The McLean Group
INVESTMENT BANKING

M&A Market Update©

Your source for information about today's mergers & acquisitions market April 2008

Inside This Issue

About Us

The McLean Group is a national, middle market investment bank serving businesses generating up to $500 million in annual revenues. For more information, visit www.mcleanllc.com.

Feature Article:

Recurring Revenue Adds Value To Your Business

By Joe Golden, Managing Director

Investment bankers often are asked what attributes of a business create the most value. In other words, what do buyers covet most highly? Is it key management people? Proprietary products? Consistent cash flow? Recurring revenue? Business reputation and longevity? Market leadership?

There is a long list of key value drivers and virtually every deal is different. Market timing can impact companies in cyclical industries dramatically and the manner in which you sell also will dictate value.

Because beauty (enterprise value) is in the eye of the beholder (the buyer), it is difficult to predict what buyers will covet most about your business. I want you to think about your business. Can you implement tactics discussed herein to enhance the perceived value of your business?

While there are many exceptions, as a general rule, consistent or consistently increasing revenue and cash flow often is a business' most important attribute. A customer base with a subset of recurring revenue increases the probability that an enterprise will have consistent revenues and cash flow. From the buyer's perspective, this reduces

Continued on p. 3

Expert Tips:
Severe Storm Warnings: Five ways to go wrong with key employees when selling a middle market business

By Dennis Roberts

Many business owners will be in for a significant shock when the day to sell comes and they find that key employees and management are suddenly not on their side after years of apparent loyalty. I have referred to this in the past as "strange, if predictable behaviors around large sums of money."

1. **Fail to arrange to retain key personnel to a point sometime after the sale.** To the extent that employees have major influence either with customers, suppliers or other key staff, employees can be a serious threat to realizing maximum value when a business is sold. Buyers will usually, under these conditions of major influence, require that they have assurance that key management will stay. If there are no mechanisms in place to assure that well before a sale, your negotiation position with the key employees in the face of large dollars will likely be very difficult.

2. **Fail to have non-intervention agreements with them.** One appropriate and time honored way to circumvent possibly damaging influence over employees or customers is to have non-intervention agreements that prevent key employees who leave from destroying the business' value, possibly to the extent of making it unsalable.

3. **Fail to have stay bonuses, timing them improperly, or overpaying them.** While stay bonuses are another time honored way of insuring that a key employee will stay, these need to be considered carefully. Make sure the bonus is constructed and timed so that it is a sufficient inducement to stay and is not paid out until the stay period expires. The payment of a large bonus immediately after a sale may in fact encourage an employee to retire immediately, generating exactly the opposite of the intended effect which was to cause him to stay.

4. **Fail to document promises that may have been made earlier or making vague promises.** It may seem excruciatingly unjust when a key employee or junior partner brings up a casual conversation from a holiday party three years ago when you promised that you "would take care of him, if and when the company was sold," especially when he brings it up with a totally different view of what is required to "take care of him" where his agreement is critical to the sale. Seems farfetched? Don't bank on it. Most mergers and acquisitions (M&A) professionals have seen this on numerous occasions. Be specific with any promises and put them in writing immediately. They are far less likely to haunt you later.

5. **Act like an absentee owner for several years without taking the right precautions.** The bad results here are so common as to be almost the rule. Absentee owners who rely on key management to run their business can almost be assured that upon a sale of the business, the key management will feel entitled to ask for a bigger share than the owner may feel they are entitled to. Key management frequently will feel that the success of the business has been all about them. The problem is that owners, in the absence of well documented agreements designed to induce key management to stay, or at least to protect sensitive customer and other key staff relationships, may find themselves in very weak negotiating positions. Some might call it blackmail, but it is a fact of life. ◆

"Recurring Revenue..." continued from p. 1

future risk and therefore enhances perceived value. Historically, telephone companies and other utilities have had the best recurring revenue models. But unless you can do business alongside these companies (i.e. selling telephone equipment), you will be operating in a highly regulated industry with major barriers to entry.

There are, however, many other opportunities for recurring revenues, including:

- Accounting firms that provide annual tax return preparation and audits
- Security firms that monitor home and commercial businesses on a monthly basis
- Heating, ventilating and air conditioning (HVAC) companies that perform semi-annual routine maintenance of equipment
- Software companies that provide annual user support and software upgrades for a maintenance fee

Real estate leasing is perhaps the best recurring revenue model because it provides for both repeating revenues and an underlying asset that generally appreciates over time. But there are many additional examples of recurring revenues for middle market companies. Be creative in your own business. The benefits of recurring revenue are significant. The recurring revenue customer base you build for your company will:

- Increase the probability that you will have stable revenues and cash flow
- Decrease future risk in the mind of a potential buyer
- Provide you with an opportunity to sell additional products or services to your existing customer base
- Keep you more attuned to your customers' needs while helping you ward off competition
- Provide a buyer with the opportunity to cross-sell its products to your customers
- Provide a justification for a higher sales price of your business ◆

Questions about this topic? Contact Joe Golden at (703) 785-5525 or call The McLean Group at (703) 827-0200.

Trends To Act On:
Lower Middle Market Captures Large Share of M&A Deal Volume

By Geoffry A. Nattans

To locate the abundance of current mergers and acquisitions (M&A) deal flow, bewildered Wall Streeters need only look down. The lower middle market – involving transactions with enterprise values of $50 million to $200 million – quietly has captured the lion's share of M&A activity in 2007/2008. Mergerstat reports that the lower middle market represented more than 38 percent of disclosed M&A transactions for the 12 months to March 2008. Furthermore, data from Thomson Financial finds that 3,706 out of 4,134 (90 percent) US middle market deals in 2007 were valued at less than $100 million, with another 824 valued between $100 million and $499 million.

Recent lower middle market deal flow has been attributed to several factors. First, an increasing number of baby boomers are approaching retirement and looking to sell their businesses. A recent PricewaterhouseCoopers (PwC) survey of family-owned businesses concluded that 25 percent of respondents expect their businesses to change hands within five years, with nearly half of them going to

Continued on p. 4

"Lower Middle Market Captures..." continued from p. 3

non-family acquirers. Second, a weakening US dollar has created excellent financial and strategic opportunities for savvy foreign buyers to capture tremendous value during an apparent economic downturn. Accordingly, Mergerstat reports that US companies accounted for 68 percent of the world's cross-border deals for the trailing 12 months to March 2008.

Although the outlook appears bright for the lower middle market, significantly increased deal flow has been accompanied by more laborious due diligence processes. Potential acquirers have grown increasingly wary of "skeletons in the closet" in regard to their prospective acquisitions. As acquirers' risk tolerance has diminished, sellers and their advisors have been forced to remain particularly alert throughout sell-side transaction life cycles to any issue that could kill a deal. In any event, as the state of the US economy threatens to creep downward, M&A activities in the lower middle market certainly are looking up. ◆

Exit Planning:
Selling Your Business To Insiders

By Enrique Brito, CFA, AVA, CM&A

Some business owners do not have children to transfer their business to, or their children do not have any interest in running the business. In these situations, owners may consider selling their businesses to employees. One option is to sell the business by means of an Employee Stock Ownership Program (ESOP). An ESOP is a trust set up by the company to buy the owner's stock, thus creating a market for otherwise non-marketable securities. By paying cash or having money deducted from their paychecks, full-time employees can then buy shares of stock in the company.

Keep in mind, however, that ESOPs are tax-qualified employee benefit plans and therefore are subject to various government restrictions and regulations. Hence, you should seek expert counsel before implementing this type of strategy. Other options available when selling to insiders are a management buyout (MBO), a qualified retirement plan or a deferred compensation program. The complication in selling to insiders is that they often lack the capital to complete the deal. As a result, financing must be obtained either from the business' cash flow or from outside sources of capital. For the latter, third party advisors are often critical in supporting the management team. ◆

About The McLean Group

The McLean Group is a national, middle market investment bank providing mergers & acquisitions (M&A), capital formation, market intelligence, business valuation, litigation support and exit planning services. The McLean Group serves businesses generating up to $500 million in annual revenues. Headquartered in Washington, DC's technology, communications and government contracting corridor, the firm is among the largest independent middle market investment banks in the region. The McLean Group is a FINRA Registered Broker/Dealer and Member FINRA/SIPC.

- **M&A:** The McLean Group uses its considerable expertise in a wide variety of industries to identify the most probable and suitable candidates in order to complete transactions under the most favorable terms for its clients.
- **Capital Formation:** The McLean Group arranges private equity, venture capital, senior debt and subordinated debt in amounts ranging from $5 million to $250 million to support clients' expansion, mergers & acquisitions, refinancing, recapitalization, leveraged buyout and shareholder liquidity objectives.
- **Market Intelligence:** By leveraging superior competitive analyses, McLean, Markowitz & McNaughton provides business executives with comprehensive market intelligence reports, which give the market insight and analytical expertise required to reduce risk and uncertainty in strategic decision making.
- **Business Valuation:** As a core competency and complement to its M&A business, The McLean Group provides business valuation services, including intangible asset and financial security valuations for a variety of transactions, financial reporting and tax purposes.
- **Litigation Support:** From quantifying economic damages to valuing a minority interest in a business, the firm has the business valuation experience and credentials to support cases involving a variety of legal issues.
- **Exit Planning Services:** Based on its extensive experience advising owners of middle market businesses, The McLean Group has developed a proprietary process that analyzes more than 60 value/risk drivers that can have a significant impact on the value of a business.

Office Locations:

Washington, DC (Headquarters)
Atlanta, GA
Austin, TX
Baltimore, MD
Baton Rouge, LA
Boston, MA
Bozeman, MT
Charlotte, NC
Cheyenne, WY
Chicago, IL
Cleveland, OH
Dallas, TX
Los Angeles, CA
Miami, FL
Orlando, FL
Phoenix, AZ
Reno, NV
Sacramento, CA
San Diego, CA
Silicon Valley, CA
St. Louis, MO
Tulsa, OK
Wooster, OH

Contact Us:

The McLean Group
1660 International Drive
Suite 450
McLean, VA 22102

(703) 827-0200 phone
(703) 827-0175 fax
www.mcleanllc.com