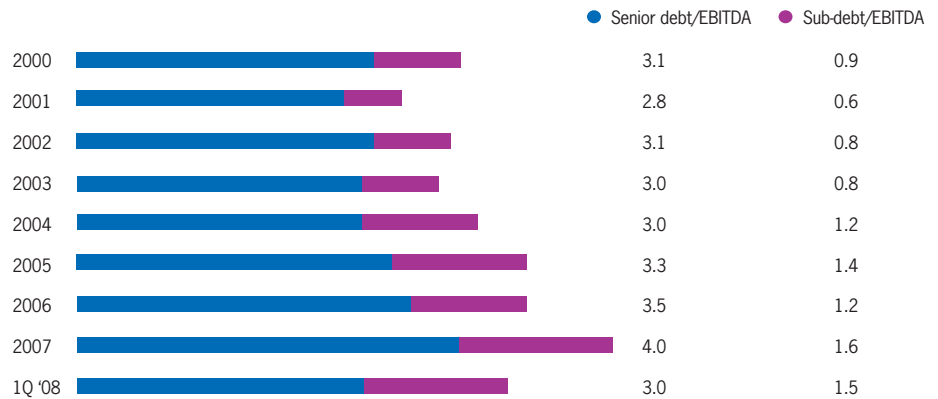
The mid-market, however, has been less affected by these challenges. Mid-market lenders initially reacted to the negative press and fears that Wall Street's troubles would cascade through the entire economy by pulling back on new loan activity, particularly on highly leveraged transactions. Lenders, however, quickly reentered the market, albeit with a slightly more conservative approach. Marginal deals (e.g., low profitability, sagging growth trends, etc.) have become more difficult to finance and are being completed at significantly reduced valuations, if at all. High-quality deals, however, have experienced continued interest and stable valuation levels, signaling that competition for the best deals often outweighs the impact of more conservative lending practices.

According to Standard and Poor's (S&P) M&A statistics, total debt/EBITDA dropped from a recent record of 5.6x in 2007 to 4.5x in the first quarter 2008 and senior debt/EBITDA fell to just over 3.0x for highly leveraged transactions in the mid-market. The first quarter also revealed a significant increase in average equity contributions by private equity firms: up to 39 percent, on average, compared to 30 percent throughout 2007. Private equity's willingness to invest additional equity to complete transactions is due to a record amount of capital that needs to be invested and has helped buoy transaction values.

Public market performance

S&P's SmallCap 600 Index includes 600 companies with market capitalizations as low as \$300 million. While above the analysis' \$200 million threshold, the index provides some insight as to the relative market valuation trends for smaller companies. Notably, over the past year, the SmallCap index typically has traded below the S&P 500 index, which consists primarily of large, well-known companies. Over the past several months, the discount has become more pronounced, suggesting investors view small-cap stocks as riskier investments in a tough economy.

S&P M&A statistics, total debt/EBITDA



S&P's SmallCap 600 Index



Conclusion

Valuation levels look to be stabilizing to slightly falling, although the affect varies by sector. The key factors appear to be the quality of the business itself, growth prospects, profitability, market position and perceived ability to weather an economic downturn. Size is also a factor. As the U.S. economic condition shifts, valuation levels are likely to move in concert with those changes, albeit at a reduced degree in the mid-market.

Plenty of capital is still available for transactions, from both strategic and financial buyers, and investors continue to pay premiums for highly attractive acquisitions. That being said, conservatism in the debt markets is tending to return valuation levels to their historic norms. •

M&A market update

By Jonathan Cooper and Erik Egerer,
Grant Thornton Corporate Finance LLC senior associates

North American M&A activity began slowing in the latter half of 2007 and has continued to slide through the first quarter of 2008. Activity could be poised to increase, however, with the prospect of overseas investors buying U.S. companies.

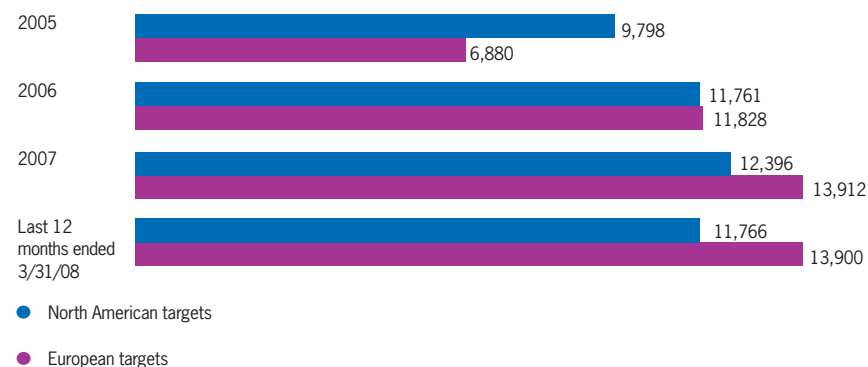
Through Dec. 31, 2007, the total number of announced M&A transactions with North American targets increased to 12,396, according to Capital IQ. These volumes reflect a 5 percent increase over deal activity in 2006. However, for the 12 months ended March 31, 2008, transaction volume with North American targets fell to 11,766. This trend is likely to reverse, at least in terms of deal volume, as European and Asian investors take advantage of strong currencies to purchase U.S. assets.

Private equity buyers

The U.S. private equity market continued its frantic pace of fundraising through 2007. According to *Buyouts*, a publication covering the private-equity market, U.S.-based buyout firms raised a record \$276 billion in 2007, up from the former record of \$226 billion raised in 2006. In addition, fundraising kept a relatively steady pace throughout 2007, at roughly \$70 billion a quarter.

Flush with cash, many private equity funds are increasing their percentage contribution to leveraged buyouts, thereby stabilizing prices somewhat despite a challenging credit market.

Announced M&A transactions (in volume)



Strategic buyers

Corporate buyers have remained active in the M&A market and have been less affected by changes to the lending environment than financial buyers. Even headline-grabbing events have had only a slight effect on these buyers, with the exception of very large transactions.

The primary shift in the strategic buyer market is an increase in due-diligence activity prior to closing transactions. With some expected corporate synergies not materializing, corporate buyers have stepped up due-diligence efforts, often hiring third-party advisors to conduct in-depth financial and, sometimes, operational diligence.

Summary

While the pace of M&A activity slowed in the first quarter, we expect an increase over the coming months, particularly among overseas investors buying U.S. companies. If the economy continues to struggle, however, any increases in M&A activity from overseas buyers might be offset by reduced activity by U.S. buyers. •

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Next 12 months: A window of opportunity for business sellers?



Stephen McGee
Grant Thornton Corporate Finance LLC
executive director

Despite recent turbulence in the credit and public equity markets, several factors create favorable conditions for business sellers in the middle market. Corporate Finance Executive Director Stephen McGee spoke with Ronan P. O'Brien, a corporate partner and M&A lawyer in the Boston Office of national law firm Seyfarth Shaw LLP, about potential market opportunities in the next six to 12 months.

McGee: As an M&A lawyer, you must get a lot of questions from clients regarding the election and proposed changes to the capital gains tax rate. Is this a real risk business owners should factor in to their decision to sell?

O'Brien: It is worthy of consideration. The capital gains rate of 15 percent was scheduled to expire at the end of 2008. With an extension from Congress, the 20 percent rate will be restored on Dec. 31, 2010. But, Congress could revisit it in early 2009, depending on the political environment and results of the presidential election.

As always, the tax tail should not wag the deal dog. However, during a period of declining EBITDA multiples, selling your business during the 15 percent tax era means avoiding a 5 percent cut in your business' value.

McGee: There has been a lot of press over the last 12 months about threatened regulation and taxation of the private equity industry. How do you see that playing out and will it have an impact on the M&A market for middle-market business owners?

O'Brien: While the likely targets of regulation would be leveraged buyout shops that wield \$15 billion funds, it is likely to affect other private equity firms that play a critical role in the success of the middle market.

Ultimately, it is difficult, if not impossible, to predict whether there will be regulation of the private equity industry and, if so, the potential effects of such regulation on business sellers. This uncertainty becomes particularly relevant if private equity firms emerge as the primary suitors for your business.

McGee: Several clients have recently asked about special purpose acquisition companies (SPACs). It seems like they have been around for a while, so what's driving the sudden increase in interest? >

During a period of declining EBITDA multiples, selling your business during the 15 percent tax era means avoiding a 5 percent cut in your business' value.

O'Brien: SPACs raise money from the public market for the purpose of executing on a plan to acquire an existing operating business. Typically, the SPAC's management team boasts significant deal experience in the particular industry the SPAC is targeting. If the SPAC fails to complete an acquisition in 18 to 24 months (depending on its corporate charter), then it returns the net offering proceeds to its investors and dissolves.

Recently, Goldman Sachs underwrote its first IPO for a SPAC, a symbolic breakthrough for the industry. While SPAC IPOs have steadily gotten larger, they rarely raise more than \$150 million and are squarely focused in the middle market.

According to my colleague, Mark Katzoff, who specializes in SPACs, as of March 2008, approximately 155 SPACs have completed IPOs since the beginning of 2004, and numerous others have filed registration statements. Of these 155 SPACs, only 46 have consummated a business combination, while 25 other companies have announced that they have entered into definitive agreements or letters of intent with respect to potential acquisitions, but have not yet consummated such transactions, and another 10 will be or have been liquidated. Accordingly, there are approximately 74 SPACs with about \$13.6 billion in trust and potentially an additional 61 SPACs with about \$13 billion in trust that have filed registration statements and are seeking, or will be seeking, to complete acquisitions. Because each SPAC only has a limited time period to complete a deal, one could have an interesting (and lucrative) impact on your sale process.

McGee: Over the last 10 years we have seen consistent and robust interest in our deals from foreign buyers. Many people seem to think that the dollar's decline is driving increased cross-border M&A activity, but we haven't seen a marked increase over our normal levels. Have you seen any pickup in cross-border M&A?

O'Brien: Due in large part to the weakness of the U.S. dollar relative to other currencies, especially the euro, pound sterling and Canadian dollar, many observers believe that foreign acquirers will increase their pursuit of U.S. targets. Standard & Poor's reports that European and Canadian businesses still represent the lion's share of foreign M&A activity as their acquisitions constitute more than 70 percent of the value of all deals in 2007. Other experts, however, indicate that there is no currency arbitrage in the U.S. dollar in acquiring a business that makes sales in U.S. dollars. Nonetheless, for non-U.S. strategic acquirers seeking a U.S. footprint, the conditions are favorable. •

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Grant Thornton Corporate Finance news

Recent deals

DisplayWorks and Marketcraft

Grant Thornton Corporate Finance LLC acted as exclusive financial advisor to MICE Group Plc on the divestiture of its subsidiaries, DisplayWorks and Marketcraft, to JPB Enterprises Inc., a Columbia, Md.-based private equity firm. Brian Basil, Grant Thornton Corporate Finance LLC director, led the transaction team.

DisplayWorks specializes in trade show design and fabrication capabilities as well as corporate branding services. “DisplayWorks is excited to join JPBE and introduce our products and services to new audiences around the world,” said DisplayWorks CEO Herb Hite.

Marketcraft, specializes in the innovative design of physical environments to communicate and build integrated brand platforms.

Commenting on the closing, Senior Vice President for the Commercial Interiors business Claudia Gerster said, “We are pleased to become a part of such an innovative and creative company like JPBE. We knew they were the right partner for Marketcraft because of their ability to continue to invest in the business and provide the strongest platform for our employees and future growth.”

NuSoft Solutions Inc.

Grant Thornton Corporate Finance LLC acted as exclusive financial advisor to NuSoft Solutions, one of the leading Microsoft consulting firms headquartered in the Midwest, specializing in enterprise business and technology solutions, to RCM Technologies Inc. Jack DiFranco, national leader of Grant Thornton Corporate Finance LLC, lead the engagement.

Commenting on the closing, NuSoft Solutions CEO Dale Mansour said, “We have assembled a talented and motivated team, acquired blue-chip customers and built strong partnerships. By joining RCM, we gain strong leadership, vast experience, rapid scalability and national delivery. Moreover, we are delighted to join RCM because of our mutual technological and cultural synergies. NuSoft was founded on the premise of earning our customers’ business every day, and such premise is favorably aligned with RCM’s customer-centric business approach.”



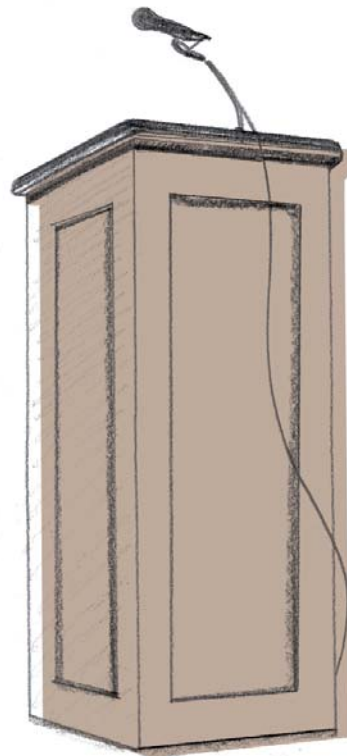
New professionals

Grant Thornton Corporate Finance LLC announces the expansion of its team with the addition of the following professionals:

- **Jack DiFranco**, principal. Jack is the national leader of Grant Thornton Corporate Finance LLC and brings more than 18 years of investment banking experience to the firm. Prior to joining Grant Thornton Corporate Finance, Jack was a founder and managing director of the investment banking group at Stout Risius Ross Inc.
- **Brian Basil**, director. Brian has 11 years of investment banking experience, advising companies in health care, business services, automotive, aerospace and defense, IT, distribution, business process outsourcing, plastics, financial services, and industrial components companies. Prior to joining Grant Thornton Corporate Finance, Brian was a director with the investment banking group at Stout Risius Ross Inc.
- **Erik Egerer**, senior associate. Erik has completed transactions across numerous industries, including media and entertainment, automotive, distribution, food and beverage and health care. Prior to joining Grant Thornton Corporate Finance, Erik was a senior associate with Stout Risius Ross and a senior analyst with Brown, Gibbons, Lang & Co.
- **Len Batsevitsky**, senior associate. Len has had experience executing transactions in the business services, consumer and industrial, and real estate industries. Prior to joining Grant Thornton Corporate Finance, Len was a senior associate with Roseview Capital Partners and a vice president with Sovereign Bank.

Speaking engagement, conference sponsorship

1. Stephen McGee, executive director, spoke at the World Financial Symposium event, M&A Strategies for Software and Internet Companies, held in Boston on May 15, 2008.
2. Grant Thornton Corporate Finance is sponsoring The Entrepreneurship Institute's President's Forum on October 2. The event will be held at Forefront Center for Meetings & Conferences in Waltham, Mass.



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About Grant Thornton Corporate Finance
Grant Thornton Corporate Finance provides boutique investment banking services to privately held middle-market businesses in the United States and around the world. As a recognized advisor on middle-market mergers and acquisitions, we offer a range of investment banking services including sell-side advisory, buy-side advisory, management buyouts, restructurings and capital raising. Grant Thornton LLP provides investment banking services through its wholly owned broker-dealer subsidiary Grant Thornton Corporate Finance LLC, member FINRA, SIPC.

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