WHITE PAPER

The Economic Environment for Middle Market Mergers & Acquisitions 2010 to 2012

Six Industries to Watch

By Douglas Rodgers, CEO, FOCUS LLC

FOCUS

Investment Banking

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Table of Contents

FOCUS LLC, a national investment banking firm providing merger, acquisition, divestiture and corporate finance services to middle market companies, presents its insights on the economic environment for middle market mergers and acquisitions (M&A) activity. Written by Douglas Rodgers, CEO of FOCUS, along with the collective feedback of FOCUS' 30 investment bankers, this white paper provides insights on the current state and two-year forecast of middle market M&A activity and addresses six industries to watch for growing transaction volume.

The State of Middle Market M&A Today

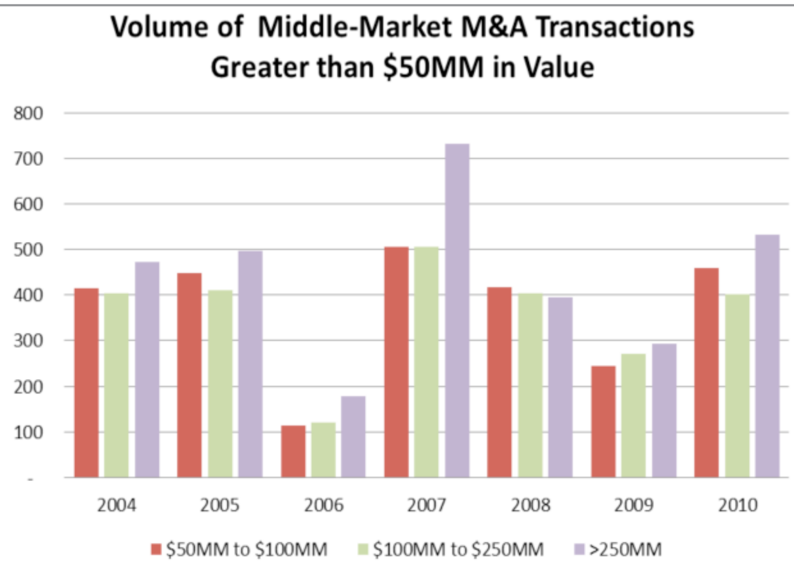
In 2010, global M&A activity increased for the first year since 2007. According to Mergermarket, the 2010 economic environment led to a worldwide increase in M&A transactions by 14 percent with the value of these transactions increasing 20 percent over 2009. For the same period, U.S. M&A transactions total value increased by 10 percent.

Additionally, Thomson Reuters reports that 2010 worldwide M&A volume was $2.23 trillion, which was 47 percent below the peak of $4.28 trillion in 2007. However, Thomson Reuters expects a robust 36 percent increase to $3.04 trillion in 2011. The 47 percent drop from peak to valley was largely a reflection of the decline in the number of transactions, but more so due to a dramatic decline in the number of large transactions during the period.

Factors Impacting Volume Fluctuation

In 2009, *Mergermarket* identified 11 private equity transactions in excess of $750 million, while that number jumped to 35 in 2010, indicative of the volatility in larger transactions. At the other end of the market, transactions under $500 million were much less volatile—staying in the range between 2,700 and 3,500 transactions annually for the 2004 to 2010 period. The 2010 results were impacted by the return of larger deals and the solid uptick in the middle market, as shown in the Chart 1 below.

Chart 1

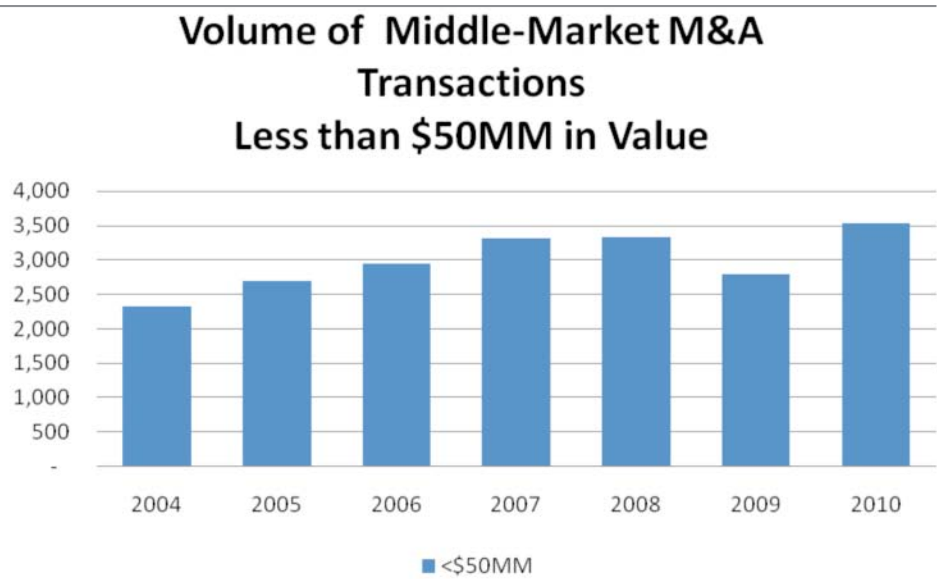


	2004	2005	2006	2007	2008	2009	2010
<$50MM	2,320	2,698	2,949	3,312	3,339	2,793	3,527
$50MM to $100MM	414	449	113	506	418	245	460
$100MM to $250MM	404	410	121	505	404	272	401
>250MM	472	496	178	732	395	294	533

At the lower end of the middle market (deals under $250 million), 2010 U.S. deal volume in 2010 was boosted by a number of factors. Below is a summary of what FOCUS believes are the largest contributing factors.

- Sellers who were motivated by the expected increase in capital gains rates at the end of 2010;
- Strategic buyers with the cash and confidence to make strategic acquisitions before the economic recovery was assured;
- Sellers in industries which were in favor (such as software and IT), who came to market as prices for good companies moved upward;
- Distressed sellers, particularly in real estate, construction, retail, and other out-of-favor industries, who were driven to an exit for lack of access to debt or strategic alternatives; and
- Private equity sellers, who saw an opportunity for exits at reasonable prices to position their firms for future fund raising efforts.

Chart 2



	2004	2005	2006	2007	2008	2009	2010
<$50MM	2,320	2,698	2,949	3,312	3,339	2,793	3,527

Middle Market Company Valuations

As Chart 2 illustrates, transaction volumes at the lowest end of the market (under $50 million) have remained much more stable than the larger deals shown in Chart 1. Valuations have followed the same direction as transaction count and deal volume, while valuations as a multiple of EBITDA, and as a multiple of revenue, have remained relatively stable, with the exception of 2009. Our macro interpretation of Charts 1, 2, and 3 is:

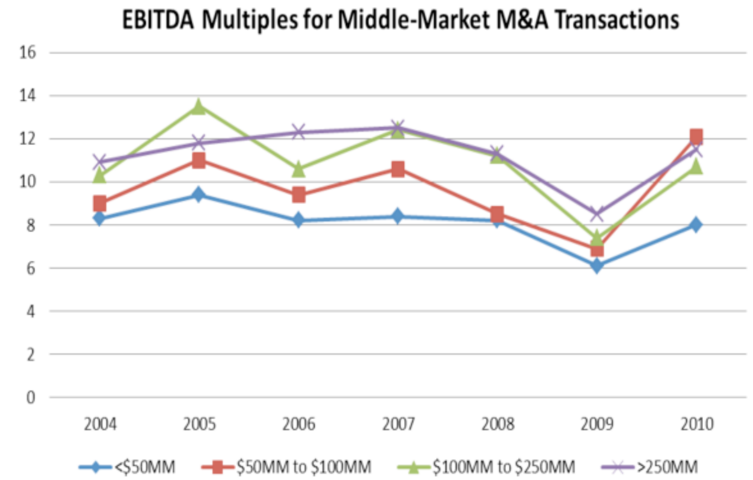
- Transaction volume for deals above $50 million fluctuate significantly from year to year, influenced by changes in confidence in the future, or fear of the unknown as the case may be.

- Transaction volumes for deals under $50 million stay in a much narrower band, as they are influenced by the life cycle of the business and its owners, to a greater extent than the larger deals.

- With the exception of watershed events such as the financial crises of 4Q08, and all of 2009, pricing multiples have remained fairly stable from year to year, even more so with smaller transactions.

- Pricing multiples consistently demonstrate that size matters, as the larger transactions deliver higher multiples, validating the concept of valuation creation by growth through acquisition.

Chart 3



	2004	2005	2006	2007	2008	2009	2010
<$50MM	8.3	9.4	8.2	8.39	8.2	6.1	8
$50MM to $100MM	9	11	9.4	10.6	8.5	6.9	12.1
$100MM to $250MM	10.3	13.5	10.6	12.4	11.2	7.4	10.7
>250MM	10.9	11.8	12.3	12.5	11.3	8.5	11.5

At FOCUS, we generally do not reveal the valuation metrics of our client's individual transactions; however, we track the metrics of all the transactions in which we are involved, and we publish the aggregate metrics as an indicator of valuation trends.

The comparison of revenue and EBITDA multiples from 2009 to 2010 shown in Chart 4 indicates the overall pricing for all of these transactions saw EBITDA multiples increase significantly—while revenue multiples remained unchanged on sell side transactions but declined 17 percent on buy side transactions. This would seem to indicate that the sellers represented by FOCUS experienced significantly higher transaction value for every dollar of cash flow when compared to 2009—while the buyers we represented paid significantly more for cash flow than in 2009 implying that fewer of these buy side transactions were distress sales.

Chart 4

FOCUS Transactions—2009–2010 Year Over Year Comparison						
	2009		2010		% Change	
	Revenue Multiple (Median)	EBITDA Multiple (Median)	Revenue Multiple (Median)	EBITDA Multiple (Median)	Revenue Multiple (Median)	EBITDA Multiple (Median)
Sell Side Transactions	1.00	7.1	1.00	10.2	0%	44%
Buy Side Transactions	0.60	2.1	0.50	5.1	-17%	143%
All M&A Transactions	0.70	6.6	0.65	7.5	-7%	14%

The Forecast for Middle Market M&A—2011-2012

Buyer And Seller Outlook

A survey of North American CEOs by Merrill DataSite on their expectations for 2011 revealed that 67 percent anticipate a significant increase in M&A activity, with 39 percent believing the activity in their industries would be driven by strategic expansion of core business, while 20 percent expect consolidation in their industries to be the key factor.

FOCUS expects the next two-year period to be impacted by specific types of buyers and sellers (listed in order of highest expected activity level):

Baby Boomer Sellers

There are an estimated 78 million Baby Boomers in the U.S., according to the Census Bureau, and this population segment will account for a large portion of the under $250 million transactions. As the Exit Planning Institute indicated, more than 8 million privately-held U.S. companies will be sold by Baby Boomers seeking retirement in the next five to ten years. Making up a quarter of the U.S. population, Baby Boomers will drive middle market M&A because they comprise the majority of current business owners—coupled with tax rates that are predicted to increase after the 2012 elections.

Selling Non-Core Business Units

As well as Baby Boomer sellers, we anticipate that large corporations will sell their non-core business units in order to concentrate management time and capital on core businesses. Additionally, corporations will expect to achieve a fair price for these non-core assets at this time in the market cycle.

Selling Portfolio Companies

In the next two years, Private Equity Groups (PEGs) are expected to sell portfolio companies. The high point in PEG fund raising was 2008, when 189 funds were formed raising $312 billion. Yet many of these funds are approaching their sunset dates, and need to sell successful portfolio companies, in order to post results to facilitate future fund raising.

Technology Company Liquidity

Only the largest technology/entrepreneurial companies (think Facebook and Twitter) are expected to do Initial Public Offerings (IPOs), while most prospects will choose liquidity via M&A—rather than the arduous, risky, and unpredictable IPO process. Entrepreneurs and their boards also have a growing reluctance to be involved in governing and managing a public company.

Active Buyer Categories

In addition, several specific categories of buyers will be quite active over the next two years, including (listed in order of highest expected activity level):

Large Corporations

Large corporations have accumulated a record amount of cash—according to the *Wall Street Journal*, nearly $2 trillion at the end of 2010—and must deploy cash to get an attractive return. The following types of large corporations will be active buyers in the near future:

- Large corporations that need to augment their organic growth to meet the market's expectations;
- Corporations large and small that are in consolidating industries, such as financial and business services or slow growth/no growth businesses; and
- Corporations large and small that choose to "buy it rather than build it" because their strategic plan requires IP, skill sets, capabilities, market access, and production capacity, which due to the costs involved or the time required, are easier to buy than build.

Private Equity Groups (PEGs)

Private Equity Groups should be increasingly aggressive buyers because of the massive fund raising before the recession, their inability to make many acquisitions when debt was scarce, and the improving availability of debt, which has generally been a required ingredient in their acquisition formulas.

Offshore Buyers

Offshore buyers are seeking acquisitions in developed markets, often to move up the value chain by gaining access to and or control of their distribution channels in the developed markets. FOCUS has significant firsthand experience with these buyers having represented buyers from Asia, primarily India, in the purchase of both U.S. and western European companies, including Glodyne Technoserve of India in its acquisition of DecisionOne, a Cerberus Capital company, in the third quarter of 2010, and Omnitech of India in its acquisition of Avensus of Belgium in the first quarter of 2011.

According to Thomson Reuters, deal volume in India surged three-fold to $67.2 billion in 2010—only slightly below the record $69.4 billion in activity in 2007. Access to cross-border transactions is facilitated by alliances between FOCUS and middle market investment banks covering 27 countries.

Six Industries to Watch for Transaction Volume

Information Technology

Recent technology deal activity has fueled the economy in the past year. Drawing on experience from the tech downturn a decade ago, the IT sector is faring far better than other industries today. Following the surge in life sciences and clean-tech growth over recent years, the National Venture Capital Association (NVCA) expects the IT sector will now attract the biggest investment increases in 2011.

Fueled by large technology companies buying up many attractive smaller tech companies, transaction volumes should increase significantly—with pricing expected to be strong. We anticipate an increase in IT M&A activity in the following high interest categories: cloud computing, SaaS, Internet commerce/group marketing (think Groupon), information security, data storage, IT infrastructure services, mobile applications, and social net working. Additionally, there is continued interest from the offshore buyers in acquiring customer base to leverage the labor cost arbitrage associated with their offshore infrastructure.

Government, Aerospace, and Defense

Government, aerospace, and defense transaction volumes should hold steady and trend slightly up, while we expect pricing to be steady to slightly down for government- and defense-oriented companies. Government and defense companies will feel the belt tightening in nearly all segments of their business, pushing the larger companies to consolidate smaller players. However, the gradual shrinking of the overall government and defense market pie will most likely create a mild downdraft on valuations, which will continue over time as companies adjust to the new normal in government spending.

Exceptions to the downward pressure on pricing in the federal government space will be cyber security, C4ISR (government speak for command, control, intelligence, surveillance, reconnaissance) and unmanned vehicles (also called autonomous vehicles) of all types, including aerial, subsea, surface maritime, and terrestrial. Acquirers looking for businesses serving civilian agencies are expected to have continued appetite for companies that service the healthcare agencies as well as Homeland Security.

Service providers to state and local government will also face revenue and margin pressure. Yet, the pressure may be so intense that state and local governments are forced to seek cost savings by outsourcing services to the private sector that are currently duplicated across many agencies. These outsourced services act as shared services centers across many state and local agencies, such as call centers, payment processing, IT services, and data centers, among others.

Aerospace is also expected to see strong activity as major programs, such as Boeings 787 and the F35 Joint Strike Fighter, ramp up production volumes, creating growth and M&A opportunities throughout their supply chains.

Healthcare and Life Sciences:

Over the past decade, biotech M&A activity resulted in a cumulative $295 billion in disclosed industry deals (DealSearchOnline). As the space matures, biotech is expected to trend up, while traditional healthcare services transactions may slow until the impact of The Patient Protection and Affordable Care Act (PPACA) becomes clearer.

Healthcare transaction volumes are expected to increase moderately—pricing steady to up moderately depending on the niche. The aging Baby Boomer population should positively impact healthcare M&A activity, particularly for products and services widely funded by Medicare and insurers, such as joint and spinal replacements and devices, home healthcare, and assisted living.

Energy and Energy Services:

The upward trend in commodity prices, particularly oil, should drive deal volume and pricing upward for energy and energy services. Although natural gas pricing in the $4 range remains weak, FOCUS anticipates continued strength in exploration for shale gas in the U.S. and gas pricing should remain weak, as the DOE states that the U.S. natural gas industry has discovered a 100 year supply in the last four years. However, as older coal fired electrical generating plants are shuttered and/or converted to natural gas, and new gas fired plants come on line, demand should increase eventually resulting in upward pricing pressure at some point in the future.

Shale gas exploration and offshore development are both large customers of oil and gas services companies, and therefore we expect increasing activity and pricing for both oil and gas service companies as well as oil and gas exploration and production companies.

Education and Human Capital Development:

The education market is a mixed bag as technology impacts winners and losers. Traditional textbook publishers and distributors may suffer as textbooks, paper-based learning aids and education records, and infrastructure go increasingly digital. This will drive consolidation with downward price pressure for companies that do not play leading roles in this paradigm shift.

Most of the innovation in the education and human capital development industry is coming from smaller companies that are developing and implementing new education technology and methods. As such, we expect this to drive M&A activity and pricing as the progressive/aggressive large traditional players acquire the innovators. Adult and for-profit education have been M&A hotbeds, but increased government scrutiny of efficacy, pricing, and financing may cloud the environment in this sector in the near term.

Telcom Technologies and Services:

Deal volume will be driven by a number of major telecom industry developments. The most notable of these is the emergence of wireless as the preferred delivery mechanism for data as well as voice communications, the networking requirements of hosted and cloud-based solutions, and the continued migration to all-IP networks that support the delivery of a wide variety of "Apps."

Software-centric technology providers, particularly those that support the delivery of new applications, should see significant M&A and capital raising activity. Data centers, metro fiber-based service providers, and hosted VoIP service providers are all expected to be active segments in the service provider sector.

For more information about FOCUS, please visit www.focusbankers.com.

FOCUS Investment Bankers

Mid-Atlantic Region—Washington, DC Office

Managing Directors:

David Freeland, Principal: david.freeland@focusbankers.com

Abe Garver, Principal: abe.garver@focusbankers.com

Marshall Graham, Founder and Non-Executive Chairman: graham@focusbankers.com

James W. Hawkins, PhD, Managing Director: jim.hawkins@focusbankers.com

Jeff Hooke, Managing Director: jeff.hooke@focusbankers.com

Eric Oganesoff, Managing Director: eric.oganesoff@focusbankers.com

Richard Pierce, Managing Director: rich.pierce@focusbankers.com

Fred Rock, Managing Director: fred.rock@focusbankers.com

Douglas E. Rodgers, Chief Executive Officer: doug.rodgers@focusbankers.com

Manan K. Shah, Partner and Government, Aerospace & Defense Team Leader: mshah@focusbankers.com

Rick Thomas, Managing Director and Education & Human Capital Development Team Leader: rick.thomas@focusbankers.com

Gerald Turner, Managing Director: gerald.turner@focusbankers.com

Southeast Region—Atlanta, GA Office

Managing Directors:
Bob Beard, Managing Director: bob.beard@focusbankers.com

James V. Millar, Managing Director and Healthcare & Life Sciences Team Leader: jim.millar@focusbankers.com

George M. Shea, Partner and Information Technology Team Leader: george.shea@focusbankers.com

John Slater, Partner and Capital Financial Team Leader: john.slater@focusbankers.com

Peter Vaky, Managing Director: peter.vaky@focusbankers.com

Jonathan Wilfong, Regional Managing Partner, Southeast and Energy Team Leader: jonathan.wilfong@focusbankers.com

Western Region—Los Angeles, CA Office

Managing Directors:
John Bradshaw, Partner: john.bradshaw@focusbankers.com

Brent Costello, Managing Director: brent.costello@focusbankers.com

Paul Richey, Managing Director: paul.richey@focusbankers.com

Robert Wagner, Managing Director: bob.wagner@focusbankers.com

About FOCUS LLC

FOCUS LLC provides a range of middle market investment banking services with an emphasis on mergers, acquisitions, divestitures and corporate finance. FOCUS is a national firm serving clients from offices in major cities across the United States. FOCUS specializes in business units with transactions or revenues in the $5-300 million range, serving entrepreneurs, corporate owners and various types of investors across a broad range of industries, throughout the U.S. and worldwide. FOCUS bankers are seasoned operating and financial executives with extensive transaction experience. Securities transactions conducted by FOCUS Securities LLC, an affiliated company, registered Broker/Dealer and member FINRA/SIPC. For more information on FOCUS, visit www.focusbankers.com.

FOCUS
Investment Banking

1133 20th Street, NW
Suite 200
Washington, DC 20036
202-785-9404
202-785-9413 fax
www.focusbankers.com