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INVESTMENT BANKING

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The McLean Group is a national investment bank serving middle market businesses. For more information, visit www.mcleanllc.com.

Feature Article:
What To Do in This Economy: Acquire, Grow Organically, or Just Hold On?

By Greg Boucher, Managing Director, Baltimore, MD

Wall Street is up—but what's happening on Main Street? Is it a good time to acquire? Should you look at selling? Should businesses wait and see what happens? Or is this a good time to implement an organic growth plan? These questions are particularly important as they apply to middle market companies.

In today's market, while some industry valuations are ratcheting up, many companies present excellent opportunities for would-be acquirers seeking to augment their companies' organic growth through acquisitions of one or more firms that fit acquirers' near- and long-term corporate strategies.

Industries experiencing depressed valuations offer excellent opportunities for well-prepared, well-positioned acquirers to buy competitors or complete vertical acquisitions at more favorable multiples than in recent years. For the past two years, the market has favored prospective

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Expert's Corner:
Myths about Middle Market Valuation Multiples

By Ron Stacey, Managing Director, Dallas, TX

Sometimes it seems as if the only requirements to become an investment banker are the ability to multiply two, usually single digit, numbers together, and write your name. Hence, upon finishing the second grade, everyone is qualified. For example, take an EBITDA (earnings before interest, taxes, depreciation and amortization) of $10 million and the median lower middle market valuation multiple of 5, multiply 10 times 5 and viola, the value is $50 million. However, determining valuation multiples actually is more intricate than 5 times 10 and bears asking, "What really drives multiples?"

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buyers with preferred terms and conditions. One critical caveat: cash, once again, is king, as it remains significantly more difficult to execute leveraged transactions now than it did before the worldwide financial meltdown. Meanwhile, earn-outs and other forms of deferred compensation have become the norm across today's M&A landscape if sellers are expected to garner full credit for future cash-flows' and/or contract backlogs' values as buyers remain skittish about what looms around the corner where our economy is concerned. When structured correctly, earn-outs or seller notes benefit both buyers and sellers by bridging the gap between higher seller valuation expectations and lower buyer risk.

Companies wishing to acquire other businesses should always conduct a strategic study on how to best leverage potential synergies and subsequently gain market growth. Given near-term market uncertainties, companies should allot necessary time to complete thorough analyses to ensure targets are suitable and the timing is right. Buyers also will need to budget into their integration and growth plans additional reserves that will allow them to withstand unforeseen consequences of potential short-term decreases in market demand. Before implementing an acquisition plan, would-be acquirers first should ensure that they have the bandwidth – advisors, staffing and the dry powder (cash reserves) – to close one or more prospective acquisitions.

Today's economy also presents very good opportunities for organic growth. Strategy consultant Josh Hurewitz, PhD, writes in his newsletter Key Business Issues for the Middle Market, that if the recession forces a company to, "…make significant changes to its approach to the market (getting new customers, new market channels or new products and services), then marketing should not necessarily be cut, and it might even need to be enhanced." Hurewitz adds that sales should not be cut if a dedicated selling effort is required to grow or maintain revenue. However, many companies cut both as a way to save costs without a critical look at how this fits their long term strategies.

Ratcheting up sales and marketing efforts in a down economy runs counter to what many companies' senior managements feel forced to do to preserve cash. However, there are many reasons not to cut, but rather redouble these efforts in market downturn. Companies that find they can compete effectively; that sales are to be had, and that they have capital to increase sales and/or marketing – should invest heavily in sales and marketing. Doing so while many of their competitors retreat, may prove an excellent strategy in a bad economy. Plus, buyers may find they have more leeway when negotiating with advertising vendors.

Three studies to note about investing in growth from past economic downturns:

McGraw-Hill Research analyzed 600 companies covering 16 different SIC industries from 1980 through 1985. The results showed that business-to-business firms that maintained or increased their advertising expenditures during the 1981-1982 recession averaged significantly higher sales growth. By 1985, sales of companies that were aggressive recession advertisers had risen 256% over those that didn't continue advertising!

In an analysis of the 1990-1991 recession, Penton Research Services and Coopers & Lybrand, in conjunction with Business Science International, found that advertising cuts during a recession decrease net income over the long haul. Companies that maintained advertising during the recession enjoyed measurably higher net income gains not only during the recession, but even more so two years after the recession, taking business away from their competitors in the process.

In a third study covering the 2008-2009 recession, Lee Frederiksen, PhD and Managing Partner at Hinge Marketing, conducted research compiled from the US' fastest-growing, privately-held companies. The study featured interviews with more than 100 US professional services companies' CEOs during one of the US' most severe downturns. The study's results found that companies that did not dial back advertising, marketing and growth spending during the recession continued to grow at 9X the average annual growth rate, and were 50% more profitable than their average counterparts. In fact, the highest growth firms were the biggest spenders, showing an average annual two-year growth rate of more 17.25% while spending more than 15% of revenues on marketing, sales and advertising. Meanwhile, the average growth firms grew at less than 10% annually while spending less than 5% of their annual revenues on marketing, advertising and sales.

Acquiring sales talent is another strategy to achieve growth. With many companies initiating hiring freezes or cutting back, the available talent pool has grown considerably in most industries. This has given employers better opportunities to hire highly qualified candidates who can hit the ground running. Good business developers already have established valuable relationships and contacts that should prove advantageous for their new employers from day one. Companies that ramp up their sales forces while their competitors are laying off talent may find that it's much easier to get in the door and close deals.

Companies whose senior management command clear strategies, reliable competitive intelligence and sufficient financial and managerial resources will find this an excellent time to make concerted efforts to react opportunistically, capturing market share at a discount. Both approaches to growth – either through business acquisition or organic customer acquisition – constitute smart strategies in down economies. Companies that pursue such strategies and execute them well should find that their efforts help them grow today while positioning them for success in an eventual market recovery.

Companies wishing to test the waters for a company sale, should first review the value drivers and the risk drivers, much like an acquirer would do (akin to a due diligence review), prior to placing their businesses on the market. Viewing the transaction through the buyers' eyes is the operative strategy. ◆

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EBITDA multiples provide a means to establish the economic value of an operating business by measuring the business' earnings stream without consideration to capital structure (before interest) or taxes (before taxes.) The distinction is similar to valuing financial assets, stocks and bonds, as a function of cash flow prior to investor leverage or taxes. An EBITDA multiple is a primary driver in M&A price negotiations where a skillful investment banker engages in price discovery among several bidders whose companies each have unique synergies, capital structures and tax attributes.

Multiples are rooted in the conceptual notion of a return on an investment. The return an investor, or buyer, requires for a specific investment is termed the cost of capital. The mathematical manifestations for cost of capital are capitalization rates and discount rates. Applying the cost of capital to the expected benefit stream determines the value of the asset.

Return on Invested Capital, Growth, Cost of Capital: True Multiple Drivers

Operating companies employ invested capital to generate a return. The capital is invested in operating assets, typically working capital and fixed assets that are financed with interest bearing debt and equity referred to as the invested capital. The return earned on this investment is the return on invested capital (ROIC) for the operating business.

Return on invested capital (ROIC) is a critical value driver (we contend the single most important factor for a given cost of capital) because businesses that produce more cash flow per dollar of investment (capital utilization) at the same risk level (cost of capital) are, well, worth more! Moreover, companies with a high ROIC have a lower reinvestment rate since less of the EBITDA needs be invested to support growth; hence more of the EBITDA is available for distribution. Known as the reinvestment rate, the math entails dividing the growth rate by the ROIC to find the percentage of EBITDA reinvested to support growth.

As the ROIC exceeds the cost of capital, the business creates value; and the faster it grows the more value it creates. A business with a ROIC that is less than the cost of capital diminishes value and the faster it grows the more its value diminishes. A business that creates value commands a higher multiple for a given cost of capital.

The below table incorporates ROIC, cost of capital and growth at a 20% (or 5x multiple) cost of capital under different growth and ROIC assumptions. As in the above examples, each scenario runs for 15 years and then defaults to a 3% long term growth rate thereafter.

Growth Rate	ROIC 10%	ROIC 20%	ROIC 30%	ROIC 40%
5%	3.4x	5.0x	5.5x	5.8x
10%	1.1x	5.0x	6.3x	6.9x
15%	-2.5x	5.0x	7.5x	8.8x

In the first column, the ROIC is less than the cost of capital. Increasing the growth simply decreases value and lowers the multiple even further to a theoretical -2.5. In this situation, the ROIC needs to improve before any attempts at growth are undertaken. We call this underperforming scenario the turnaround, and it rarely receives a multiple of 5, particularly if both the ROIC and growth need to be improved. This scenario is ideal for distressed investors and turnaround types.

In the second column the company is earning the cost of capital; the ROIC and cost of capital are the same at 20%. In this situation, a higher growth rate neither creates nor destroys value; it simply adds more zeros to the absolute numbers.

The real exciting columns are the third and forth columns where the value is driven by an expected ROIC greater than the cost of capital. Additionally, the more ROIC grows the faster value increases. These outcomes dramatically demonstrate the power of primary multiple drivers, ROIC and growth.

In an M&A context ROIC, growth and cost of capital are in the eye of the beholder, the specific buyer. All buyers are different, which is why sell side investment bankers engage in price discovery via an auction at the EBITDA level using multiples.

Summary

The magic 5 multiple is a point of departure for cost of capital typically applied to the purchase of a lower middle market business. As illustrated in this article, a transaction that occurs at a 5 multiple is one that is expected to earn the 20% cost of capital. The real drivers of multiples are ROIC and growth, but only if the ROIC exceeds the cost of capital. Multiples occurring in excess of 5 are for high ROIC, high growth business, and at less than 5 for turnarounds. ROIC is a function industry economics and sustainable competitive advantage; good execution can help but it's not enough on its own. Across the deal spectrum from small to large, larger companies command higher multiples because the risk and cost of capital are less. For the smaller companies the converse is true.

Our objective has been to shed light on the origins of that magic 5 multiple and hopefully we made some progress in that regard. We leave you with a quote from Warren Buffett: "People always want a formula—but it doesn't work that way. You have to estimate total cash generated from now to eternity, and discount it back to today. Yardsticks such as P/E's are not enough by themselves." ◆

International Outlook:
Where are the M&A Deals?

By Richard Wottrich, Senior Managing Director, International Desk

China has sustained 10% per annum growth for so long that we take it for granted. We do not stop to consider the factors driving this growth. Clearly, low cost labor has been the primary engine of this growth, but as its supply of rural labor dries up and as its population ages, China must move up the value chain to more sophisticated technologies and markets. Chinese companies gradually but surely are moving into M&A in world markets.

Datatracker Dealogic reports that public offerings by Chinese companies totaled $126 billion in 2010. The US, on the other hand, closed a mere $34 billion in IPO transactions in 2010, the second straight year China exceeded US IPO volume.

Chinese companies also closed 3,235 acquisitions in 2010 worth a collective $190 billion, accounting for 9% of all global transactions (ranking second to the US in this sector while the United Kingdom, with $162 billion in M&A transaction volume, finished third).

US venture funds are doing deals in China and India: 22 of the 61 venture-backed US IPOs during 2010 involved Chinese companies. As China and India continue to develop their own research and development centers, more Asian venture partners will launch IPOs and acquisitions and the "center of gravity" of M&A activity will begin shifting to Asia.

Three-quarters of the firms on the 2011 Forbes Midas list are backers of China startups and emerging companies. Ten of the 100 tech investors on the list have done deals or overseen their firms' China strategies — which shows where many of the industry leaders are focused today.

India figures on the Forbes Midas list with three venture capitalists who are regulars in India deal making: Vinod Khosla of Khosla Ventures (SKS Microfinance and), Peter Wagner and Sameer Gandhi. Grant Thornton reports 198 year 2010 India-outbound mergers and acquisitions (M&A) valued at $22.5 billion, compared with 2009's 82 deals worth $1.38 billion (with much of the difference accounted for by the global economic downturn).

Included among India's most highly respected companies are the Tata Group, Sun Pharmaceutical Industries Ltd., Air India, Jet Airways (India) Ltd. and TVS Motor Co. The highest-ranking senior executives of large Indian conglomerates included Ratan Tata, Mukesh Ambani and Kumar Mangalam Birla.

Dealogic reports that the volume of Asia-Pacific region M&A and other deals jumped 29% to $146.3 billion year-to-date as of March 25, 2011. India-targeted deals more than doubled to $18.5 billion.

With trillions of dollars in cash on their balance sheets, many of the world's largest companies will make significant acquisitions during 2011, leading some experts to predict that M&A transaction volume may exceed 2006's record volume.

Research recently conducted by Booz Allen suggests that M&A deals undertaken to add capabilities to the acquiring company were especially successful while those intended for diversification were more likely to fail.

Booz Allen Partner Booz Gerald Adolph observed, "It's no surprise that M&A strategies with a capabilities lens outperform others: in today's competitive marketplace, companies that have a winning set of capabilities create significantly more value than their peers—and M&A is one vehicle for making sure that you have the right capabilities and right portfolio that leverages what you're great at." ◆

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* headquarters office

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. Headquartered in Northern Virginia's technology, communications and government contracting corridor, the firm is among the largest independent middle market investment banks in the Washington, DC area. Securities transactions are cleared through The McLean Group's affiliate, McLean Securities LLC, a FINRA registered broker dealer and member SIPC.

- **M&A:** The McLean Group uses its considerable expertise in a wide variety of industries to identify the most probable and suitable candidates 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' expansions, mergers & acquisitions (M&A), refinancings, recapitalizations, leveraged buyouts and shareholder liquidity objectives.

- **Market Intelligence:** By leveraging superior competitive analyses, the firm provides business executives with comprehensive market intelligence reports, which provide 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.